Proskauer

Wealth Management Update

January 2023

January 2023 AFRs and 7520 Rate

The January 2023 Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 4.6%, a decrease from the December 2022 rate of 5.2%. The January applicable federal rate ("AFR") for use with a sale to a defective grantor trust or intra-family loan with a note having a duration of:

- 3 years or less (the short-term rate, compounded annually) is 4.5%, down from 4.55% in December;
- 3 to 9 years (the mid-term rate, compounded annually) is 3.85%, down from 4.27% in December; and
- 9 years or more (the long-term rate, compounded annually) is 3.84%, down from 4.34% in December.

New York Estate Tax – 2023 Basic Exclusion Amount

The New York State Department of Taxation and Finance has announced that the basic exclusion amount for NY estate tax will increase to $6.58 million (currently $6.11 million), effective January 1, 2023.

Massachusetts Millionaires Tax

In the November midterm elections, Massachusetts voters approved the Fair Share Amendment to the Massachusetts Constitution, amending Article XLIV to impose a 4% surtax on a taxpayer's annual taxable income in excess of $1 million (adjusted for inflation), effective beginning January 1, 2023. The full text of the Fair Share Amendment is as follows:

"To provide the resources for quality public education and affordable public colleges and universities, and for the repair and maintenance of roads, bridges and public transportation, all revenues received in accordance with this paragraph shall be expended, subject to appropriation, only for these purposes. In addition to the taxes on income otherwise authorized under this Article, there shall be an additional tax of 4 percent on that portion of annual taxable income in excess of $1,000,000 (one million dollars) reported on any return related to those taxes. To ensure that this additional tax continues to apply only to the commonwealth's highest income taxpayers, this $1,000,000 (one million dollars) income level shall be adjusted annually to reflect any increases in the cost of living by the same method used for federal income tax brackets. This paragraph shall apply to all tax years beginning on or after January 1, 2023."

Alejandro J. Rojas et al. v. Commissioner, No. 7453-19, T.C. Memo. 2022-77 (July 18, 2022)

The Tax Court ruled that certain payments made by a Taxpayer to his former spouse pursuant to a divorce decree were nondeductible child support payments for Federal tax purposes, despite the fact that the California Superior Court with jurisdiction over the divorce had previously issued an order which expressly stated that such payments were *not* child support for state law purposes.

The payments at issue were described as "family support" under the Taxpayer's California divorce decree but were subject to a "child-related contingency", in that the Taxpayer's obligation to make such payments would terminate upon the emancipation of both his minor children. On the Taxpayer's 2016 Federal income tax return, he deducted these family support payments as alimony pursuant to I.R.C. 215. Although the IRS did not dispute that the family support payments here would otherwise meet the definitional requirements of alimony, the fact that such payments included a child-related contingency rendered them nondeductible child support payments under I.R.C. 71(c)(2)(A).

The existence of a separate spouse-related contingency here (specifically, that the family support payments would continue until the Taxpayer's former spouse remarried) did nothing to change this outcome, in light of the Tax Court's "well-established caselaw" providing that "section 71(c)(2)(A) is triggered by 'a contingency . . . relating to a child' without regard to the existence of other contingencies."

The Tax Court also rejected the Taxpayer's argument that the Full Faith and Credit Act (28 U.S.C. 1738, which generally provides that orders of state courts are afforded full faith and credit in Federal court proceedings) precluded the Tax Court from characterizing the family support payments as nondeductible child support payments because of the California Superior Court's prior order stating that "there is no current child support order". The Tax Court reasoned that the Full Faith and Credit Act was inapplicable here because: (a) the California Superior Court's prior order merely reflected that the payments at issue were not labeled as "child support" or "spousal support" under divorce decree, but rather as "family support" payments, which represent combined but unallocated child support and spousal support under California law; and (b) more fundamentally, because "federal law rather than state law governs the federal income tax treatment of such payments."

Finally, the Tax Court also rejected the Taxpayer's argument that it would be inequitable to treat the payments at issue as nondeductible child support, given that the California Superior Court previously denied the Taxpayer's request for a reduction of such payments on the ground that they were not child support payments subject to modification. On this issue, the Tax Court simply stated that it is *not* a court of equity, and that the Taxpayer was, in effect, petitioning the Tax Court to legislate from the bench.

Jennifer Joy Fields et al. v. Commissioner, No. 2925-20S, T.C. Summary Op. 2022-22 (November 10, 2022)

The Tax Court rejected a Taxpayer's argument that certain payments from her employer reflected gifts unrelated to work that were made in the context of the Taxpayer's personal relationship with the employer's CEO, rather than taxable compensation.

The relevant facts were as follows:

- The Taxpayer was employed by the employer from January 2009 to January 2017.

- The Taxpayer's text messages with the employer's CEO indicated that there was some personal relationship between the two outside of the workplace.
- On February 29, 2012, the employer wired $35,000 (CAD) to the Taxpayer.
- On March 20, 2014, the employer wired $53,020 (USD), an amount equal to the Taxpayer's downpayment on the new house she was then purchasing to the title company acting as escrow for such purchase.
- Upon the Taxpayer's severance from the employer in January 2017, the severance agreement signed by the Taxpayer and a representative of the employer indicated that the payments described above were employee advances which would be written off by the employer, thereby triggering cancellation of debt income to the Taxpayer that would be reflected in a Form 1099 issued by the employer.
- Soon thereafter, the Taxpayer purportedly entered an oral agreement with the employer's CEO to revise the terms of her severance agreement; this revised severance agreement was put in writing but never signed by the relevant parties. Under the terms of the revised agreement, the payments described above were characterized as personal loans from the employer to the Taxpayer that would be withheld from the Taxpayer's total severance package.
- The Taxpayer's 2017 income tax return did not include any amounts reported on the Form 1099-MISC issued by the employer in accordance with the original, signed severance agreement.
- The IRS issued a notice of deficiency with respect to the payments described above, which it characterized as unreported income to the Taxpayer.

The Tax Court sustained the notice of deficiency, noting that "[t]here is a strong presumption that payments made beyond an employee’s salary are compensation for services and not gifts." Although the Tax Court recognized the existence of an exception to this general rule, which provides that a "payment between an employer and an employee may be a gift when the relationship between the employer and the employee is personal and unrelated to work" (*see,* e.g., *Caglia v. Commissioner*, T.C. Memo. 1989-143; *Harrington v. Commissioner*, T.C. Memo. 1958-194), the Court reasoned that there was insufficient evidence to support applying this exception to the case at bar.

First, the only evidence of the Taxpayer's personal relationship with her employer's CEO here were "an email with [the CEO's] administrator scheduling dinner in 2017, a meeting scheduling email with Paragon stakeholders in 2019, and unverified text messages from petitioner to [the CEO]." Second, the Taxpayer's reliance on the revised draft severance agreement that she orally negotiated with the CEO (which provided that the payments at issue were personal loans being withheld from the Taxpayer's severance) was misplaced because the agreement was never signed, and even if it had been signed, it was still ambiguous with regard to whether the payments at issue were intended as gifts or compensation. "At best, [the revised draft severance agreement] reflects petitioner's attempt to recharacterize the payments as a gift, which apparently neither [the CEO] nor [the employer] agreed to."

Estate of William E. DeMuth, Jr. v. Commissioner, No. 18724-19, T.C. Memo. 2022-72 (July 12, 2022)

The Tax Court held that personal checks written by a Decedent before his death but not paid until after his death were properly includible in his gross estate. The relevant facts were as follows:

- On September 6, 2015, five days before his death, the Decedent wrote eleven checks, totaling $464,000.
- Only one of the eleven checks was actually paid by the Decedent's bank to the relevant payee's bank before the Decedent's death on September 11, 2015.
- Another three of the remaining ten checks were apparently deposited by the respective payees and credited to their accounts by the *depositary banks* (i.e., the payees' banks) before the Decedent's death. However, in its prior briefing, the IRS erroneously conceded that these three checks had been deposited by the payees and credited by the *drawee bank* (i.e., the Decedent's bank) prior to the Decedent's death.

As a starting point for its analysis, the Court stated that "the value of any check written by a decedent that still belongs to them at their death is includible in their gross estate; *however, the funds from such a check no longer belong to a decedent at their death if they executed a completed gift of the check during their life*." Accordingly, the Court focused its inquiry on the determination of when an inter vivos gift of a check is deemed complete under the state law of the Decedent's domicile, Pennsylvania. The Court found that Pennsylvania law provides, in effect, that the gift of a check is not complete until the time at which a stop-payment order can no longer be made by the donor, which in turn can be no earlier than the time "when the drawee bank accepts, certifies or makes final payment of the check."

Thus, the Court reasoned that *ten* of the eleven checks at issue here should have been includible in the Decedent's gross estate, because they were not paid by the Decedent's bank (the drawee bank) until after his death. However, the Court also determined that it would be prejudicial to the Taxpayer to allow the IRS to withdraw its prior erroneous concession (discussed above) that three of the remaining ten checks were deposited by the payees and credited by the drawee banks before the Decedent's death, an error which supposedly stemmed from the IRS's conflating the terms of art "drawee bank" and "depositary bank". Consequently, the Court held that only *seven* of those remaining ten checks were includible in the Decedent's gross estate.

***Betty Amos v. Commissioner*, No. 4331-18, T.C. Memo. 2022-109 (Nov. 10, 2022)**

The Tax Court held that a Taxpayer was not entitled to net operating loss (NOL) deductions claimed on her 2014 and 2015 Federal income tax returns where she failed to adequately substantiate that she had incurred such NOLs in the first place (purportedly in 1999 and 2000), or that such NOLs remained available for use in 2014 and 2015. This case serves as a cautionary reminder of the importance of recordkeeping obligations for tax professionals (including attorneys).

In essence, the Taxpayer here failed to maintain or produce adequate records to substantiate her entitlement to the NOL carryover deductions at issue, instead relying primarily on her prior tax returns and worksheets, as well as her own testimony. The Court explained that this type of evidence was insufficient to substantiate the deductions at issue; tax returns and the like merely prove that the Taxpayer claimed the deduction in prior years, not that she was entitled. Furthermore, although the Taxpayer did supply some scattered primary records (e.g., related entity tax returns, business ledgers and loan documents), she apparently did so without any context, explanation or computations that would enable an outside reviewer to understand how such records substantiated the deductions at issue. Although the Court acknowledged that it has the power to "estimate the amount of allowable deductions where there is evidence that deductible expenses were incurred," the Court declined to estimate the Taxpayer's allowable deductions in this case, given the "dearth of evidence" upon which to base any such estimate.

Furthermore, the Court sustained the accuracy-related penalty imposed by the IRS with respect to the Taxpayer's unsubstantiated NOL deductions, finding that the Taxpayer failed to prove she acted with reasonable cause and in good faith. In reaching this conclusion, the Court repeatedly emphasized the fact that the Taxpayer had been a licensed CPA and tax adviser for several decades before the events at issue in the case ("Ms. Amos is a longtime CPA who has worked for high-profile clients, owned her own accounting firm, and been involved with national and state CPA associations . . . . It beggars belief that she would be unaware that each tax year stands alone and that it was her responsibility to demonstrate her entitlement to the deductions she claimed.").

PLR 202247004

In this PLR, the IRS excused an inadvertent lapse in the Taxpayer's S corporation status caused by an amendment to the Taxpayer's operating agreement which failed to satisfy the requirement under I.R.C. 1361(b) that all outstanding shares of an S corporation must have identical rights to distribution and liquidation proceeds. The Taxpayer subsequently amended the relevant provision in the operating agreement in order to comply with the requirements of I.R.C. 1361(b), and the IRS concluded that the Taxpayer's lapse in compliance caused by the prior amendment was "inadvertent" within the meaning of I.R.C. 1362(f). Consequently, the IRS ruled that the Taxpayer's S corporation status was never terminated by reason of the prior non-conforming amendment.

Proposed Treasury Regulations – REG-106134-22, Syndicated Conservation Easement Transactions as Listed Transactions (Dec. 6, 2022)

These proposed regulations categorize "syndicated conservation easement transactions" as "listed transactions" which are subject to various reporting requirements. Crucially, the proposed regulations require any "material advisor" (including an attorney) who assists with such a transaction to file a Form 8918 Material Advisor Disclosure Statement with the IRS Office of Tax Shelter Analysis.

Syndicated conservation easement transactions are defined in Proposed Reg. 1.6011-9(b) as transactions that include the following steps, in any order:

1. "A taxpayer receives promotional materials that offer investors in a pass-through entity the possibility of being allocated a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the taxpayer's investment in the pass-through entity . . . ;"
2. "The taxpayer acquires an interest directly, or indirectly through one or more tiers of pass-through entities, in the pass-through entity that owns real property (that is, becomes an investor in the entity);"
3. "The pass-through entity that owns the real property contributes an easement on such real property, which it treats as a conservation easement . . . , to a qualified organization and allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the taxpayer; and"
4. "The taxpayer claims a charitable contribution deduction with respect to the conservation easement on the taxpayer's Federal income tax return."

U.S. Treasury Department, 2022-2023 Priority Guidance Plan (Nov. 4, 2022)

This publication sets forth various topics which the Treasury Department intends to prioritize in issuing regulations and guidance during the coming year. Noteworthy topics for estate planners and other wealth management professionals include the following (items added from the preceding Priority Guidance Plan, issued June 1, 2022, are underlined below):

- Regulations relating to the timing of the use or allocation of forfeitures in qualified retirement
- "Final regulations relating to SECURE Act modifications to §401(a)(9) and addressing other issues under §401(a)(9). Proposed regulations were published on February 24, 2022."
- "Regulations relating to SECURE Act modifications to certain rules governing §401(k) plans."
- "Final regulations on §509(a)(3) supporting organizations. Proposed regulations were published on February 19, 2016."
- "Regulations under §512 regarding the allocation of expenses in computing unrelated business taxable income and addressing how changes made to §172 net operating losses by section 2303(b) of the CARES Act apply for purposes of §512(a)(6)."
- "Guidance under §4941 regarding a private foundation's investment in a partnership in which disqualified persons are also partners."
- "Regulations under §4966 regarding donor advised funds, including excise taxes on sponsoring organizations and fund management."
- "Regulations under §4967 regarding prohibited benefits, including excise taxes on donors, donor advisors, related persons, and fund management."
- "Regulations under §4958 regarding donor advised funds and supporting organizations."
- "Guidance regarding the public-support computation with respect to distributions from donor advised funds."
- "Regulations under §6104(c) [regarding the Treasury's required publication to state officials of certain information and records concerning exempt organizations]. Proposed regulations were published on March 15, 2011."

- "Regulations under §1001 on the modification of debt instruments, including issues relating to disregarded entities."
- "Guidance on applying the state and local tax deduction cap under §164."
- "Guidance under §170 regarding charitable contributions."
- "Guidance under §170 regarding conservation easements, including facade easements."
- "Regulations under §199A related to the determination of unadjusted basis immediately after acquisition (UBIA) of qualified property, the definition of qualified business income (QBI) and other issues."
- "Regulations under §267 regarding related party transactions and partnerships."
- "Guidance under §280F clarifying the business use of an aircraft by parties related to a lessee."
- "Guidance on the tax treatment of transactions involving digital assets."
- "Guidance concerning validation of digital asset transactions, including staking."
- "Final regulations under §§1014(f) and 6035 regarding basis consistency between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016."
- "Guidance regarding availability of §1014 basis adjustment at the death of the owner of a grantor trust described in §671 when the trust assets are not included in the owner's gross estate for estate tax purposes."
- "Regulations under §2010 addressing whether gifts that are includible in the gross estate should be excepted from the special rule of § 20.2010-1(c). Proposed regulations were published on April 27, 2022."
- "Regulations under §2032(a) regarding imposition of restrictions on estate assets during the six-month alternate valuation period. Proposed regulations were published on November 18, 2011."
- "Final regulations under §2053 regarding the deductibility of certain interest expenses and amounts paid under a personal guarantee, certain substantiation requirements, and the applicability of present value concepts in determining the amount deductible. Proposed regulations were published on June 28, 2022."
- "Regulations under §20.2056A-2 for qualified domestic trust elections on estate tax returns, updating obsolete references."
- "Regulations under §2632 providing guidance governing the allocation of generation-skipping transfer (GST) exemption in the event the IRS grants relief under §2642(g), as well as addressing the definition of a GST trust under §2632(c)

and providing ordering rules when GST exemption is allocated in excess of the transferor’s remaining exemption."

- "Final regulations under §2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption. Proposed regulations were published on April 17, 2008."
- "Final regulations under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates. Proposed regulations were published on September 10, 2015."
- "Regulations under §7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests. Proposed regulations were published on May 5, 2022."
- "Guidance under §§6039F, 6048, and 6677 on foreign trust reporting and reporting with respect to large foreign gifts, and regulations under §§643(i) and 679 relating to certain transactions between U.S. persons and foreign trusts. Revenue Procedure 2020-17 excepting certain tax-favored foreign retirement and non-retirement trusts from §6048 reporting was published on March 16, 2020."
- "Guidance under §707 on disguised sales."
- "Guidance on abusive use of partnerships for inappropriate basis adjustments."
- "Final regulations under §752 regarding related person rules. Proposed regulations were published on December 16, 2013."

Case of the Month
From Proskauer's Fiduciary Litigation Group

***Matter of Walls*, No. 2021-1074/A, 2022 NY Slip Op 51165(U) (Monroe Cty. Surr. Ct., Nov. 29, 2022)**

The Monroe County Surrogate's Court dismissed a petition brought by a Testator's son (and beneficiary of a testamentary trust receiving half of the Testator's residuary estate) to invalidate the Testator's most recent life insurance beneficiary designation as the product of a mistake or undue influence.

The relevant facts are as follows. On February 2, 2020, a few days after being diagnosed with brain cancer, the Testator, William Walls, Jr., executed a Will that left one half of his residuary estate outright to his wife, Susan Del Pozzo, whom was also named as his sole executor, and divided the other half into separate share trusts for his three adult sons from a prior marriage. The next day, the Testator updated his life insurance beneficiary designation via electronic signature to provide that the insurance proceeds would be divided in half between his wife and his estate, such that the wife would ultimately receive a combined 75% of the proceeds (i.e., 50% from being named in the beneficiary designation, and 25% from being the beneficiary of one half of the Testator's residuary estate under his Will). The Testator died the following year, on February 9, 2021.

The Testator's son Benjamin petitioned the Surrogate's Court to challenge the validity of the updated beneficiary designation on the following alternative grounds: (1) the beneficiary designation did not accurately reflect the Testator's true intent, which Benjamin claimed was for the insurance proceeds to be divided in the same proportions as the Testator's residuary estate (i.e., one half to Susan and one half to the continuing trusts for the Testator's sons), and/or (2) the beneficiary designation was the product of the undue influence of his stepmother, Susan.

The Surrogate's Court reached the following conclusions:

- Petitioner lacked standing under each of (a) SCPA 2103 (for actions to recover property brought by a fiduciary of an estate), because he was not a fiduciary of the estate; (b) SCPA 2105 (for actions brought by a person having a claim on property against a fiduciary holding such property)

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