Proskauer

Wealth Management Update

August 2023

August 2023 AFRs and 7520 Rate

The August 2023 Section 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 5%, an increase from the July 2023 rate of 4.6%. The August 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 5.07%, up from 4.8% in July;
- 3 to 9 years (the mid-term rate, compounded annually) is 4.09%, up from 3.85% in July; and
- 9 years or more (the long-term rate, compounded annually) is 4.03%, up from 3.98% in July.

California Passes Law Taxing Incomplete Gift Non-Grantor Trusts in Same Manner as Grantor Trusts – S.B. 131

Newly enacted Section 17082 of the California Revenue and Taxation Code provides that, effective January 1, 2023, California resident grantors of "incomplete gift non-grantor trusts" ("INGs", as defined below) must report the income of said INGs on their individual income tax returns pursuant to the same rules applicable to grantor trusts under Cal. Rev. & Tax. Code § 17731. This new California law is essentially the same as New York's 2014 law treating INGs as grantor trusts for state income tax purposes. *See* N.Y. Tax Law § 601(b)(41).

Section 17082(d)(1) provides that an ING is a trust that (1) does not qualify as a grantor trust under the federal I.R.C. and (2) is funded by a transfer of assets treated as an "incomplete gift" under I.R.C. § 2511 (e.g., a gift that is subject to the grantor's right of revocation or amendment, power to change beneficial interests or retained non-discretionary income interest).

However, for INGs that are charitable split-interest trusts, Section 17082(b) provides a limited exception to the rule treating INGs as grantor trusts where the trustees file a California fiduciary income tax return making an irrevocable election to treat the ING as a resident non-grantor trust, but only if 90% or more of the ING's annual DNI is distributed (or required to be distributed) to charity.

In general, under California's unique trust residency rules, a nongrantor trust is taxed in proportion to the number of fiduciaries who are California residents, or, if none, the number of non-contingent beneficiaries who are California residents. *See* Cal. Rev. & Tax. Code §§ 17742-44. California taxes grantor trusts based on the residence of the grantor. *See* Cal. Rev. & Tax. Code §§ 17014, 17731

***Estate of Hoensheid v. Comm'r*, No. 18606-19, T.C. Memo. 2023-34 (Mar. 15, 2023)**

The Tax Court held that a taxpayer's charitable contribution of appreciated stock to a DAF was effectively incomplete where said stock was subject to an existing agreement for the company (CSTC) to be sold to a third party which closed only two days after the transfer to the DAF. Consequently, the taxpayer was (1) required to recognize capital gains from the sale of said stock under the anticipatory assignment of income doctrine and (2) denied a charitable income tax deduction for the stock contributed to the DAF but (3) was *not* liable for an accuracy-related penalty. Each of these rulings is discussed further below.

1. **Assignment of Income:** The Tax Court explained that "[i]n general, a donor's right to income from shares of stock is fixed if a transaction involving those shares has become 'practically certain to occur' by the time of the gift, 'despite the remote and hypothetical possibility of abandonment.'" This requirement was satisfied here because, although the Tax Court found that the DAF did not yet have a legal obligation to sell the CSTC stock at time of the taxpayer's contribution, (i) the parties had then already taken various actions to effect the sale of CSTC which made it virtually certain to occur (e.g., the purchaser had formed a subsidiary holding company to acquire CSTC, and CSTC had made amendments to its Articles of Incorporation and completed "cash-sweeping" employee bonus payments and shareholder distributions that were "highly significant conditions precedent" for the sale to close) and (ii) there were virtually no unresolved sales contingencies at the time of said contribution.

2. **Denial of Charitable Deduction:** The Tax Court determined that the taxpayer here was not entitled to a charitable income tax deduction for his contribution of CSTC stock to the DAF because he failed to satisfy the qualified appraisal requirement for charitable contributions of property in excess of $500,000. The appraisal submitted by the taxpayer was insufficient because (i) it did not substantially comply with regulatory requirements for qualified appraisals (e.g., it failed to include information showing that the appraiser was a *qualified* appraiser and provided an incorrect date for the contribution), and (ii) the taxpayer failed to demonstrate reasonable cause for the defective appraisal (the taxpayer couldn't prove that he relied in good-faith on his estate planning attorney to arrange the appraisal).
3. **Accuracy-Related Penalty:** The Tax Court ruled that the taxpayer here was not liable for an accuracy-related penalty with respect to his underpayment of tax attributable to gain from the sale of CSTC stock contributed to the DAF because the IRS failed to demonstrate that the taxpayer lacked reasonable cause for this underpayment. The Tax Court reasoned that the taxpayer permissibly relied on the advice of his estate planning attorney in failing to report gain from the sale of CSTC stock on his income tax return ("We do not consider the anticipatory assignment of income issue to be so clear cut that petitioner should have known it was unreasonable to rely on [his attorney's] advice.").

***Suzanne Montes v. Commissioner*, No. 17332-21 (U.S. Tax Ct., June 29, 2023)**

The Tax Court determined that settlement proceeds of a female firefighter's sex discrimination claim must be included in her taxable income where such amount did not represent compensation for physical injuries (rather, the taxpayer's claim was principally based on allegations of emotional distress and psychological injuries). This result is not in itself particularly interesting, given the general rule that settlement proceeds are excludable under I.R.C. § 104(a)(2) only if the settlement is attributable to a taxpayer's personal physical injuries or illness. However, the final full paragraph of the opinion contains the following noteworthy statement affirming the continued reliance of American law on a dualistic theory of mind (i.e., the philosophical view that body and mind co-exist as separate and distinct physical systems), notwithstanding mounting scientific evidence that this theory is fundamentally flawed:

"While I have noted in previous opinions about the crumbling barrier between psychiatry and neurology. Where the Code itself assumes a dualist view of mind and body, we must assume such a view as well when we apply the Code to the facts of the particular case."

This continued embrace of the dualist theory of mind by U.S. tax law has wide-ranging potential implications beyond the specific issue addressed in this case. In spite of the Tax Court's conclusion here that the taxpayer's settlement proceeds were clearly includable in her taxable income under a plain-text reading of I.R.C. § 104, the Court nevertheless found that the taxpayer's decision to exclude this amount from her return was a "reasonable" one, particularly given that this decision was made based on advice from her CPA, and that she could not be charged a penalty for the resulting underpayment.

***Yost v. Carroll*, No. 20-C-5393 (N.D. Ill., Nov. 18, 2022)**

This case involved a plaintiff who made intra-family loans totaling $7,000,000 to his daughter and her then-husband, the defendant, and then sued his former son-in-law to collect amounts payable under the promissory notes for said loans after the couple divorced years later. The defendant's pleadings alleged that the purported loans in fact represented large gifts, but that the plaintiff sought to disguise these amounts as loans for the explicit purpose of evading federal gift taxes and had induced the defendant to execute the notes at issue by promising that he would never attempt to collect on them. The plaintiff filed a motion to dismiss the defendant's pleadings for failure to adequately state a cognizable affirmative defense, arguing that the defendant's legal theory centered on the validity of tax-motivated transactions – an improper basis for resolving private contract disputes. However, the court denied said motion to dismiss, holding that the defendant had successfully pleaded affirmative defenses based on (1) the *in pari delicto* ("of equal fault") doctrine, which essentially prevents a plaintiff who participates in wrongdoing from suing to recover damages resulting from such wrongdoing, and (2) the allegation that the promissory notes here were in fact sham agreements that the parties did not intend to create binding legal obligations.

***Glade Creek Partners LLC et al. v. Commissioner,* No. 22272-17, T.C. Memo. 2023-82 (June 29, 2023)**

The Tax Court held that the amount of the income tax deduction to which a taxpayer LLC was entitled for its charitable contribution of a conservation easement was limited under I.R.C. § 170(e)(1)(A) to the amount of the LLCs adjusted basis in the property subject to the easement, rather than the fair market value in the easement itself. This holding turned on the court's conclusion that the property at issue was inventory in the hands of the LLC under I.R.C. § 724(b), rather than investment property. In reaching this conclusion, the Tax Court relied on the following factors:

- The easement property was previously reported as inventory on the corporate income tax return of the LLC's parent company, which then transferred the property to the LLC and sold off membership interests in the LLC to investors before the easement was contributed to charity.
- The easement property was evidently held for the purpose of sale in the real estate business, given that the parent company was formed to operate as a real estate dealer and was actively engaged in that business throughout the time period at issue here. Indeed, the parent company reported on in its income tax returns that it was in business as a real estate dealer.
- Improvements made to the easement property indicated that it was held primarily for the purpose of sale, rather than being segregated as investment property.

***Estate of Susan R. Block et al. v. Commissioner,* No. 10618-19, T.C. Memo. 2023-30 (Mar. 13, 2023)**

The Tax Court held that an estate was not entitled to a charitable deduction for property bequeathed to a defective CRAT under the decedent's revocable trust because:

(1) Said CRAT did not conform to the requirement under I.R.C. § 664(d)(1) that the annuity amount be fixed as a "sum certain" between 5% and 50% of the initial fair market value of property contributed to the CRAT.

- Here, the CRAT provided for payment of an “annuity amount equal to the greater of: (a) all net income, or (b) the sum of Fifty Thousand Dollars ($50,000), at least annually.”

(2) The trustees' amendment of the CRAT to comply with the above "sum certain" requirement was not a "qualified reformation" under I.R.C. § 2055(e)(3)(A), which would have required the commencement of a judicial proceeding to reform the CRAT within 90 days of the due date for the decedent's estate tax return.

Here, the trustees attempted to reform the CRAT through a nonjudicial amendment under the terms of the trust, not a judicial proceeding, and they didn't even do this until over a year after the decedent's estate tax return was due.

***Donald E. Swanson v. Commissioner,* No. 21701-18, T.C. Memo. 2023-81 (June 29, 2023)**

In this case, the Tax Court held that a taxpayer could not deduct expenses associated with chartering his fishing boat where such activity did not qualify as a for-profit business under I.R.C. § 183. In concluding that the taxpayer's fishing charter activity was a mere hobby, the Tax Court relied on the following factors:

- The taxpayer didn't conduct this activity in a businesslike manner (he didn't maintain business records, didn't have a commercial fishing license or insurance, didn't have a business plan, and didn't alter his conduct in response to losses).
- The taxpayer did not have expertise in running a fishing charter business and did not consult with any advisers to compensate for his lack of expertise.
- The taxpayer spent very limited time on his fishing charter activity during the years at issue (only 11 chartered trips during 2015-2016, and none in 2014).
- The taxpayer's continuous and significant losses during the years at issue indicated a lack of profit motive.
- The taxpayer separately engaged in the management of rental properties (a similar activity) which also generated losses for all years at issue.
- The taxpayer did not rely on income from the fishing charter activity for his financial security (he was retired with a pension and Social Security retirement benefits).
- The taxpayer also used his fishing boat for personal fishing trips.

***Scot Thompson Farms LLC v. HAP Holdings Trust et al.*, No. 8:23-cv-00025 (D. Neb., June 21, 2023)**

The court entered default judgment against two trusts with respect to claims arising from fraudulent 1099-MISC forms filed by the trustee that falsely reported payments of income by the trusts to the plaintiff. Default judgment was entered here because the trustee refused to obtain legal counsel for the defendant trusts, despite being ordered to by the court.

By way of background, the trusts here were previously the subject of a tax enforcement action that also ended in default judgment when the trustee refused to obtain legal counsel for the trusts. As a result, the court ordered enforcement of the tax lien through seizure and sale of the trust property that was purchased by the plaintiff in the present case. Thereafter, the trustee apparently sought to retaliate against the plaintiff by filing fraudulent 1099-MISC forms reporting payments to the plaintiff of income attributable to the former trust property purchased by plaintiff. These false filings prompted the plaintiff's lawsuit (brought under I.R.C. § 7434) and resulting default judgment at issue, which ordered the trusts to pay statutory damages of $5,000 per false filing and declared that the payment amounts reflected in the 1099-MISC forms should be zero.

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