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Early distribution from qualified plan included in gross income despite taxpayer's claim of diabetes disability

Robert B. Lucas v. Commissioner, No. 2808-20, T.C. Memo. 2023-9, January 17, 2023.

Facts

Taxpayer was domiciled in San Diego, California, at all relevant times in this case. In 2017, Taxpayer worked as a software developer at Engineering, where he had worked for approximately four years. In 2017, Taxpayer lost his job at Life Cycle Engineering ("Engineering") and began to experience financial problems. Up to that point, Taxpayer had provided financial support to his children, paying for his daughter's nursing education and providing housing for his son. To make ends meet, Taxpayer obtained a distribution of $19,365 during that year from his 401(k) plan account to which he had contributed while working at Engineering. Because Taxpayer had not reached 59½ years old at the time, the administrator of the 401(k) accordingly reported this amount as an early distribution with no known exception on IRS Form 1099-R (Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts). Taxpayer reported this distribution on his 2017 federal income tax return but did not include it in taxable income. In 2015, Taxpayer had been diagnosed with diabetes, which he treated with insulin shots and other medications. Taxpayer claimed that the distribution did not constitute income because of his medical condition. The IRS ultimately issued Taxpayer a notice of deficiency in the amount of $4,899 for the 2017 tax year attributable to his failure to include the retirement plan distribution in his 2017 gross income and the 10% early withdrawal penalty tax imposed by IRC §72(t). Taxpayer appealed to the Tax Court.

Holding

For federal income tax purposes, under IRC §61(a) gross income includes all income from whatever source unless excepted by an express provision of the Code. This income includes distributions from a qualified plan. Taxpayer admittedly received a distribution from his 401(k) plan account in 2017. Unfortunately, Taxpayer relies on a website that claims to speak to his situation rather than legal authority. IRC §72(t), supported by judicial interpretation, provides that distributions from a qualified retirement account (including a 401(k) plan) to a taxpayer under 59½ years of age at the time of the distribution are subject to a 10% additional tax unless an exception applies. Section 72(t)(2)(A)(iii) provides one such exception for a distribution "attributable to the employee's being disabled within the meaning of subsection (m)(7)." A taxpayer is considered disabled if, at the time of the disbursement, he is "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration." IRC §72(m)(7), Treas. Reg. § 1.72-17A(f)(1).

For these purposes, substantial gainful activity refers to "the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability." Treas. Reg. § 1.72-17A(f)(1). The determination whether an impairment makes one unable to engage in substantial gainful activity depends on all the facts of the case, focusing primarily on the nature and severity of the impairment, as well as factors such as the individual's education, training, and work experience. "An individual will not be deeme disabled if, with reasonable effort and safety to himself, the impairment can be diminished to the extent that the individual will not be prevented by the impairment from engaging in his customary or any comparable substantial gainful activity." Id. subpara. (4). Taxpayer's diabetes did not render him "unable to engage in any substantial gainful activity" within the

meaning of §72(m)(7) and its regulations. Although Treasury Regulation §1.72-17A(f)(2) identifies diabetes as an impairment that "would ordinarily be considered as preventing substantial gainful activity," it clarifies that "[a]ny impairment, whether of lesser or greater severity, must be evaluated in terms of whether it does in fact prevent the individual from engaging in his customary or any comparable substantial gainful activity." Taxpayer was diagnosed with diabetes in 2015 but was able to work as a software engineer for two years, including the year that he received the distribution from his 401(k) plan account, effectively treating his diabetes with a mix of insulin shots and other medications. The Court found that the record contained no indication that Taxpayer's diabetes prevented him from engaging in his customary (or any comparable) substantial gainful activity at the time of the distribution, and concluded that his condition did not constitute a disability for purposes of IRC §72(m)(7).

Takeaway

The foundation of Taxpayer's argument was not without merit, but as applied to his circumstances, it did not fit. While an exception from the §61(a) definition of income exists, a taxpayer's circumstances must meet all the strict requirements of such an exception. A further takeaway that should go without saying is that taxpayers should not rely solely on the internet for legal or tax advice that requires interpretation of the Internal Revenue Code.

California Court of Appeals denies summary judgment for flawed beneficiary change

Judy Randle v. Farmers New World Life Insurance Company No. B304970, Cal. 2d App Dist, Div. 8, November 7, 2022

Facts

In 1992, spouses Decedent and Plaintiff were domiciled in California and purchased a life insurance policy with a face amount of $250,000 and naming Plaintiff as the sole beneficiary. The spouses were divorced in 2004 and their divorce settlement gave Plaintiff "[a] beneficial interest of one-quarter (1/4) of" the policy. Decedent and Plaintiff were responsible for paying premiums for their respective interests in the policy. If either party decided to discontinue paying premiums, the divorce decree stated he or she "shall forfeit [her or his] ownership" as to his or her interest in the policy. In 2006, referring to the divorce settlement provisions, Decedent submitted a new beneficiary designation to the Insurer naming Plaintiff and the spouses' three sons as equal 25% beneficiaries of the policy. Because California is a community-property jurisdiction, Insurer required either (1) the signature of a married policyowner's spouse on a beneficiary change form OR (2) a copy of the full final divorce decree and settlement agreement if divorced. Decedent provided neither. In 2008, Plaintiff began paying the full premium on the policy (through her wholly-owned company) because Decedent had stopped paying his portion of the premiums and she had been notified of the policy risk of lapse. The agent with whom Plaintiff dealt was unaware of the beneficiary change form that had been filed two years earlier and assured Plaintiff that she was still the sole beneficiary of the policy. Decedent died in 2014 and Plaintiff applied immediately for the death benefit, which Insurer denied due to the controversy created by the incomplete beneficiary change form filed years before. Plaintiff ultimately sued Insurer for breach of the covenant of good faith and fair dealing and breach of contract. Insurer filed for summary judgment.

Holding

Insurer contended Plaintiff could not establish a breach of contract because she was never the owner of the policy, and her actions "post-2008" were inconsistent with being a policy owner; there was no assignment of the policy to her that bound Insurer; and there was no writing between Decedent and Plaintiff evidencing an assignment as required by the divorce decree. Insurer pointed out several terms of the policy, in addition to the "Change of Beneficiary" provision. The policy provision on "Change of Owner" stated: "The owner may name a new owner by notifying us in writing while the insured is alive. When we receive acceptable signed notice, the change will take effect on the date the notice was signed." Insurer further contended that without a viable breach of contract claim, there could be no claim for breach of the covenant of good faith and fair dealing, and there was no evidence of malice, fraud or oppression to support a punitive damages claim. The court noted that to support a motion for summary judgment, a defendant moving for summary judgment must show that one or more elements of the cause of action cannot be established, or that there is a complete defense to the cause of action. The court held that it could be determined, upon evidence presented, that ownership of the policy passed from Decedent to Plaintiff upon contract right under the divorce settlement agreement. Furthermore, based upon local community-property law and the provisions of the policy contract, a beneficiary change could only be effected by filing the form with the spouse's name or with the full divorce decree, neither of which happened. Whether this invalidated Decedent's 2006 attempt to change the beneficiary designation must be determined at trial. Motion for summary judgment was denied.

Takeaway

The laws of a jurisdiction may change the rights of individuals involved in a divorce without express notification. For example, in many jurisdictions, will provisions for the benefit of a spouse are vitiated by operation of law upon divorce. Likewise, provisions incorporated in a final divorce decree can create rights that override pre-existing property rights of the individuals involved. While these changes can be durably enforceable, it is usually cleaner, cheaper and faster to ensure that the changes are clear to all involved.

District Court treats trusts as nominees for IRS defendant, allows reach of trust assets to satisfy tax liabilities

U.S. v. Shant S. Hovnanian, et al., 2022 U.S. Dist. LEXIS 231765; 2022 WL 17959583, January 31, 2023.

Facts

The IRS determined that Defendant owes more than $16.2 million in federal income tax, penalties, fees and interest that arose because he engaged in illegal tax shelters. The IRS seeks to attach Defendant's property in partial satisfaction of his outstanding tax liabilities and, to the extent necessary, seeks to include property of which the record owners are irrevocable trusts. At all times relevant to this case, Defendant and his spouse resided in Residence, a large and valuable residential property on the New Jersey shore. Defendant's parents had Residence built in 2008 and Defendant and his spouse moved in immediately. In 2012, after Defendant had lost his first case relating to this tax liability, Defendant's parents transferred ownership of Residence to Trust A (created by Defendant for the benefit of his children) for $1. Defendant's sister is Trustee of Trust. In 2012, Defendant's parents also transferred ownership of Office Building to Trust B. Defendant's sister is also the trustee of Trust B. (Trust

A and Trust B together will be referred to as "Trusts.") The IRS brings this action to seize Residence and Office Building and seeks summary judgment on its claims. The Trusts move for summary judgment on their claims of ownership and control.

Holding

The Court considered "nominee theory" to determine whether the Trusts were merely the nominees of Defendant and Defendant in fact exercised "active" and/or "substantial" control over the valuable properties held by the Trusts. This theory examines a list of weighted factors to consider the level of control and the probable illegitimate reasons for transfer of ownership to the nominee. Although Residence was owned by Trust A, Defendant paid all utilities, taxes and other costs from personal funds. Furthermore, although he was not a beneficiary of Trust A, Defendant resided in Residence rent-free and treated the property as his own. Similarly, although Office Building was owned by Trust B, Defendant used space in it rent-free and tenants of Office Building were directed to pay rent to Defendant's business account. Trust B never filed a federal income tax return or otherwise reported the rental income as trust income. Defendant paid the taxes and other expenses of Office Building from his personal funds. The Court found that the factors indicated overwhelmingly that the Defendant exercised active and substantial control over the properties ostensibly owned by the Trusts, and granted the IRS motions for summary judgment to seize the properties.

Takeaway

In satisfaction of liabilities to the US government, the IRS has broad power to reach beyond just the property of which a defendant is the owner of record. This broad power includes, as here, the ability to reach property owned by a nominee for the benefit of a defendant, which is also supported under theories of fraudulent conveyance, alter ego, transferee liability and others. Attempts to hide assets from the reach of the IRS for righteous liabilities are rarely successful.

IRS 2023 "no ruling" list: Items of interest

IRS Rev. Proc. 2023-3, 2023-1 IRB 144, January 3, 2023.

Facts

Each year the IRS updates its list of issues for which it will not ordinarily provide a private letter ruling or determination letter. Here are a few of the new items from that list that we believe will be of greatest interest to our rreaders.

- **§101. Certain death benefits.** Whether there has been a transfer for value for purposes of §101(a) in situations involving a grantor and a trust when (i) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (iv) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§673 to 677.
- **§§101, 761, and 7701. Certain death benefits; terms defined; definitions.** Whether, in connection with the transfer of a life insurance policy to an unincorporated organization, (i) the organization will be treated as a partnership under §§761 and 7701, or (ii) the transfer of the life insurance policy to the organization will be exempt from the transfer for value rules of §101, when substantially all of the organization's assets consist or will consist of life insurance policies on the lives of the members.

- **§2601. GST tax imposed.** Whether a trust exempt from generation-skipping transfer (GST) tax under §26.2601-1(b)(1), (2), or (3) of the generation-skipping transfer tax regulations will retain its GST-exempt status when there is a modification of a trust, change in the administration of a trust, or a distribution from a trust in a factual scenario that is similar to a factual scenario set forth in one or more of the examples contained in §26.2601-1(b)(4)(i)(E).
- **§§2035, 2036, 2037, 2038, and 2042.** Whether trust assets are includible in a trust beneficiary's gross estate under §§2035, 2036, 2037, 2038, or 2042 if the beneficiary sells property (including insurance policies) to the trust or dies within 3 years of selling such property to the trust, and (i) the beneficiary has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of §2041, (ii) the trust purchases the property with a note, and (iii) the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.
- **§§661 and 662. Deduction for estates and trusts accumulating income or distributing corpus; inclusion of amounts in gross income of beneficiaries of estates and trusts accumulating income or distributing corpus**. Whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is a distribution for which a deduction is allowable under §661 or which requires an amount to be included in the gross income of any person under §662.

IRS Chief Counsel Advices memorandums issued addressing valuation of cryptocurrency

IRS Chief Counsel Advice 202302011 (January 24, 2023) and 202302012 (January 10, 2023).

Facts

In two consecutive Chief Counsel Advice (CCA) memoranda, the IRS provided guidance on the tax treatment of cryptocurrency units — one related to a claim of a deduction for the loss of substantially all of the value of a taxpayer's cryptocurrency units, and the other for the claim of a charitable deduction for the contribution of cryptocurrency to a charity. These short CCAs are grouped together solely by subject matter and are otherwise unrelated (although the sequence of their issue may mean that they were requested by the same taxpayer).

Holding

In *CCA 202302011*, the taxpayer purchased units of cryptocurrency in 2022 for $1.00 per unit as a personal investment. During that same year, the value of these newly purchased cryptocurrency units decreased until, by the end of the year, they were worth less than $0.01 per unit. However, the taxpayer's cryptocurrency continued to be traded on at least one cryptocurrency exchange and the taxpayer "maintained dominion and control" over the cryptocurrency he purchased. The taxpayer claimed a loss deduction on his 2022 tax return taking the position that the cryptocurrency, purchased as a capital asset, was either worthless or abandoned. IRC §165 allows a

deduction for certain unreimbursed losses that are "evidenced by closed and completed transactions, fixed by identifiable events, that were actually sustained" during the tax year. Worthless securities, which are defined by law, can be deducted as a loss. However, cryptocurrency is not within the definition of a security under §165(g). Furthermore, even if the cryptocurrency was listed as a security, it wasn't worthless because it continued to be traded on more than one cryptocurrency exchange and still had value, albeit less than one cent. Also, while IRS Reg §1.165-2(a) permits a taxpayer to take a loss deduction if they sustain a loss from property that is "permanently discarded from use," the taxpayer did not abandon or otherwise dispose of the cryptocurrency. The IRS Chief Counsel determined that loss deduction should be disallowed.

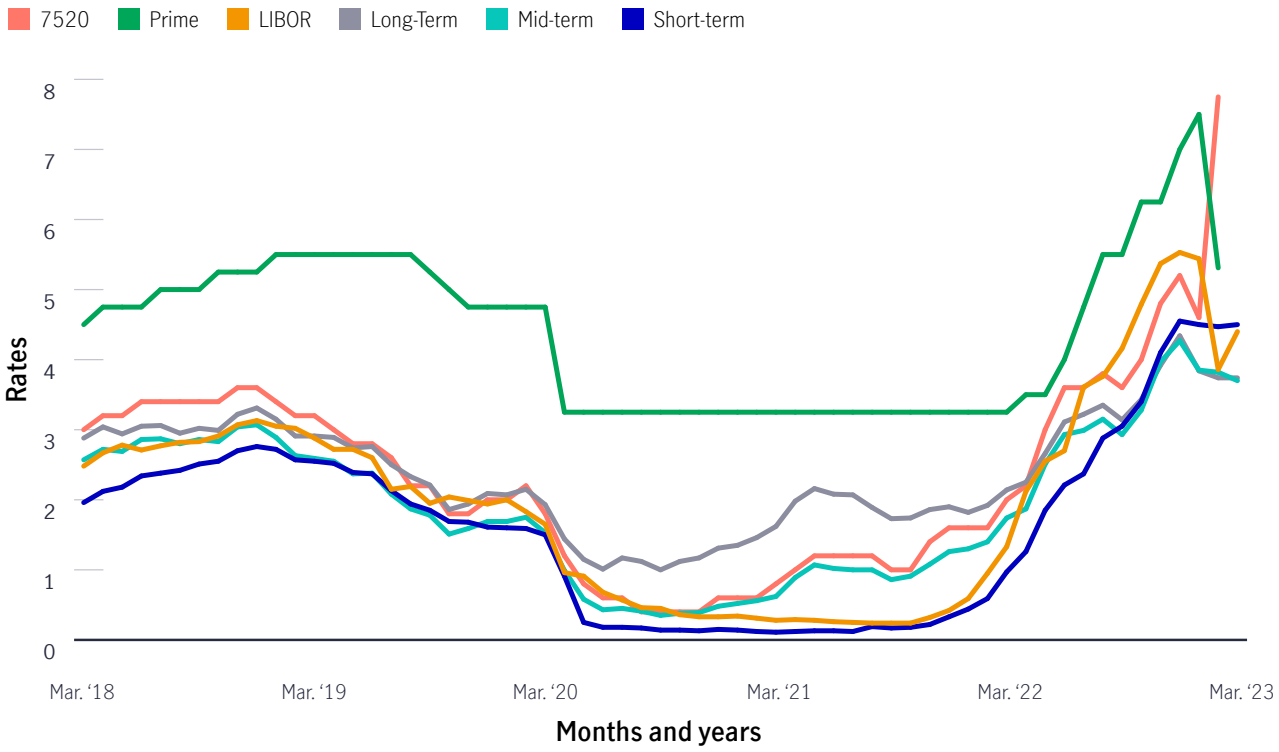
In *CCA 202302012*, the taxpayer requested guidance on whether the "reasonable cause exception" (to the qualified appraisal requirement for a charitable contribution of noncash property) provided in IRC §170(f)(11)(A)(ii)(II) applies if a taxpayer determines the value of contributed cryptocurrency based on its value on a cryptocurrency exchange where it is traded. In general, to claim a charitable deduction over $5,000 for contributions of noncash property, the taxpayer must obtain a qualified appraisal of such property for the taxable year in which the contribution is claimed. IRC §170(f)(11)(E)(i) defines "qualified appraisal" as one that is (1) treated as a qualified appraisal under regulations or other guidance prescribed by the Secretary, and (2) conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations. IRC §170(f)(11) provides that no qualified appraisal is required for donations of certain readily valued property specifically enumerated (e.g., publicly-traded securities, certain vehicles, etc.). As noted above, cryptocurrency is not within the definition of a "security" for purposes of this exception to the qualified appraisal requirement, and no other exception exists. Thus, a charitable deduction for contribution of a cryptocurrency to a charity will require a qualified appraisal of the value of the contribution.

Takeaway

Although a taxpayer may think of an asset in a particular way, more may be required under the Internal Revenue Code for the asset to be treated as such. Some may feel that because cryptocurrencies are quasi-reified representations of virtual value and are traded on exchanges similar to equities exchanges, that the units of cryptocurrency are securities in the same way as equities. The IRC and the regulations thereunder do not agree in most instances (not yet, anyway). Extra care and attention are due when dealing with these types of assets for tax purposes. Before making assumptions about how such assets will be treated for tax purposes, advice of competent tax and legal counsel would be helpful.

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

Short, Mid, Long Term AFR, 7520, LIBOR, Prime Rates from March 2018 – March 2023



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

	Short-term AFR	Mid-term AFR	Long-term AFR	7520	LIBOR	Prime
March '23	4.50%	3.70%	3.74%	4.40%	—*	—*
February '23	4.47%	3.82%	3.86%	3.86%	5.31%	7.75%

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*March '23 LIBOR and Prime rates not available based on publication date.

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Comments on taxation are based on tax law current as of the time we produced the material.

Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds. There can be costs associated with drafting a trust.

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