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Tax court denies charitable deduction under tax-evasion scheme

Calvin A. Lim, et ux. v. Commissioner, T.C. Memo. 2023-11, January 23, 2023.

Facts

During 2016 and 2017, spouse Taxpayers were the sole shareholders of "S Corp" with a business address in Irvine, California. Taxpayers served as S Corp's officers and were also its employees. In the final weeks of 2016, Taxpayers' attorney presented Taxpayers with an arrangement he called "The Ultimate Plan: The Ultimate Tax, Estate and Charitable Plan" (called here the "Plan"). That same day, Taxpayers signed an agreement to have the attorney carry out the Plan for them. Under this agreement, the attorney agreed to (1) create a "Charitable LLC," (2) transfer assets to Charitable LLC, (3) donate interests in Charitable LLC to a registered charity, and (4) provide valuation documentation to support a charitable deduction for the donation. (The attorney's fee for these services was based on the value of the charitable deduction, which was somehow determined more than a month before any appraisal of the asset values was undertaken.) That same day, the attorney created Charitable LLC, wholly owned by S Corp. The following week, the attorney prepared five promissory notes by which one of the Taxpayers promised to pay Charitable LLC a total of $2,008,500 in seven years. Taxpayers claim to have donated interests in Charitable LLC to Foundation (a charitable foundation for which the attorney is listed as registered agent) on December 31, 2016. Taxpayers claimed a charitable income tax deduction for this alleged gift in the amount of $1,608,108 for 2016, which they also claim generated a carryforward deduction of $415,711 for 2017. Taxpayers offered an "acknowledgment letter" as evidence of the donation of Charitable LLC interests to Foundation. This letter appears to be a form letter with Taxpayers' information inserted and is dated January 1, 2017. The letter read, "We received your non-cash donation of **one thousand (1,000) units** in **[XYZ LLC]** in **2016**. **[Foundation]**, provided no goods or services to you in exchange for your contribution. Please allow this letter to serve as official receipt of your unrestricted gift of 1000 units received in **2016**. Your support is greatly appreciated." The IRS denied these deductions for lack of substantiation both of the value of the claimed deduction and, in part, of the very fact that the transfers occurred at all. Taxpayers brought this action in Tax Court and the IRS moved for summary judgment on the facts.

Holding

The Tax Court granted the IRS motion for summary judgment. Apart from the acknowledgment letter, there is no evidence that there was ever any transfer of property of any kind to Foundation. Furthermore, even the acknowledgment letter does not comport with the Taxpayers' factual claims. The letter is addressed to one of the Taxpayers and not S Corp that is claimed to be the donor. The letter is not signed by an officer or employee of Foundation or by any human at all; rather someone merely signed "Sincerely, Foundation." Further still, the letter refers to the donation of interests in XYZ LLC and not Charitable LLC. (Attorney changed the name of Charitable LLC to XYZ LLC some months after the purported transfer.) Finally, the Taxpayers offer as substantiation of the value of the donation for charitable income tax deduction purposes only an "appraisal" prepared by the attorney that was incomplete, frequently inaccurate as to many of the facts it did present, falsely claimed that the attorney preparer had no personal interest or bias in the amount of the valuation, and was prepared after an invoice that anticipated its conclusion. The Court pointed out that when a contribution of property is valued in excess of $500,000, IRC §170(f)(11) requires that the taxpayer attach a copy of a qualified appraisal to its return. The Court held that the attorney's appraisal cannot be "qualified" because he prepared it in exchange for an appraisal fee based on the appraisal valuation, which is prohibited by the regulations under IRC §170. Finally, §170(f)(11)(G) provides that, in the case of a partnership or S corporation, the qualified appraisal requirements "shall be applied at the entity level." To the extent that the requirements were attempted at all, they were at the level of the Taxpayer and not the S Corp.

Takeaway

Don't let this happen to you. Taxpayers rushed into an arrangement seeking a charitable deduction worth more than $2M, and agreed in the process to pay fees of $84K and bind themselves to transfer large amounts of cash in the future. The barest investigation would have revealed the fatal flaws in the plan (and perhaps that the promoter was under investigation that ultimately resulted in being enjoined from promoting this and other impermissible tax-evasion schemes). If a plan that you have just heard about today requires you to commit your property to loss and subject yourself to legal risk immediately, usually the right answer is to walk away.

District court holds that US tax treaties can affect individual FBAR requirements

Alberto Aroeste, et ux. v. United States, Case No.: 22-cv-682-AJB-KSC, USDC, So Dist. Calif., February 13, 2023.

Facts

As we approach income tax filing season for most taxpayers, the requirement to report foreign bank accounts for certain individuals comes back to mind. It is important to remember that the "foreign bank account report" (FBAR) requirement comes not from the Internal Revenue Code, but from Title 31 of the US Code. (FBAR regulations refer to Title 26 and the IRC, however.) A new case still pending before the United States District Court for the Southern District of California is hammering out some of the finer points that will determine whether some individuals are subject to the FBAR requirements at all. In this case, Taxpayer and his spouse are citizens of Mexico with a US "green card" and, in the Court's words, Taxpayer "is, and for many years has been, a 'lawful permanent resident' of the United States *as a matter of immigration law*." [Emphasis added.] In 2012 and 2013, the IRS found Taxpayer to be in willful violation of FBAR requirements and imposed the onerous penalties triggered by such a violation, approximately $3M in this case. Taxpayer answered that he and his spouse have elected to be treated as residents of Mexico under the then-current tax treaty between the US and Mexico. The IRS asserted that the election under the tax treaty cannot supersede the determination under US law of an individual as a "U.S. person" subject to FBAR requirements because, in part, FBAR requirements are not tax laws. Taxpayer brought this action.

Holding

To begin, it is important to understand that the US and many other countries have entered into tax treaties that govern taxation of individuals that might be captured by the laws of both countries, in part to avoid double taxation of such individuals. The US and Mexico have such a tax treaty that, under certain circumstances, allows an individual to elect to be treated as a resident of Mexico for tax-treaty purposes. The Taxpayer claims to meet the requirements to make such an election and has done so for the years in question, despite residing in the US during those years. Taxpayer has sought through discovery to receive the entire administrative record of the IRS audit of Taxpayer for 2011–2015, inclusive, claiming that this record contains information relevant to his determination as a US person under the treaty for FBAR purposes. The IRS opposed this discovery request as irrelevant to the determination of liability. After examination, the Court ordered the parties to file a joint discovery motion on the relevance of the administrative record to the issues to be decided. The Court applied a new five-part analysis to determine whether an individual resident in the US is subject to FBAR requirements. The final line of the analysis is, "Therefore, any person allowed to permanently reside in the United States by virtue of US immigration laws must file an FBAR unless that person is entitled to be treated as a resident of a foreign country under a tax treaty." For this reason, that part of the IRS administrative record that is relevant to Taxpayer's right to elect under the US-Mexico tax treaty to be treated as a resident of Mexico must be produced as discovery in this case.

Takeaway

FBAR requirements are more often an issue for taxpayers with property outside the US. A lot of the discussion regarding FBAR violations has been whether particular violations were "willful" or not, and the analysis directing these determinations. However, going forward, we can expect more early attention to be paid on both sides of disputes to whether the individual is subject to the FBAR requirements in the first place.

State court of appeals upholds trust amendment despite lack of original

Linda Beaumont, Trustee of the Pasquale Storto, Jr. Living Trust v. Priscilla Parness, et ux., No. 360134, Michigan CA, January 12, 2023.

Facts

Decedent was a resident of Michigan when he executed an inter vivos Trust on October 17, 2005. Decedent served as trustee of Trust until his death in May 2020 from complications related to COVID-19. As many trusts do, Trust provided that Decedent may leave a written statement, "either entirely in his handwriting or just signed by him, to dispose of tangible personal property to a certain person or person[s] in the future. If the list does not qualify as an amendment, I nevertheless hope those entitled to my estate will respect it." The residue of Trust was to be distributed 50% to the settlor's sister (successor Trustee) and 50% equally between (1) Decedent's ex-wife and (2) Decedent's grandchildren. Trust also provided that Decedent reserved the right to amend or revoke the trust by a writing signed by him or on his behalf and delivered to Trustee. After his death, his long-time life Partner provided numerous estate-planning documents to Trustee in a large binder, including a "Memorandum Regarding Desire [sic] Distribution of Personal Property" (the Memo). Partner testified that the original of the Memo was in the binder provided to Trustee. Trustee claims to have made copies of each item in the binder before returning the binder to Partner. The Memo contained the following, written in Decedent's hand and signed on November 21, 2011, items to be distributed to Partner: (1) his personal motor vehicle, (2) his primary residence and (3) "$50,000 – Cash Minimum". Below these items, also written in Decedent's hand, was an additional entry giving a vacation time-share to Partner and dated June 24, 2017. Trustee disputed the Memo because (a) after the binder was returned to Partner, the original could not be located and (b) Trustee had never been made aware of the Memo. Partner filed an action with the appropriate probate court to determine the validity of the Memo as an amendment to the trust. Both parties filed motions for summary judgment and the probate court denied Trustee's motion and granted Partner's. Trustee appeals to the Court of Appeals.

Holding

The parties do not dispute that the writing in the Memo appears to be Decedent's. Rather, Trustee suggests that the absence of the original suggests that Decedent destroyed the original Memo to nullify it as indicia of his intent. Indeed, under the law of the local jurisdiction, where only a copy of a will is available after a testator's death, there is a rebuttable presumption that the testator destroyed the will with the intent to revoke it." However, the Court points out that the State Supreme Court has required the nonmoving party to produce evidence putting the affiant's or deponent's credibility at issue to survive a motion for summary disposition. In the present case, Trustee has not met this burden. Trustee's claim that Partner gave her a copy of the Memo that may or may not have been an original, but at a time after Partner delivered the binder to her, is not inconsistent with, and does not overpower, Partner's claim to have delivered the original Memo to her in the binder and thereafter. Trustee offered no evidence that the Memo was not in the binder, that the version Trustee received later was not an original, or that Partner's claims are false in any way. In the alternative, Trustee argues that the Memo does not meet statutory requirements for the amendment of wills, because under local law statutory rules of interpretation applicable to wills are applied to trusts. The Court dismissed this argument as missing the mark. The rules applicable to the *interpretation* of wills do not control the *amendment* of trusts. Local law permits trusts to be amended according to their own terms (as do many states' laws), and this trust permits amendment in the form taken by the Memo. The probate court's grant of summary judgment is affirmed.

Takeaway

As is often the case, the takeaway here is that one must pay attention to details. The Trustee admitted that there were quite a lot of estate-planning documents in the binder and could not say for sure that the original Memo was not in there, nor that the copy of the Memo she copied later was not an original. Partner testified credibly that it was both in the binder and an original. Based on these unrefuted statements, one might wonder why this dispute arose in the first place.

IRS rules that retirement plan properly allows medical benefits for employed participants receiving substantially equal early distributions

IRS Private Letter Ruling 202305001, November 4, 2022.

Facts

Taxpayer maintains a Retirement Plan A, that includes a retiree medical account (Retirement Plan A's 401(h) account). Retirement Plan A's 401(h) account was funded in a spinoff from a previous qualified plan and has not received any further employer contributions. Retirement Plan A has significantly more assets than needed to satisfy liabilities for post-retirement medical benefits. Retirement Plan A's 401(h) account provides for funding and payment of health benefits for Retirement Plan A participants who are eligible to receive benefits under the provisions of the employer's plan. Under this plan, participants are eligible for benefits if they meet certain age and service criteria upon termination of employment. Taxpayer amended Retirement Plan A (as allowed under IRC §401(a)(36)) to allow participants who have not yet separated from service to begin receipt of pension benefits beginning at age 59½ (those participants, along with their eligible dependents, are referred to as 401(a)(36)-Eligible Participants). A lump, sum distribution of pension benefits is not permitted, but all other benefit forms otherwise available under Retirement Plan A may be elected. Taxpayer then amended Retirement Plan A to permit the payment of health benefits from the 401(h) account for 401(a)(36)-Eligible Participants who are eligible to receive benefits under the employer's Health and Welfare Plan (which covers Taxpayer's active employees.) Taxpayer does not have a contractual obligation to fund health benefits, including those provided under the Health and Welfare Plan and the Post-Employment Health Benefit Plan. Taxpayer has requested a ruling that payment of health benefits from Retirement Plan A's 401(h) account for participants in Retirement Plan A who are not yet retired but have already commenced receiving substantially equal distributions (as allowed under IRC §401(a)(36)) does not violate §401(h) or Treas. Reg. §1.401-14 or otherwise cause Retirement Plan A to lose its tax-qualified status under §401(a).

Holding

The IRS concluded, based on review and analysis of the relevant statutes and regulations, that the payment of health benefits from Retirement Plan A's 401(h) account for participants in Retirement Plan A who are not yet retired but have already commenced receiving substantially equal distributions (as allowed under IRC §401(a)(36)) *does not* violate §401(h) or Treas. Reg. §1.401-14 or otherwise cause Retirement Plan A to lose its tax-qualified status under §401(a). This ruling is based largely on interpretation of Treas. Reg. §1.401-14(b)(1), which provides in part that an employee is eligible as a "retired employee" to receive medical benefits from a 401(h) account if the employee is eligible to receive retirement benefits under the associated pension plan. Here, the 401(a)(36)-Eligible Participants are eligible to receive retirement benefits under the terms of Retirement Plan A. Thus, the 401(a)(36)-Eligible Participants satisfy the definition of a "retired employee" as described in the second sentence of Treas. Reg. § 1.401-14(b)(1). That same regulation further provides that an employee is not considered to be eligible to receive retirement benefits under the plan if he is still employed by the employer and a separation from employment is a condition to receiving the retirement benefits. However, because 401(a)(36)-Eligible Participants are eligible to receive pension benefits prior to separation from employment, separation from employment is not a condition to the 401(a)(36)-Eligible Participants receiving retirement benefits under Retirement Plan A.

Takeaway

The old quip, "the large print giveth and the small print taketh away," is clearly not (always) true with regard to the Internal Revenue Code, at least in Subchapter D. To a certain extent, the rules governing qualified retirement plans give employers some flexibility to craft a plan that will meet the needs of its employees without stepping out of bounds.

Tax court denies treatment of gifts as transfers for consideration

Estate of Richard D. Spizzirri et al. v. Commissioner, No. 19124-19, T.C. Memo. 2023-25 February 28, 2023.

Facts

Decedent was a successful attorney and investor focused on the biotechnology industry. By his death, Decedent has accumulated a net worth approximately $81M. Decedent was married four times, with his first marriage producing four children. His fourth and final marriage was to Spouse, who had three children of her own from a previous marriage. Decedent and Spouse entered into an antenuptial agreement (Prenup) about a month before they married, which they modified five times over the following 18 years. The parties agreed that the Prenup would be "construed in accordance with the laws of the State of New York." The Prenup provides that the parties waive "all rights in and to each other's estate under any rule or law... entitling a surviving spouse to all or any part of the estate or property of a deceased spouse or to any interest therein." In return, if Spouse survived Decedent while married, Decedent was required to create a funded trust for Spouse giving her a generous annual income, grant her rights to live rent-free in Decedent's real estate, and promise her a percentage of the proceeds from the sale of certain property. If divorced, however, Spouse was guaranteed $1M–4.5M depending on how long they remained married. The last modification of the Prenup included Decedent's promise to bequest $1M to each of Spouse's three children from a previous relationship. Decedent and Spouse were estranged, however, for several years before Decedent's death. In that time, Decedent fathered two more children, each with a different mother, and Decedent made numerous unreported large gifts to his children, to Spouse's children, and to several women with whom he had relationships, romantic or otherwise. He did not, however, maintain his will as required by the Prenup. At the time of his death, his will (which predated his marriage to Spouse, providing for his first four children) had been changed only to add provisions for his last born two children. None of the provisions of the Prenup were contained in Decedent's will. Decedent died in 2015 in Colorado, where his will was probated. Spouse filed numerous claims against the estate, as did her children. Decedent's return showed a gross estate of more than $81M, but a taxable estate of only about $31M, and tax due of about $10M. The IRS had a different opinion and issued a notice of deficiency. Decedent's estate brought this action in Tax Court.

Holding

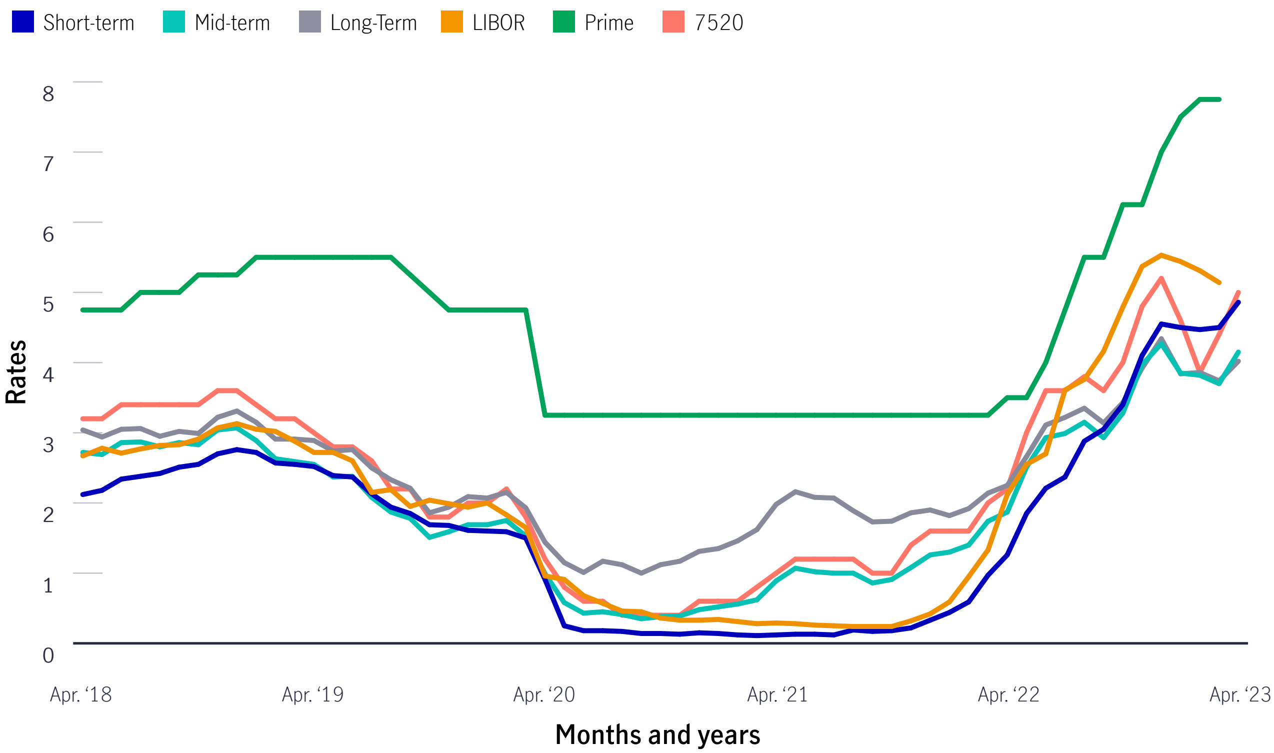
Decedent's return claimed deductions for payments made in settlement of legal actions initiated by Spouse and her children against Decedent's estate, and for repairs to certain real estate that the estate claimed were necessary to satisfy contractual obligations. The IRS denied these deductions and treated all these payments as taxable gifts. The IRS also reached back and included all of the unreported gifts that Decedent had made to multiple parties during his final years. Decedent's estate argued that the transfers to individuals through his final years were not taxable gifts, but rather payments in consideration for care and companionship services during the last years of his life. The Court found that Decedent's estate has not carried its burden to prove that the transfers where not donative in nature, but that the evidence suggested that they were in fact in appreciation, rather than legal consideration. As to the settlement with Spouse in satisfaction of Decedent's obligations under the Prenup, the Court found that, although these obligations were "bargained for" under the Prenup, IRC §2043(b)(1) prohibits characterizing a relinquishment of marital rights as consideration "in money or money's worth." Finally, as to the $1M bequests to each of Spouse's three children, the Court found that this last modification of the Prenup was, in itself, unsupported by additional consideration, but was in fact merely added on and donative in nature. The Court notes that none of the donee children reported the $1M as taxable income, inferring that they themselves considered the transfers to be gifts. Thus, the Court ruled largely for the IRS in the action.

Takeaway

The arguments offered by Decedent's estate at trial make one wonder why this action was filed in the first place. What evidence was offered by Decedent's estate mainly illustrated how Decedent's transfers to others were made spontaneously and with little planning and that his "negotiations" of the Prenup were ignored or forgotten before the ink was dry. Successful planning to achieve well-considered goals with an eye to reducing tax costs requires time, attention and execution. It is rarely possible to save the day – especially with respect to tax costs – after all the impulsive actions have long been recorded.

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 April 2018 – April 2023



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

	Short-term AFR	Mid-term AFR	Long-term AFR	LIBOR	Prime	7520
April '23	4.86%	4.15%	4.02%	—*	—*	5.00%
March '23	4.50%	3.70%	3.74%	5.14%	7.75%	4.40%

*April LIBOR and Prime rates not available based on publication date of this CI.

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