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# Central Intelligence

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# IRS issues proposed regulations governing interplay between TFV/RPS rules and §1035 exchanges

**REG -108054-21, 88 Fed. Reg. 30058, May 10, 2023.**

## Facts

Life insurance death benefit is generally received entirely income tax-free under IRC §101(a)(1) unless (among other exceptions) the policy has been transferred in exchange for valuable consideration as described under IRC §101(a)(2), commonly referred to as a "transfer for value" (TFV). Certain TFVs are excepted (e.g., a sale to the insured, etc.) and thus the death benefit still enjoys exemption from income taxation. However, the Tax Cuts and Jobs Act (TCJA) of 2017 created IRC §101(a)(3) and its "reportable policy rules," which, among many other things, deny availability of the TFV exceptions to the transfer of a policy that is a reportable policy sale (RPS). Generally, any transfer of a policy is considered an RPS unless the transferee has a substantial family, business, or financial relationship (as defined by the statute) with the policy insured (RPS exceptions). Regulations under IRC §101 issued in 2019 can be read to require that a policyholder making a §1035 exchange of a policy to qualify for an RPS exception to avoid treating the exchange as a reportable policy sale under IRC §101(a)(3). (See Treas. Reg. §1.101-1(c)(2)(v).) The TCJA also created IRS §6050Y containing reporting requirements triggered by a RPS and imposed on the transferee and potentially on other parties. After considering comments on the 2019 final regulations, received both before and after those regulations were released, the Treasury drafted the amendments in the current proposed regulations, with the stated goal of correcting the unintended change made in the 2019 final regulations that could result in a §1035 exchange being treated as a TFV or a RPS and thus making the death benefit partially or wholly income-taxable. The preamble to the proposed regulations also states the concern that the reporting requirements under §6050Y(c) could be avoided by exchanging a policy transferred in a reportable policy sale for a new policy in a §1035 exchange. Four amendments to the final regulations are proposed in this pronouncement.

**First:** Treas. Reg. §1.101-1(e)(2), "Transfer Of An Interest In A Life Insurance Contract," is revised to remove the issue of a life insurance policy in a §1035 exchange from the definition of "transfer" for RPS purposes.

**Second:** A new regulation subsection §1.101-1(b)(2)(iv) is inserted to provide that (a) if the death benefit from the original policy was wholly excludible under §101(a)(1), then the death benefit from the new policy would likewise be wholly excludible, and (b) if less than all of the death benefit from the original policy was excludible, then an adjusted carryover amount from the new policy would be excludible.

**Third:** A new regulation subsection §1.101-1(c)(3) is inserted to provide that when a new policy is issued in a §1035 exchange and less than the entire death benefit is excludible under IRC §101(a)(1), the new policy will be treated as having been previously transferred for valuable consideration and as a reportable policy sale unless specified exceptions are met (relating to specific reorganization circumstances).

**Fourth:** Reporting requirements under §6050Y would be modified to conform to the reality of the other amendments. For example, generally no reporting would be triggered solely by reason of an exchange under §1035 (though other actions at the time of the exchange might be independently sufficient to trigger reporting).

## Takeaway

These amendments provide a great deal of clarity in an area that was in dire need of it. We are happy to learn from the preamble that some of the scariest aspects of the RPS regulations were unintended and these proposed amendments remove a lot of concern that the new RPS rules would have a chilling effect or necessary exchanges while we all waited for guidance.

# US Court of Appeals affirms District Court disregard of buy-sell agreement obligations and inflates company value by value of death benefit received

**Thomas A. Connelly, Executor of the Estate of Michael P. Connelly, Sr. v. Commissioner, 131 AFTR 2d 2023-XXXX, (USCA8), June 2, 2023.**

## Facts

Decedent and Brother were the sole shareholders owning Company, a closely held family business that sold building materials. Decedent owned a 77.18% interest in Company and Brother owned a 22.82% interest. In 2001, Company, Decedent, and Brother entered into a hybrid stock redemption Agreement. The Agreement provided that upon the death of an owner, the surviving owner held a right of first refusal to purchase some or all of the decedent's shares. If a surviving owner declined to exercise their right to purchase a decedent's share, Company was obligated to purchase the shares from the decedent's estate. The Agreement specified that at the end of each year the owners would execute a "certificate of agreed value" that would govern the value of an owner's shares in the subsequent year. The Agreement also provided that for any year after the owners failed to execute a certificate of agreed upon value, the value of an owner's shares would be determined by securing at least two qualified appraisals. In fact, the owners never executed a single certificate of agreed value or obtained a single appraisal. However, to fund Company's potential obligation to purchase a decedent's interest, the owners directed Company to purchase life insurance in the face amount of $3.5 million on each owner (despite the disparity in ownership percentage). Decedent died in 2013 and Company received the death benefit from its policy insuring Decedent's life. As part of a larger agreement between Brother and Decedent's son, Brother directed Company to purchase Decedent's shares from his estate for $3 million. However, no appraisal of the value of Company was undertaken. Brother, as Decedent's executor, filed his federal estate tax valuing the shares of Company owned at the time of Decedent's death at $3 million, relying solely on the redemption paid under the Agreement. The IRS audited the estate and determined that the value of Company interest held at Decedent's death was in fact $5.3 million. The IRS held that the estate should have had the shares appraised and the appraised value should include the value of the death benefit to which Company was entitled upon Decedent's death. IRS issued a notice of deficiency for $1 million additional estate tax. Decedent's estate appealed the ruling to the District Court, which granted summary judgment to the IRS. Decedent's estate appealed to the US Court of Appeals for the Eighth District.

## Holding

Decedent's estate argued that the fair market value of Decedent's shares of Company should not include the life insurance proceeds used to redeem Decendent's shares because, although the proceeds were an asset, they were immediately offset by a liability: Company's contractual obligation to redeem Decedent's shares. The IRS, on the other hand, argued that the Agreement should be disregarded, and that any calculation of Company's fair market value must account for the proceeds used for redemption. The Court notes that as provided under IRC §2703, the value of an estate asset must be determined "without regard to any option, agreement, or other right to acquire . . . the property at a price less than the fair market value"

or to "any other restriction on the right to sell or use such property." Under §2703(b), to affect valuation, an agreement must (1) be a bona fide business arrangement, (2) not be a device to transfer property to members of the Decedent's family for less than full and adequate consideration, and (3) have terms that are comparable to other similar arrangements entered into in arm's length transactions. Here, the Court noted, the Agreement fixed no price nor prescribed a formula for arriving at one. It merely laid out two mechanisms by which the owners might agree on a price, both of which were ignored. Where the Company ignored the valuation mechanisms established in the Agreement, the District Court properly also ignored the Agreement and included the life insurance proceeds in the Company's value.

## Takeaway

This is yet another case where the taxpayers disregarded the formalities and obligations of their own agreements but expected the IRS to be bound by the provisions that they ignored. There is some disturbing obiter dicta at the end of the opinion that seems to suggest that the redemption obligation should be disregarded even if the agreement is not, but the case had already been lost by the taxpayers' behavior. Had the taxpayers complied with the provision of the Agreement that required a qualified appraisal, we can expect that the Court would have respected it (although the fate of the "certificate of agreed value" is unclear, at least in the Eighth Circuit). In this case the Agreement was disregarded because the taxpayer's ignored it, and the value of the estate necessarily reflected as much.

# Tax Court affirms IRS certification resulting in the revocation of taxpayer's US passport due to taxpayer's "seriously delinquent tax debt"

**Prince Amun-Ra Hotep Ankh Meduty v. Commissioner, No. 32817-21P, 160 T.C. No. 13 May 23, 2023.**

## Facts

This case will be of particular interest to those readers with US clients who either travel internationally on a regular basis or live abroad. In this case, Taxpayer was a resident of Georgia at all relevant times during the described events. Taxpayer failed to file timely tax returns for the 2003 through 2007, 2009, and 2012 tax years. For each of these years except 2007, the IRS prepared a substitute for return under §6020(b) and later assessed the tax shown on the substitute for return with penalties and interest. Taxpayer filed a belated tax return for 2007, and the IRS assessed the amount shown on that return. The IRS also assessed frivolous tax return penalties against Taxpayer with respect to his 2005 through 2008 tax years. In an effort to collect these liabilities, the IRS levied against Taxpayer's right to receive his state income tax refunds through an automated levy process known as the State Income Tax Levy Program. These levies took place on a rolling basis from 2012 through 2018 as liabilities for various periods were assessed. On July 3, 2018, the IRS sent via certified mail to Taxpayer's last known address a notice of intent to levy with respect to his outstanding liabilities. Although the IRS received a signed return receipt three days later, Taxpayer did not request a collection due process (CDP) hearing or otherwise contest the levy (and the time for doing so has long since expired). The IRS recorded an "initial levy" transaction code with respect to each of the periods and liabilities at issue on August 31, 2018. On October 1, 2018, the IRS certified Taxpayer as an individual owing a seriously delinquent tax debt arising from tax years 2003 through 2009 and 2012. The IRS concurrently sent Taxpayer, at his last known address, a Notice CP508C, Notice of Certification of Your Seriously Delinquent Federal Tax Debt to the

State Department. At that point, Taxpayer's assessed liabilities totaled $106,346. Approximately three years later, Taxpayer petitioned the Tax Court to review the §7345 certification under §7345(e)(1). He asserted in his petition, among many things, that the Commissioner had failed to cite any authority implementing regulations for Code §7345, that a levy is restricted to salary or wages of an officer, employee, or elected official of the United States or District of Columbia, and (without evidence) that value of $10,000,000 was sent for acceptance, approval, and discharge of any debt.

## Holding

By way of background, IRC §7345 was enacted in 2018 (as part of the FAST Act) as a measure of recovering serious tax liabilities (in excess of $59,000 by an individual as of 2023) by revoking such a taxpayer's US passport or denying the application for a US passport by such a taxpayer. This is accomplished by the Commissioner of the IRS certifying to the US Secretary of State that the taxpayer has been assessed for more than $59,000 in outstanding liability ($50,000 indexed for inflation after 2016), a notice of lien had been filed, and a levy made. These provisions do not apply in cases where a settlement has been negotiated or a payment plan has been determined and is being timely followed by the taxpayer but is reserved for seriously delinquent tax debt. The Court found that as to the scope of review, there is no material dispute between the parties regarding the evidence it was required to consider. In addition, to prevail on his motion for summary judgment, the Commissioner must demonstrate that either "(i) a notice of lien has been filed and the administrative rights under §6320 with respect to such filing have been exhausted or have lapsed, or (ii) a levy is made pursuant to §6331." IRC §7345(b)(1)(C). If a certification is found to be erroneous, or if the certified debt is fully satisfied or ceases to be seriously delinquent, the IRS must reverse its certification and notify the Secretary of State and the taxpayer. Section 7345(e)(1) permits a taxpayer who has been certified as having a "seriously delinquent tax debt" to petition this Court to determine "whether the certification was erroneous or whether the [IRS] has failed to reverse the certification." If the court finds that a certification was erroneous, it "may order the Secretary [of the Treasury] to notify the Secretary of State that such certification was erroneous." IRC §7345(e)(2). The Court notes that the statute specifies no other form of relief that it may grant. The Court found that the statute's requirements had been met and that Taxpayer's arguments with respect to authoritative regulations to be frivolous and specious. The Court held that the certification of Taxpayer as owing a "seriously delinquent tax debt" was not erroneous and granted summary judgment for the IRS.

## Takeaway

It is probably safe to assume that most taxpayers are aware that their federal tax liabilities could affect their ability to travel internationally. For most of them, outstanding liabilities will never get to a point where they have to learn about it. But for those who are or become aware, this relatively new IRS tool will likely have the compliance effect intended.

# US Court of Appeals reverses District Court, stops end-run around transferee liability

**United States v. James D. Paulson et al., No. 21-55197, No. 21-55230, May 17, 2023.**

## Facts

Decedent, a California resident at the time of his death, was the founder of an internationally known private jet design and manufacture company and died in 2000 with an estate value of approximately $200 million. At the time of his death, most of Decedent's assets were held in his revocable trust, which then became irrevocable. The trust distributed all of these assets among its beneficiaries in the years following Decedent's death. Decedent's estate elected under IRC §6166 to pay a portion of the estate tax due with the timely filed federal estate tax return and to pay the balance in installments over the following 15 years. However, Decedent's estate missed several payments, and ultimately the IRS terminated the §6166 election, issuing a notice of final determination under §7479 and recording notices of federal tax lien against the estate. When the approximately $10 million deficiency went unpaid, the IRS filed an action against the beneficiaries, seeking a judgment against Decedent's estate and the trust for the outstanding tax liability. The IRS also sought judgment in District Court against the trust trustee and beneficiaries under §6324 (which provides for transferee liability) and state law. The District Court concluded that the trust trustee and beneficiaries were not liable because (1) none of the defendants were transferees of the estate and (2) the trust beneficiaries were not in possession of estate property at the time of Decedent's death. The IRS appealed to the US Court of Appeals.

## Holding

The Court reversed the decision below and ruled for the IRS. IRC §6324(a)(2) provides in pertinent part: "If the estate tax imposed . . . is not paid when due . . . then the spouse, transferee, trustee . . . or beneficiary, *who receives, or has on the date of the decedent's death,* property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of decedent's death, of such property, shall be personally liable for such tax." (Emphasis added.) The District Court interpreted this highlighted language to apply only to transferees who, on the date of decedent's death, received or already had possession of trust assets. The Court of Appeals disagreed, interpreting the language instead to apply to transferees or any others who have or receive estate property, either on the date of the decedent's death or at any time thereafter (as opposed to only on the date of death), subject to the applicable statute of limitations. The Court held that the defendant trustee and beneficiaries were within the categories of persons listed in §6324(a) when they had or received estate property and are thus liable for the unpaid estate taxes as trustees and beneficiaries. The Court also held that each defendant's liability under §6324 cannot exceed the value of the estate property at the time of decedent's death, or the value of that property at the time they received or had it as trustees and beneficiaries. It is worth noting that one of the three judges on the appellate court panel strenuously dissented, arguing that the taxpayers' reading of the statute is more plausible, avoids an illogical result (namely, that a person who receives estate property years after the estate is settled could be held personally liable for estate taxes in an amount that potentially exceeds the current value of the property received), and is a better indication of Congress's intent to impose such personal liability only on the date of the decedent's death.

## Takeaway

While the dissent makes a cogent argument, others may argue that it proves too much. If taxpayers are able easily to avoid satisfying federal estate tax liability merely by use of fully funded revocable trusts that dissipate trust assets quickly after the grantor's death, then it is foreseeable that Congress would modify transferee liability statutes to foreclose that moral hazard completely. The better lesson is that proper planning reduces interpretation risk.

# IRS limitations period on assessment of gift taxes runs from “adequate disclosure” received, Tax Court finds

**Ronald Schlapfer v. Commissioner, T.C. Memo. 2023-65, May 22, 2023.**

## Facts

Taxpayer was born in Switzerland and was transferred to the US in his employment. He has been a resident since 1979 and became a citizen in 2008. In 2006, Taxpayer applied for a life insurance policy from a Swiss insurer, insuring the lives of his mother, his aunt, and his uncle, naming himself as the owner, and himself and his spouse as the primary beneficiaries. (The purported purpose of the policy was to create a fund that his mother, aunt, and uncle could use to benefit the children of Taxpayer’s deceased brother.) Taxpayer’s four children were named as successor beneficiaries. The policy was held by a Swiss bank as custodian, which also received from Taxpayer $50,000 and 100 shares of the stock of Taxpayer’s wholly owned US company in 2006 and the initial premium was paid on August 1, 2006. Taxpayer transferred ownership of the policy in April 2007 to his mother, aunt, and uncle as joint owners. In 2012, Taxpayer enrolled in the IRS’s Offshore Voluntary Disclosure Program (OVDP). The OVDP offered US taxpayers with undisclosed income from offshore assets a compliance avenue to resolve income tax liabilities and tax information reporting obligations. In 2013, Taxpayer submitted his information disclosure package that included a US federal gift tax return for 2006 reporting a gift of foreign company stock. Taxpayer erroneously claimed that the gift was not taxable under Treas. Reg. § 25.2501-1 because it was a gift of intangible personal property from a non-domiciled foreign citizen. The IRS determined that there were no taxable gifts in 2006 because Taxpayer did not relinquish dominion and control over the policy until 2007. Because, the IRS claimed, the gifts were made in 2007 and Taxpayer failed to file a gift tax return for 2007, the IRS determined that he had not adequately disclosed the gifts. Taxpayer withdrew from the OVDP. The IRS issued a notice of gift tax deficiency in the amount of $4,429,949, and additions to tax under §6651 of $4,319,200. Taxpayer appealed to the Tax Court after which both the IRS and Taxpayer filed motions for summary judgment.

## Holding

The IRS claimed first that the taxpayer made taxable gifts of an insurance policy in 2007 but filed no timely return and is thus liable for the tax on the gifts and additions to tax that it assessed. For his part, Taxpayer claimed that the period of limitations to assess the gift tax expired before the notice of deficiency was issued because the taxpayer adequately disclosed the gifts, whenever they were made, on his 2006 gift tax return as part of the OVDP disclosure. The Court begins by noting that under IRC §6501(a) the IRS generally has three years after a gift tax return is filed to assess gift taxes attributable thereto. However, the statute also provides that the IRS may assess gift tax at any time for any gift of property, the value of which is required to be shown on a gift tax return and is not shown on such a return. This exception applies unless the gift has otherwise been “disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the [IRS] of the nature of such item.” If a gift has been adequately disclosed on the gift tax return, or a statement attached to the return, that was filed for the year the transfer occurred, then the ordinary three-year period for assessment commences upon filing. According to Treasury Regulation § 25.2511-2, this is true even if the gift disclosed is ultimately determined to be an incomplete transfer, so long as there was adequate disclosure. The Court cites existing case law to define what constitutes “adequate disclosure:” “A disclosure is `adequate’ if it is `sufficiently detailed to alert the Commissioner and his agents as to the nature of the

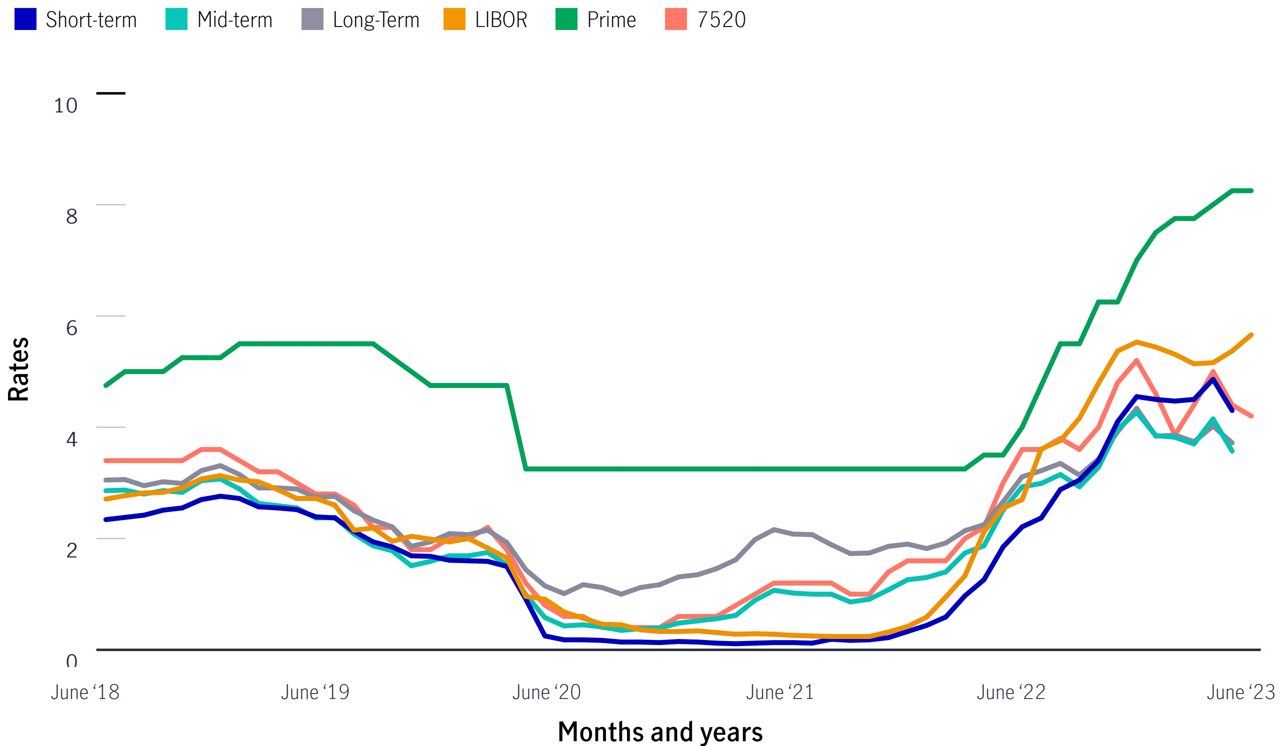
transaction so that the decision as to whether to select the return for audit may be a reasonably informed one.'" But Treasury Regulation §301.6501(c)-1(f)(2) provides that transfers reported on a gift tax return will be considered adequately disclosed if the return (or a statement attached to the return) provides the following information: (1) a description of the transferred property and any consideration received by the transferor; (2) the identities and relationship of the transferor and each transferee; (3) any transferee trust's tax identification number and a brief description of the terms of the trust; (4) the method used to determine the fair market value of property transferred, including any financial data that was utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts claimed in valuing the property....; and (5) a statement describing any position taken that is contrary to any proposed, temporary, or final Treasury regulations or revenue rulings published at the time of the transfer. Considering this authority and precedential interpretation, the Court found that Taxpayer had adequately disclosed the gift, its value, and the attendant circumstances to the IRS on his 2006 gift tax return (filed in 2013), such that the assessment time limit ran from the time of the disclosure. Thus, the 2019 notice of deficiency was outside the allowable time for gift tax assessment. Summary judgment was granted to the Taxpayer.

## Takeaway

This is a very good outcome for the Taxpayer and underscores that while required tax returns are subject to fairly strict compliance with requirements, the IRS limitations period on assessing tax is satisfied by substantial compliance. It is fair to ask whether the same outcome would have resulted outside of the OVDP, but this case now exists as citable authority.

## 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, LIBOR, Prime Rates from June 2018 – June 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 |
|---|---|---|---|---|---|---|
| **June 2023** | 4.43% | 3.56% | 3.79% | 5.66% | 8.25% | 4.20% |
| **May 2023** | 4.30% | 3.57% | 3.72% | 5.09% | 8.25% | 4.40% |

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

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