2021 FEDERAL TAX UPDATE

Recent Developments in Federal Income, Estate and Gift Taxes Affecting Individuals and Small Businesses

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These materials summarize important developments in the substantive federal income, estate and gift tax laws affecting individual taxpayers and small businesses in 2020 and 2021. The materials are organized roughly in order of significance. These materials generally do not discuss developments in the areas of deferred compensation or the taxation of business entities (except to a very limited extent).

I. INFLATION-ADJUSTED FEDERAL INCOME TAX BRACKETS FOR 2021 (Adapted from Rev. Proc. 2020-45)

Taxable Income Exceeding		Ordinary Income	Adjusted Net Cap Gain* & Qualified Dividends	Medicare Surtax on Earned Income**	Medicare Surtax on Net Investment Income
Single	Married Filing Jointly				
$0	$0	10%	0%	2.9%	0%
$9,950	$19,900	12%			
$40,400	$80,800		15%		
$40,525	$81,050	22%			
$86,375	$172,750	24%			
$164,925	*AGI over $250,000*	32%			
AGI over $200,000	$329,850			3.8%	3.8%
$209,425	$418,850	35%			
$445,850	$501,600		20%		
$523,600	$628,300	37%			

* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).

** Includes employer contribution of 1.45% (§3111(b)(6)), individual contribution of 1.45% (§3101(b)(1)), and additional tax of 0.9% for adjusted gross income over $200,000 for an unmarried individual and $250,000 on a joint return (§3101(b)(2), for years after 2012).

FEDERAL INCOME TAX RATES FOR TRUSTS AND ESTATES FOR 2021

(Adapted from Rev. Proc. 2020-45)

Taxable Income Exceeding	Ordinary Income	Adjusted Net Cap Gain* & Qualified Dividends	Medicare Surtax on Net Investment Income
$0	10%	0%	0%
$2,650	24%		
$2,700		15%	
$9,550	35%		
$13,050	37%		
$13,250		20%	3.8%

* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).

II. ADJUSTED BASIC EXCLUSION AMOUNT FOR FEDERAL WEALTH TRANSFER TAXES

The 2017 Tax Cuts and Jobs Act doubled the basic exclusion amount under §2010(c)(3) from $5 million to $10 million, with adjustments for inflation after 2011 using a new, "chained-CPI" method. The 2017 Act provides that the basic exclusion amount will revert to $5 million (adjusted for post-2011 inflation) after 2025. The estimated revenue loss from doubling of the basic exclusion amount is $83 billion over ten years.

For decedents dying in	The basic exclusion amount is
2011	$ 5,000,000
2012	$ 5,120,000
2013	$ 5,250,000
2014	$ 5,340,000
2015	$ 5,430,000
2016	$ 5,450,000
2017	$ 5,490,000
2018	$11,180,000
2019	$11,400,000
2020	$11,580,000
2021	$11,700,000

III. PANDEMIC RELIEF LEGISLATION

Congress enacted five major pieces of tax legislation intended to provide economic relief in connection with the COVID-19 pandemic. First came the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), signed by the President on March 27, 2020. Then there was the Paycheck Protection Program Flexibility Act of 2020, signed on June 5, 2020 (the "Flexibility Act"). On December 27, 2020, the President signed the Consolidated Appropriations Act of 2020 (the

"Appropriations Act"). The Appropriations Act contained, among its record-setting 5,593 pages, two pieces of tax legislation: the COVID-related Tax Relief Act of 2020 and the Taxpayer Certainty and Disaster Relief Act of 2020. Finally, on March 11, 2021, the President signed the American Rescue Plan Act of 2021 ("ARPA"). The following paragraphs summarize key income tax changes made by these Acts affecting individuals and small businesses.

A. Credits (in the Form of "Recovery Rebates") for Individuals in 2020 and 2021

Under new §6428, enacted as part of the CARES Act, "eligible individuals" received two tax credits for the first taxable year beginning in 2020. The first credit, payable in April, 2020, was in the amount of $1,200 per person ($2,400 for married couples filing a joint return if both spouses are "eligible individuals") and $500 for each "qualifying child" (using the same definition from the child tax credit). The second credit, under new §6428A, payable in early 2021 under the COVID-related Tax Relief Act of 2020, was in the amount of $600 per person ($1,200 for married couples filing a joint return if both spouses are eligible) and $600 per qualifying child. The credits are nominally in the form of a rebate.

An eligible individual is defined to mean all but two types of individuals: nonresident alien individuals and individuals "with respect to whom a deduction under section 151 is allowable to another taxpayer." Section 151 refers to the (currently suspended) deduction for personal and dependency exemptions. Since no taxpayer may claim a dependency exemption deduction in 2020, this disqualification is not entirely clear. Presumably it means to disqualify an individual who *could* have been claim as another's dependent had the deduction not been suspended. Furthermore, it is not entirely clear why Congress tied the disallowance to the dependency exemption and not directly to the definition of a "qualifying child" as is the case for the bonus rebates.

New §§6428 and 6428A also makes clear that no credits are available to estates or trusts.

Importantly, the amount of the credit phases out once the eligible individual's adjusted gross income exceeds a set threshold. Specifically, the credit is reduced by 5 percent of the amount by which the eligible individual's adjusted gross income exceeds the applicable threshold:

Unmarried	$ 75,000
Head of Household	$112,500
Married filing jointly	$150,000

Because any one taxpayer's credit amount depends on whether the taxpayer receives one or more bonus credits for each qualifying child, the amount at which the credit reduces to zero will vary.

Rebates paid in 2020 act as advance payments of the §6428 credit. The exact amount of the credit, then, is a function of a taxpayer's 2020 adjusted gross income. It would be conceivable, therefore, that a taxpayer receiving a rebate in 2020 might have to pay some of that rebate back in the form of additional 2020 tax if the taxpayer's 2020 adjusted gross income is higher than the 2019 adjusted gross income. The House version of this rule expressly required the payment of extra tax but the final version of the CARES Act and the omits express mention of the possibility of extra tax.

ARPA created a third round of "recovery rebates" in new §6428B, this one applicable to taxable years beginning in 2021. The rebate amount is $1,400 per taxpayer ($2,800 for a married couple filing jointly) and $1,400 per dependent of the taxpayer. As with the 2020 advance rebates, the credit available only to "eligible individuals," a term defined the same way as in the other Acts. The credit phases out once a taxpayer's adjusted gross income exceeds $75,000 ($150,000 for joint filers and $112,500 for heads of households) and is reduced to zero once adjusted gross income exceeds $80,000 ($160,000 for joint filers and $120,000 for heads of households).

B. Special Rules for "Coronavirus-related Distributions" from IRAs and Defined Contribution Plans in 2020

The CARES Act offered three significant benefits for "coronavirus-related distributions" from IRAs and defined contribution plans. A "coronavirus-related distribution" is any distribution made in 2020 to an individual who meets either of two tests: (1) the individual, the individual's spouse, or the individual's dependent is diagnosed with COVID-19 in a CDC-approved test; or (2) the individual "experiences adverse financial consequences as a result of being quarantined, being furloughed or laid off or having work hours reduced due to such virus or disease, being unable to work due to lack of child care due to such virus or disease, closing or reducing hours of a business owned or operated by the individual due to such virus or disease, or other factors as determined by the Secretary of the Treasury (or the Secretary's delegate)." For this purpose, plan administrators may rely on an employee's certification that the employee meets the requirements for a coronavirus-related distribution.

In *Notice 2020-50*, issued on June 19, 2020, the Service accepted the statute's invitation to identify additional individuals eligible to take a coronavirus-related distribution. The Notice states that an individual receiving a coronavirus-related distribution includes "an individual who experiences adverse financial consequences as a result of: the individual having a reduction in pay (or self-employment income) due to COVID-19 or having a job offer rescinded or start date for a job delayed due to COVID-19; the individual's spouse or a member of the individual's household being quarantined, being furloughed or laid off, or having work hours reduced due to COVID-19, being unable to work due to lack of childcare due to COVID-19, having a reduction in pay (or self-employment income) due to COVID-19, or having a job offer rescinded or start date for a job delayed due to COVID-19; or closing or reducing hours of a business owned or operated by the individual's spouse or a member of the individual's household due to COVID-19." The Notice defines a member of a household as someone who shares the same principal residence.

Notice 2020-50 also clarified that an individual may take a coronavirus-related distribution from a beneficiary IRA or from the beneficiary account of an employer-sponsored retirement plan. The Notice also identified several distributions that do not qualify as coronavirus-related distributions, including: (1) corrective distributions of elective deferrals and employee contributions returned to the employee, as well as excess elective deferrals under §402(g), excess §401(k) contributions, and excess aggregate §401(m) contributions; (2) dividends paid under §404(k); (3) costs of current life insurance protection; and (4) distributions of premiums for accident or health insurance.

Finally, *Notice 2020-50* provided that "coronavirus-related distributions are permitted without regard to the qualified individual's need for funds, and the amount of the distribution is not required to correspond to the extent of the adverse financial consequences experienced by the qualified individual."

1. No Early Distribution Penalty

Section 2202 of the CARES Act provides that §72(t) (the 10-percent penalty on early distributions from qualified plans and individual retirement accounts) does not apply to any coronavirus-related distributions up to $100,000 made in 2020.

2. Three-Year Ratable Inclusion in Gross Income

An individual receiving a coronavirus-related distribution in 2020 may elect to include the distribution in gross income for 2020 under normal rules. Absent an election, however, the default rule under the CARES Act is that any amount required to be included in gross income from a coronavirus-related distribution shall be included ratably over the three-taxable-year period beginning with the taxable year of the distribution.

Notice 2020-50 clarified that periodic payments and distributions that would have been required minimum distributions (but for the suspension of required minimum distributions, as discussed below) can be treated as coronavirus-related distributions and thus be eligible for three-year ratable gross income inclusion.

3. Three-Year Period to Recontribute

Under the CARES Act, the recipient of a coronavirus-related distribution may (but is not required to) re-contribute all or any portion of a coronavirus-related distribution back to the qualified plan or IRA during that same three-taxable-year period without regard to the typical limits on rollovers and plan contributions. *Notice 2020-50* clarified that "only a coronavirus-related distribution that is eligible for tax-free rollover treatment under §402(c), 403(a)(4), 403(b)(8), 408(d)(3), or 457(e)(16) is permitted to be recontributed to an eligible retirement plan, and that recontribution will be treated as having been made in a trustee-to-trustee transfer to that eligible retirement plan. Any coronavirus-related distribution (whether from an employer retirement plan or an IRA) paid to a qualified individual as a beneficiary of an employee or IRA owner (other than the surviving spouse of the employee or IRA owner) cannot be recontributed."

C. Suspension of Required Minimum Distributions for 2020

New §401(a)(9)(I), added by the CARES Act, provided that the so-called "minimum distribution rules" applicable to defined contribution plans and IRAs shall not apply for the 2020 calendar year. (The suspension of the minimum distribution rules does not apply to defined benefit plans or to §457 plans administered by non-governmental tax-exempt employers.) The suspension applied both to plan participants and their beneficiaries.

The suspension specifically included distributions from 2019 that would have been required by April 1, 2020, due to the participant's attaining age 70-1/2 in 2019.

A participant who already took all or part of the required minimum distribution for 2020 could re-contribute the distribution back to the IRA or defined contribution plan. This same opportunity is generally available to beneficiaries who already received part or all of the 2020 minimum distribution. The CARES Act originally contained a 60-day deadline for re-contributions, but *Notice 2020-51*, issued on June 23, 2020, provided that the deadline for re-contributions would be no earlier than August 31, 2020. The Notice also clarified that the repayment is not subject to the "one rollover per 12-month period" limit nor the restriction on rollovers for inherited IRAs.

D. Deduction for Charitable Contributions by Standard Deduction Taxpayers

1. Rules for 2020

New §62(a)(22), added under the CARES Act, provided that for 2020 only, up to $300 in "qualified charitable contributions" made by an "eligible individual" could be deducted in computing adjusted gross income. Under prior law, all charitable contributions were "below-the-line," itemized deductions; a taxpayer could only deduct charitable contributions by foregoing the standard deduction. But in 2020, up to $300 in donations could be taken "above the line" in determining adjusted gross income, meaning a taxpayer could claim both the standard deduction *and* up to $300 in charitable contributions for 2020.

New §62(f)(2), also enacted under the CARES Act, defined a qualified charitable contribution as one made in **cash** in 2020 to a public charity and not to a supporting organization or donor advised fund. It does not include carryover deduction amounts from donations made in prior years. Importantly, a qualified charitable contribution does not require any connection between the coronavirus and either the charity or the use to which the donation is put. And new §62(f)(1) defined an eligible individual as "any individual who does not elect to itemize deductions." So if the taxpayer itemizes, the entire donation is taken below the line as an itemized deduction.

The statute does not specify whether married couples filing a joint return may claim a maximum above-the-line deduction of $600 (one per spouse) or $300. The Joint Committee on Taxation explained that "[t]he $300 limit applies to the tax-filing unit. Thus, for example, married taxpayers who file a joint return and do not elect to itemize deductions are allowed to deduct up to a total of $300 in qualified charitable contributions on the joint return." Staff of the Joint Committee on Taxation, 116th Cong., 2d Sess., *Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security (CARES") Act* 22, n. 76 (April 23, 2020).

2. Rules for 2021

The Appropriations Act contains a similar rule for 2021, but with two key differences. First, while unmarried persons, heads of households, and married individuals filing separately may claim a maximum deduction of $300, married couples filing jointly may claim a maximum deduction of $600.

Second, the Appropriations Act provides that a standard deduction taxpayer may claim this deduction in addition to the standard deduction. It does not provide that the deduction is used to compute adjusted gross income. This means the deduction would still be taken in the computation of taxable income (along with the standard deduction and, if applicable, the deduction for qualified business income). Lest one think this was an oversight, note that the 2021 bonus deduction for standard deduction taxpayers is found in §170 of the Code (the provision allowing a deduction for charitable contributions) and not in §62 (the provision listing deductions allowed in the computation of adjusted gross income). This placement suggests Congress knows the deduction for 2021 is not to be taken "above the line."

In other key respects, the deduction for 2021 is the same as for 2020. Specifically, the taxpayer must make a cash contribution during the calendar year to a public charity. Carryover deductions from prior gifts will not qualify, nor will gifts to supporting organizations or donor-advised funds.

E. Other Provisions Related to the Deduction for Charitable Contributions

Under prior law, the total itemized deduction a taxpayer could claim for cash contributions in any one taxable year was limited to 60 percent of the taxpayer's "contribution base," generally defined to mean the taxpayer's adjusted gross income with some modifications. The CARES Act provides that for 2020 only, this limitation on cash contributions did not apply at all to "qualified charitable contributions," meaning an individual who itemized in 2020 could deduct qualified charitable contributions up to 100 percent of the taxpayer's contribution base.

Prior law also limited the total charitable contribution deduction for corporations generally to 10 percent of the corporation's modified taxable income. For qualifying contributions made in 2020, the limit was raised to 25 percent of the corporation's modified taxable income. No connection between the contributions and COVID-19 activities was required.

Finally, the CARES Act eased the limits in connection with contributions of food inventory made in 2020. Under prior law, the deduction was limited to 15 percent of taxable income in the case of C corporation donors and to 15 percent of the net aggregate income from all business from which the contributions were made in the case of all other taxpayers. For 2020 only, both limitations increased from 15 percent to 25 percent.

F. Expanded (and Refundable!) Child Tax Credit in 2021

ARPA makes several changes to the §24 child tax credit for 2021 only. First, the credit is **refundable**. Second, a **17 year-old** can be treated as a "qualifying child" (prior law capped the age for qualifying children to age 16). Third, the credit amount increases from $1,000 per child to **$3,000 per child** aged 6 to 17, and **$3,600 per child** aged 0 to 5. This amount is subject to a phaseout once adjusted gross income exceeds $75,000 ($150,000 for joint filers and $112,500 for heads of households). Finally, new §7527A compels Treasury to establish a program for making periodic payments of up to half of the 2021 child tax credit to qualifying taxpayers.

G. Enhanced (and Refundable!) Child and Dependent Care Tax Credit in 2021

ARPA also makes the §21 child and dependent care tax credit **refundable** for 2021 only. It further increases the maximum 2021 credit amount from $6,000 to $16,000. Finally, ARPA allows a taxpayer to claim up to 50 percent of the amounts paid for household and care services (instead of just 35 percent of such expenses).

H. Provisions Related to Health Savings Accounts

Section 223 permits eligible individuals with high-deductible health plans to deduct contributions made to health savings accounts. The CARES Act provides that for years prior to 2021, a health plan will not fail to qualify as a high-deductible health plan if the plan pays for tele-health and other **remote medical care services** without imposing a deductible, and an eligible individual will not lose status as an eligible individual just because the plan pays for such services without imposing a deductible.

Section 223 requires that a health savings account be used exclusively for paying the "qualified medical expenses" of the account beneficiary. The statute defines an account beneficiary's qualified medical expenses as amounts (not compensated for by insurance or otherwise) paid for medical care for themselves, their spouses, and their dependents. But the statute expressly excludes from the definition of qualified medical expenses amounts paid for medicine or drugs that are not prescribed. The CARES Act removes the prohibition against **nonprescription medicine or drugs** and also provides that the definition includes amounts paid for "**menstrual care products**." Menstrual care products are defined as a tampon, pad, liner, cup, sponge, or similar product used by individuals with respect to menstruation or other genital-tract secretions. These changes are effective for 2020 and beyond.

I. Provisions Related to Student Loans

The CARES Act made two important modifications impacting student loans. First, the CARES Act **suspended federal student loan payments** (both principal and interest) through September 30, 2020, without penalty to the borrower, and no interest will accrue on these loans during this period.

Second, §127 now provides that "the **payment by an employer**, whether paid to the employee or to a lender, of principal or interest on any **qualified education loan** (as defined in section 221(d)(1)) incurred by the employee for education of the employee" will be treated as an **education assistance payment** (and thus eligible for an exclusion of up to $5,250 from the employee's gross income) in the case of payments made between March 27, 2020, and December 31, 2020. To avoid a double benefit, the statute makes clear that an employee may not also claim a deduction for any student loan interest paid by an employer that is excluded under this new rule.

ARPA made an even more significant change, amending §108(f)(5) to **exclude from gross income any discharge in 2021 through 2025 of a student loan** for postsecondary education expenses. Under prior law, the exclusion was limited to cases where the loan was discharged due to death or disability. The statute limits this rule to four types of student loans, but the four types are sufficiently broad such that most student loans qualify for the exclusion.

J. Paycheck Protection Program Loans and Loan Cancelations

A signature feature of the CARES Act was the creation of Paycheck Protection Program loans. Under this initiative, any lender approved to make Small Business Administration "§7(a) loans" and certain other regulated lenders may loan up to $10 million to a small business. A business is eligible for this program if it: (1) is a small business, nonprofit organization, veterans organization, or tribal business concern with 500 or fewer employees; (2) was in operation on February 15, 2020; (3) had employees to whom it paid salaries and payroll taxes or independent contractors that it paid; and (4) was substantially impacted by the coronavirus. Sole proprietors, independent contractors and many self-employed individuals meeting these criteria are expressly eligible for a loan. Note that some small businesses with more than 500 employees can also qualify if they satisfy the definition of a "small business concern" under §3 of the Small Business Act.

Although a Paycheck Protection Program loan is intended to be used to pay compensation, such amounts should not be used to pay cash compensation to an individual employee making more than $100,000 in annual salary (but funds can be used to meet employer contributions to retirement plans benefitting such employees, to provide health insurance coverage to such employees, and to pay state and local taxes on compensation paid to such employees). Loans also should not be used to pay compensation to an employee whose principal place of residence is outside of the United States.

Importantly, the loans are nonrecourse unless the proceeds are used for an unauthorized purpose. In addition, small business owner need give no personal guarantee or collateral. During the "covered period," defined to mean February 15, 2020, through June 30, 2020, a loan shall bear interest at a rate not to exceed 4 percent, and any payments on the loan may be deferred for up to 12 months. (The SBA website states a Paycheck Protection Program loan "has a maturity of 2 years and an interest rate of 1%." It also provides that "[l]oan payments will … be deferred for six months.")

Even more importantly, a Paycheck Protection Program loan will be forgiven to the extent the proceeds are used for payroll costs, mortgage interest, rent, and utilities during the "covered period." Initially, the covered period was the eight-week period starting with the date of receipt of the loan proceeds. The Flexibility Act extended the covered period for loan forgiveness from eight weeks after the date of loan disbursement to 24 weeks after the date of loan disbursement (but not later than December 31, 2020). The 24-week period applies to all borrowers, but borrowers that received a loan before June 5, 2020, still had the option to use an eight-week period.

The Appropriations Act provided that a taxpayer could also use Paycheck Protection Program loan proceeds for four other purposes and still qualify for complete forgiveness of the loan. These additional permitted purposes are: (1) **covered operations expenditures** (costs of business software or cloud computing service, product or service delivery, processing or tracking of payroll expenses, human resources, sales and billing functions, and accounting expenses); (2) **covered property damage costs** (costs related to property damage and vandalism or looting due to public disturbances that occurred during 2020 not covered by insurance or otherwise); (3) **covered supplier costs** (costs for the supply of goods essential to business operations made pursuant to a contract in effect at any time before the covered period or, in the case of perishable goods, in effect before or at any time during the covered period); and (4) **covered worked protection expenditures** (costs to make the business compliant with public health restrictions and worker safety requirements, including air ventilation systems, sneeze guards, drive-through windows, and other measures).

The CARES Act originally provided that at least 75 percent of the loan proceeds have to be used for payroll costs in order to qualify for any forgiveness. The Flexibility Act lowered the required payroll amount to 60 percent of the loan proceeds.

Any forgiven amount will be reduced proportionally if: (1) full-time employee headcount declines compared to the prior year; or (2) the salary and wages of any employee declines by more than 25 percent of the employee's compensation from the prior year. The CARES Act originally provided that borrowers that re-hired workers previously laid off by June 30, 2020, would not be penalized for having a reduced payroll at the beginning of the period. The Flexibility Act extended the deadline to restore full-time employee headcount to December 31, 2020. The Flexibility Act also states that if a borrower can document that it was unable to rehire former employees and could not fill such positions with similarly qualified individuals, the amount of forgiveness will not be reduced. Likewise, no reduction in loan forgiveness will occur where the borrower can document that it has been unable to return to the same level of business activity as before February 15, 2020, due to compliance with requirements or guidance issued by the Department of Health and Human Services, the Centers for Disease Control and Prevention, or the Occupational Safety and Health Administration "related to the maintenance of standards for sanitation, social distancing, or any other worker or customer safety requirement related to COVID-19."

From an income tax perspective, the most important feature of the program is that **any indebtedness cancelled will not be included in the borrower's gross income**. Commentators immediately questioned whether the exclusion of debt discharge income from forgiven loans affected the ability of business owners to deduct expenses paid for with the proceeds from the forgiven loan. There are reasonable arguments in support of both answers. The argument in favor of a deduction works by analogy. Suppose a taxpayer borrows $1 million from a bank and uses the loan proceeds to pay $1 million in compensation to employees. The taxpayer can deduct the $1 million compensation paid, no questions asked. Now suppose the bank cancels the loan. We know that the taxpayer very likely has gross income under §61(a)(12) because there has been a discharge of indebtedness. But this has no effect on the taxpayer's compensation deduction. The fact that the compensation was paid for using loan proceeds that were eventually canceled does not unwind the claimed deduction.

Section 108 of the Code identifies a handful of situations where otherwise includible debt discharge income is excluded from gross income, like when the discharge occurs in a bankruptcy case or when the taxpayer is insolvent. Admittedly, §108 requires a taxpayer to "pay" for forgiveness by requiring reductions to tax attributes in a total amount equal to the amount discharged. But that atonement mechanism only applies to amounts excluded under §108. The Paycheck Protection Program exclusion is not part of §108, so there is no requirement for a taxpayer to have to reduce tax attributes at all. Even if there was, the mechanism does not serve to disallow otherwise allowable deductions like the payment of compensation. In short, because Congress does not provide for an atonement mechanism under the Paycheck Protection Program, there is no authority for denying the compensation deduction to the taxpayer.

But there's also a pretty good argument that the taxpayer should not get a deduction for the compensation paid. Section 265 of the Code prevents taxpayers from deducting expenses paid in connection with income that is exempt from tax. The theory behind this rule is that it's a double benefit for a taxpayer both to deduct compensation paid and exclude the source of the funds used to pay that compensation. This is the same provision that prevents, for example, a taxpayer from deducting premiums paid for life insurance since the death benefit is excluded under §101. Likewise, one can argue that the compensation paid to employees using Paycheck Protection Program loan proceeds is an expense incurred in connection with obtaining tax-free forgiveness of the loan and is thus an expense incurred in connection with income that is exempt from tax. Indeed, that was the reasoning of the Service in *Notice 2020-32*, issued on April 30, 2020. The Notice cited a Tax Court case from 1982 in which a taxpayer had flight-training courses 90-percent paid for by an education assistance reimbursement program operated by the Veterans Administration. Federal law provided that the payments were not includible in the taxpayer's gross income, but the taxpayer tried to deduct all of the costs for the flight-training courses. The Tax Court held that §265 applied so the costs related to the reimbursed expenses were not deductible. Using that authority, the IRS stated in the Notice that "where tax exempt income is earmarked for a specific purpose, and deductions are incurred in carrying out that purpose, section 265(a) applies because such deductions are allocable to the tax-exempt income."

The Service then followed up this guidance with *Revenue Ruling 2020-27*, issued on November 18, 2020, in which it held that:

> A taxpayer that received a covered loan guaranteed under the PPP and paid or incurred certain otherwise deductible expenses listed in section 1106(b) of the CARES Act may not deduct those expenses in the taxable year in which the expenses were paid or incurred if, at the end of such taxable year, the taxpayer reasonably expects to receive forgiveness of the covered loan on the basis of the expenses it paid or accrued during the covered period, even if the taxpayer has not submitted an application for forgiveness of the covered loan by the end of such taxable year.

But then along came the Appropriation Act, which bluntly states that "No deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied" by reason of excluding a forgiven Paycheck Protection Program loan from gross income. This specifically overrides the rule from *Revenue Ruling 2020-27* and *Notice 2020-32*. It also makes clear that S corporations and entities taxed as partnerships should treat excluded Paycheck Protection Program loan proceeds as tax-exempt income for pass-through purposes. This means owners of pass-through businesses will get to adjust the basis of their stock and partnership interests by their shares of the forgiven loan proceeds so as to preserve the tax-free treatment of the loan proceeds.

K. Changes to Rules on Loss Limits

The CARES Act eased two loss limitation rules introduced by the 2017 Tax Cuts and Jobs Act.

The first limitation related to **net operating losses**. Prior to the 2017 Act, a taxpayer could deduct net operating loss carryovers to the taxable year plus any net operating loss carrybacks to such year. The 2017 Act capped this deduction to 80 percent of taxable income (computed without regard to the net operating loss deduction). It also repealed the two-year carryback of net operating losses except in the case of certain losses incurred by farmers. Similarly, the net operating losses of a property and casualty insurance company could be carried back two years and carried forward 20 years. Finally, the 2017 Act allowed for indefinite carryforwards of net operating losses, as opposed to the 20-year limit that was in place under prior law (with the exception for property and casualty insurance companies described above).

The CARES Act provided that for net operating losses arising in 2018, 2019, and 2020, the taxpayer may carry the loss back five years, although a taxpayer may make an irrevocable election to relinquish the carryback. The CARES Act also provided that the 80 percent of taxable income cap does not apply until 2021. That means net operating loss carryovers from 2019 and earlier years would be fully deductible against 2020 income. Taxpayers that were subject to the 80 percent cap on their 2018 returns could amend the prior return to claim the additional deduction associated with repeal of the 80 percent cap.

The second limitation related to so-called "**excess business loss**." The 2017 Tax Cuts and Jobs Act introduced new §461(l), set to expire at the end of 2025, which disallows a noncorporate taxpayer's excess business loss for the taxable year and treats it as a net operating loss carryover to the next taxable year. "Excess business loss" is defined as the amount by which the taxpayer's aggregate deductions attributable to all trades or businesses exceeds the sum of the taxpayer's aggregate gross income attributable to all such trades or businesses plus $250,000 (or $500,000 in the case of joint filers).

The CARES Act effectively delayed implementation of the limitation on excess business loss until 2021. It also made some clarifying amendments, like specifying that only net capital gains are considered in computing excess business losses (and not any net capital loss) and that excess business loss is to be determined without regard to any net operating loss deduction or qualified business income deduction. The Act also changed the rule to provide that instead of treating the disallowed excess business loss as a net operating loss carryover to the next taxable year, the disallowed loss is to be treated as a net operating loss for the taxable year for purposes of determining any net operating loss carryover for subsequent taxable years. In other words, the disallowed excess business loss does not automatically carry over to the next taxable year; it does so only to the extent the disallowed excess business loss adds to (or, presumably, creates) a net operating loss.

ARPA extended the period for which the excess business loss limitation applies through 2026.

L. Eased Limitations on Deduction for Active Business Interest

The 2017 Tax Cuts and Jobs Act provided that the deduction for "business interest" in the case of a taxpayer with average annual gross receipts of $25 million or more over the past three years is limited to an amount equal to the sum of: (1) the taxpayer's "business interest income;" plus (2) 30 percent of the taxpayer's "adjusted taxable income;" plus (3) where applicable, the taxpayer's "floor plan financing interest." Any business interest not allowed as a deduction under this rule carries over the next taxable year.

The CARES Act permitted a taxpayer to increase the deduction limit from 30 percent of adjusted taxable income to 50 percent of adjusted taxable income for 2019 and 2020. Even better, a taxpayer could use the adjusted taxable income from 2019 in calculating the 2020 limitation.

M. Retroactive Treatment for Qualified Improvement Property

The 2017 Tax Cuts and Jobs Act consolidated the separate rules and depreciation limits for "qualified improvement property," "qualified leasehold improvements," "qualified restaurant property," and "qualified retail improvement property" by eliminating the last three categories so those assets generally become qualified improvement property. Section 168(e)(6) defines qualified improvement property as "any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service."

Congress intended to make qualified improvement property eligible for a 15-year recovery period instead of the normal 39-year period. This would not only speed up the timeframe for depreciation deductions but would also make qualified improvement property eligible for the 100% bonus depreciation election temporarily in effect. But Congress forgot to give qualified improvement property the shorter recovery period. Oops.

The CARES Act fixed this by technical correction, enacting a rule retroactive to 2018 that qualified improvement property qualifies for a 15-year recovery period. Thus, a taxpayer that incurred qualified improvement property costs in 2018 should amend the 2018 federal income tax return, as the deduction related to the qualified improvement property will no doubt be significantly higher.

N. Other Income Tax Changes

The Appropriations Act snuck in a number of changes to the federal income tax laws, some permanent and others temporary. Here are some of the significant changes not already discussed thus far:

1. Medical Expense Floor Permanently Set at 7.5% of Adjusted Gross Income

The Affordable Care Act raised the threshold for deducting medical expenses. Prior to 2013, an individual taxpayer could deduct medical expenses paid during the taxable year to extent they exceeded 7.5 percent of the taxpayer's adjusted gross income. Effective in 2013, taxpayers under age 65 could deduct medical expenses only to the extent they exceeded 10 percent of the taxpayer's adjusted gross income. (Taxpayers at least 65 years of age could still deduct medical expenses in excess of 7.5 percent of adjusted gross income.) Under the Tax Cuts and Jobs Act, the threshold for all taxpayers was set at 7.5 percent of adjusted gross income, but that adjustment was temporary. Under the Appropriations Act, it is now permanent.

2. Deduction for Tuition and Related Expenses Repealed but Lifetime Learning Credit Enhanced

Congress repealed the deduction for qualified tuition and related expenses while at the same time increasing the income limits applicable to phasing out the lifetime learning credit. For some middle-income taxpayers, this effectively trades a deduction for a credit.

3. Qualified Principal Residence Indebtedness

Since its introduction in 2007, Congress has routinely extended the exclusion for income from the cancelation of qualified principal residence indebtedness on a year-by-year basis. Under the Appropriations Act, the exclusion continues through 2025, but the maximum amount excludable has now been reduced from $2 million to $375,000 ($750,000 in the case of a married couple filing a joint return).

4. 100% Deduction for Business Meals

For 2021 and 2022 only, a taxpayer may deduct 100 percent of the cost of any deductible business meal furnished by a restaurant. Prior to 2021, a taxpayer could deduct, at most, 50 percent of the cost of a business meal. This change does not affect the current treatment of entertainment expenses; the costs of business entertainment remain nondeductible through 2025. Regulations under §274 finalized in October, 2020, make clear that "entertainment" does not include food or beverage unless the food or beverage is provided at (or during) an entertainment activity and the cost of the food or beverage is neither separately purchased nor separately stated from the cost of the entertainment. So if you take a client to a baseball game, the cost of the ticket is nondeductible, but the cost of a hot dog and soda at the game may be fully deductible if the hot dog and soda is furnished by a "restaurant" (a term not defined in the Appropriations Act or elsewhere in Code provisions related to entertainment expenses).

In Notice 2021-25, issued on April 8, 2021, the Service announced that for purposes of this rule, "the term 'restaurant' means a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business's premises. However, a restaurant does not include a business that primarily sells pre-packaged food or beverages not for immediate consumption, such as a grocery store; specialty food store; beer, wine, or liquor store; convenience store; newsstand; or a vending machine or kiosk." The guidance goes on to say that "an employer may not treat as a restaurant … (1) any eating facility located on the business premises of the employer and used in furnishing meals excluded from an employee's gross income under §119, or (2) any employer-operated eating facility treated as a de minimis fringe under §132(e)(2), even if such eating facility is operated by a third party under contract with the employer."

IV. I WAS TODAY YEARS OLD WHEN I LEARNED THAT CONTROLLING INTERESTS QUALIFY FOR A LACK OF CONTROL DISCOUNT (*Estate of Warne v. Commissioner*, T.C. Memo. 2021-17, February 18, 2021)

The decedent's living trust owned controlling interests in five limited liability companies, each of which owned a parcel of real estate. Specifically, the decedent's living trust owned 72.5% of one entity, 78% of another, 86.3% of a third, 87.432% of a fourth, and 100% of the fifth and final entity. With respect to that last entity, the one owned entirely by the living trust, the decedent directed that 75% of the interest in that entity pass to a foundation and the remaining 25% interest pass to a church.

In this case, the estate argued for a lack of control discount ranging from 5% to 8% based on "strong opposition and potential litigation" that would arise if the holder of a controlling interest sought to dissolve the entity. The Service argued that the lack of control discount should be no more than 2%, analogizing to closed-end mutual funds. The Tax Court rejected the Service's position, finding that the analogy to a closed-end fund would be appropriate in valuing a minority interest but not a controlling interest like the ones in the case at bar. Instead, the court applied a 4% discount, finding the risk of opposition claimed by the estate to be a tad overstated.

Before you get too excited about this 4% lack of control discount for a controlling interest, note that the court then applied a 5% marketability discount in valuing each controlling interest, a discount far more modest than what one normally sees in valuing closely-held business interests. The total blended discount, then, was a modest 8.8%.

The estate also argued that since the entire 100% interest in the fifth LLC was passing to charity (75% to a foundation, 25% to a church), the charitable deduction should completely offset the 100% value of the LLC included in the decedent's gross estate. The Tax Court rejected this argument, finding that the deduction amount for the gift to each charity is the value of what that charity receives, not the total amount that is given to all charities. In other words, the estate can deduct the (discounted) 75% interest given to the foundation and the (discounted) 25% interest given to the church, but not the value of the 100% interest in the LLC. Because the two fractional interest gifts are subject to greater discounts, this means the estate will still be taxed on some portion of the interest in the LLC. If the decedent had a mulligan, the decedent might have left the entire interest to the foundation (thus allowing for a complete deduction) and then the foundation could give a 25% interest to the church.

V. THE WAY YOU MAKE ME FEEL AFFECTS THE VALUE OF YOUR IMAGE AND LIKENESS (*Estate of Michael Jackson v. Commissioner*, T.C. Memo. 2021-48, May 3, 2021)

The decedent was at one time the King of Pop. His 1982 album, *Thriller*, remains the best-selling album of all time. But by the time of his death in 2009, the decedent had been tried for child sexual abuse. Although acquitted, the decedent became reclusive and moved to Bahrain. His eccentric habits had become fodder for many late-night talk shows and gossip magazines. And there were persistent rumors of bad finances and poor health.

It turns out the rumors of financial woes had legs. Back in 1985, the decedent purchased ATV Music, a song catalog that included all of the songs written by John Lennon and Paul McCartney. Ten years later, the decedent merged ATV Music with Sony Music Publishing to create Sony/ATV, a music catalog and publisher. The decedent held a 50% interest in Sony/ATV, but the decedent started borrowing heavily against this asset in order to maintain his profligate lifestyle.

At issue in this case is the valuation of three assets: (1) the decedent's image and likeness (his "right of publicity"); (2) the decedent's interest in the bankruptcy trust holding his 50% interest in Sony/ATV; and (3) the decedent's interest in a different bankruptcy trust holding Mijac Music, another publishing catalog that owned rights to the songs of the decedent and a few other artists. Though only three assets are at issue, the Tax Court opinion spans 271 pages. That gives some insight into the dollars involved, the notoriety of the case, and the extent to which the estate and the Service disagree.

Right of Publicity. The federal estate tax return valued the decedent's image and likeness at $2,105. But in its deficiency notice, the Service set the value at $434 million. At trial, the estate's experts (a CEO of an international licensing and right-management company for entertainers and a professional appraiser with 40 years of experience) determined the value of the decedent's image and likeness to be $3 million, but the Service's expert concluded the correct value was $161 million. Why are the experts so far apart? The estate's experts noted that the revenues generated from the decedent's image and likeness around the time of death were quite modest given the public reaction to allegations of conduct involving moral turpitude. At the time of the decedent's death, then, the rights to image and likeness just weren't worth very much. The Service's expert, on the other hand, valued the right of publicity based on foreseeable revenue opportunities that existed at death, including themed attractions, branded merchandise, a Cirque du Soleil show, a film, and a Broadway musical.

The Tax Court rejected the approach of the Service's expert, finding the expert "did not value the asset he should have." California law does not include trademarks, copyrights, licensing rights, and endorsement rights within its statutory right of publicity, so considering these other post-death revenue opportunities was improper. In the end, the Tax Court determined that the value of the decedent's image and likeness was $4.15 million, a figure much closer to the valuation offered by the estate's experts.

Interest in Sony/ATV. The estate tax return claimed the decedent's interest in Sony/ATV was worth nothing because of all of the decedent's outstanding loans secured by this asset. The estate's expert, the head of the Media and Entertainment team in Ernst & Young's United Kingdom practice, agreed with this conclusion. Yes, the decedent's share of Sony/ATV's equity was worth over $250 million, but the decedent owed more than $316 million in loans secured by this asset. The Service's expert, however, insisted that the decedent's interest was worth

$206 million (although that is less than half of the $469 million valuation initially determined by the Service). The Tax Court held that the interest was worth zero because the trust's liabilities exceeded its assets by nearly $89 million.

Interest in Mijac Music. To value the interest in the Mijac Music catalog, the estate produced yet another expert, an appraiser with over 20 years of experience in valuing high-profile music catalogs. This expert valued the interest at $2.3 million, a figure quite close to the $2.2 million value originally reported by the estate on the federal estate tax return. But the Service said in its deficiency notice that the asset was worth $60.6 million, and by the time the Service's expert was through the alleged value was up to $114 million.

One adjustment made by the estate's expert was for "tax affecting." Since the trust is a passthrough entity, its projected revenues will not account for federal income taxes. But the rates used to determine the present value of projected revenues are derived from publicly available data from C corporations. Since C corporations are separate taxable entities, those discount rates already reflect federal income taxes. This leads some to conclude that the projected revenues of passthrough entities should be reduced to after-tax amounts so that the discount rates can be applied accurately. This is the argument for "tax affecting" the projected revenues of a passthrough entity. In this case, the Tax Court held that tax affecting was not proper. Although the Tax Court applied tax affecting to an S corporation in the 2019 case of *Estate of Jones v. Commissioner*, the court here observes that the *Jones* court had no choice but to apply tax affecting since the Service in that case did not challenge its application. Because the estate could not show by a preponderance of the evidence that a C corporation would be the most likely buyer of this asset, the court rejected tax affecting in this case.

The court went on to hold that the interest in the Mijac Music catalog was $107.3 million, devoting dozens of pages to parsing through the various assets of the catalog and its projected revenue sources.

Penalties. Given the ginormous gap in valuation between the estate tax return and the Service's deficiency notice, the Service imposed accuracy-related penalties totaling nearly $200 million. But the Tax Court refused to uphold the penalty, finding the estate reasonably relied in good faith on the early valuations used in preparing the estate tax return, especially once it learned of the little revenue the decedent earned from the use of his name and likeness. The court observed that, as its lengthy opinion indicates, valuing Mijac Music was complicated. Although the court ultimately rejected the value offered from the estate's expert, it was again reasonable for the estate to rely on it.

A Note on Credibility. The estate offered opinions from four valuation experts, but the Service used just one. That's quite a gamble, because if the court does not like the Service's expert, there is no other evidence to support the expert's conclusions. And from this excerpt of the opinion, it's clear that the court did not like the Service's expert, one Mr. Anson:

> As the Commissioner's only expert witness, Anson's credibility was an especially important part of the case. And it suffered greatly at trial. His problems began when he was asked about the effect on himself and his firm if the Commissioner prevailed in the case. He responded: "I have no idea. I've never worked for the Internal Revenue Service before." Later when asked whether he or his firm had previously been retained by the Commissioner to write an intellectual-property valuation report in Whitney Houston's estate-tax case, Anson replied: "No. Absolutely not." That was a lie.
>
> Approximately two years before he testified, the Commissioner had retained Anson to write a valuation report titled, "Analysis of the Fair Market Value of the Intangible Property Rights Held by the Estate of Whitney E. Houston as of February 11, 2012, for Estate Tax Purposes." It was only after a recess and advice from the Commissioner's counsel that Anson admitted to this.
>
> Anson also testified that neither he nor his firm ever advertised to promote business. This was also a lie. In the midst of trial, Anson's firm touted his testimony in ... [an] email blast ... And in a lecture given before trial Anson referred to his valuation in this case, stating, "I'm sitting today ... in a deposition in what's known as the 'Billion Dollar Tax Case.' ... [W]e've just spent the last year valuing the estate of Michael Jackson."

The court denied the estate's request to strike all of Mr. Anson's testimony, but the court confessed that his lying "affects our factfinding throughout." That's … not a good look.

VI. SPLIT-DOLLAR PLAN FOR SHAREHOLDER-EMPLOYEE IS COMPENSATION, NOT A DIVIDEND (*De los Santos v. Commissioner*, 156 T.C. No. 9, April 12, 2021)

During the taxable years at issue (2011 and 2012), Ruben was the sole shareholder of an S corporation that employed him and his spouse, Martha. The corporation adopted a split-dollar life insurance plan that for the benefit of Ruben, Martha, and four other employees. Ruben and Martha did not report any gross income from their participation in the split-dollar arrangement.

In its notice of deficiency, the Service determined that the benefits from the split-dollar arrangement were taxable to Ruben and Martha as compensation (i.e., as ordinary income). But Ruben and Martha marched to Tax Court, arguing that because Ruben is the sole shareholder of the corporation, the economic benefits he realized from the arrangement should instead be treated as a dividend distribution and, thus, taxed at the preferential rates applicable to qualified dividend income. Ruben and Martha cited Regulation §1.301-1(q)(1)(i), which states that "The provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement ... is treated as a distribution of property." They claim the regulation requires dividend treatment (not compensation treatment) no matter whether the taxpayer receives the benefits of the split-dollar arrangement in the capacity as an employee or as a shareholder.

Their argument is consistent with the Sixth Circuit's opinion in *Machacek v. Commissioner*, 906 F.3d 429 (6th Cir. 2018), a case that reversed a Tax Court memorandum decision from 2016. But the Tax Court stuck to its guns in a unanimous reviewed opinion. The court reasoned that because the compensatory split-dollar life insurance arrangement in this case afforded benefits to Ruben in his capacity as an employee of the corporation, the benefits simply may not be characterized as a distribution by a corporation to a shareholder "with respect to its stock." Moreover, reasoned the court, for purposes of taxing employee fringe benefits, Ruben is a 2-percent shareholder, meaning he is treated as a partner of a partnership. That in turn means that the economic benefits he realized from the arrangement are taxable under §707(c) as "guaranteed payments" (and thus as ordinary income). So under either approach, Ruben has ordinary income.

VII. FORMULA GIFT CLAUSES STILL WORK, JUST NOT THIS ONE (*Nelson v. Commissioner*, T.C. Memo. 2020-81, June 10, 2020).

When making inter-vivos gifts, some taxpayers want to make full use of the federal gift tax annual exclusion and/or the applicable exclusion amount. When the gifted property is difficult to value—like fractional interests in real estate, works of art, or interests in closely-held businesses—there is a risk that a gift intended not to trigger gift tax liability might do so if the Service successfully asserts that the value of the gifted property is higher than the value claimed by the taxpayer. But in *Wandry v. Commissioner*, T.C. Memo. 2012-88, the Tax Court approved the use of a gifting formula that made reference to the *value* of the gifted property rather than the property itself. In that case, the taxpayers gave interests in a limited liability company to their children and grandchildren according to a formula that read as follows:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units [in the LLC] so that the fair market value of such Units for federal gift tax purposes shall be as follows:

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	261,000
Jason K. Wandry	261,000
Jared S. Wandry	261,000
Grandchild A	11,000
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000
Grandchild E	11,000
	1,099,000

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

The Service argued that the language created an invalid savings clause, but the court upheld the language as a valid formula clause. Practitioners have relied on *Wandry* in utilizing similar formula gift clauses to minimize the risk of liability for gift tax based on a valuation adjustment.

In this case, the taxpayers, a married couple, created a limited partnership that owned a 27-percent in a closely-held equipment business and about $675,000 in investment assets. They were the 1-pecrent general partners and Mrs. Nelson owned a nearly 94-percent limited partner interest. The remaining interests were held by UTMA accounts and trusts established for their children. On December 31, 2008, Mrs. Nelson signed an assignment instrument stating that she:

> * * * desires to make a gift and assign to *** [a trust for the benefit of herself and her daughters] her right, title, and interest in a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 * * *, as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment.

On January 2, 2009, she then sold "a limited partner interest having a fair market value of TWENTY MILLION AND NO/100THS DOLLARS ($20,000,000.00) as of January 2, 2009 * * *, as determined by a qualified appraiser within one hundred eighty (180) days of the effective date of this Assignment." A subsequent appraisal determined the value of a 1-percent limited partner interest was $341,000. If the formulas in the gift and sale documents worked, that meant Mrs. Nelson gifted a 6.14-percent limited partner interest and sold a 58.65-percent limited partner interest. The partnership then recorded transfers of percentage interests consistent with the appraisal.

On their 2008 federal gift tax returns, the taxpayers split Mrs. Nelson's gift, meaning each had gifted $1,048,000, an amount that utilized (but did not exceed) four annual exclusions and the applicable exclusion amount. In 2013, the Service determined that the value of each gift was $1,761,009, not $1,048,000. The Service also determined that the property transferred in the $20 million sale was really worth just over $33.6 million, meaning each taxpayer had made a 2009 gift of just over $6.8 million.

The taxpayers argued that the language in their assignment documents used valid formula clauses consistent with that approved in *Wandry*, but the Tax Court observed that the gifted and sold interests "are expressed in the transfer instruments as an interest having a fair market value of a specified amount as determined by an appraiser within a fixed period. The clauses hang on the determination by an appraiser within a fixed period; value is not qualified further, for example, as that determined for Federal estate tax purposes." So because the transfers were based on the value as determined by the appraisal and not on the finally determined gift tax value, the taxpayers were stuck with the percentage interests reflected on the gift tax return. The Tax Court then went on to address the value of the transferred interests, holding that the taxpayers made combined gifts of about $2.5 million in 2008 and about $4.1 million in 2009. From the perspective of the taxpayers, this was a better result than the Service's initial determination, but the result likely still stings.

If they had a mulligan, one suspects the taxpayers would omit the "as determined by a qualified appraisal…" clauses from the gift and sale instruments. Indeed, had there been transfers simply of interests with a fixed "fair market value" or a fixed "fair market value as finally determined for federal gift tax purposes," the results likely would have been different. In the end, then, this case signals that well-drafted formula gift clauses still work.

VIII. AN OPINION TEN YEARS IN THE MAKING THAT TAKES ALMOST THAT LONG TO EXPLAIN (*Estate of Moore v. Commissioner*, T.C. Memo. 2020-40, April 7, 2020)

The decedent may have had an eighth-grade education, but he had a Ph.D. in grit. Starting work as a land leveler and often paid with the land he leveled, the decedent started a farming operation that became quite successful. In September 2004, at the age of 88, the decedent began negotiating the sale of his farm. In December, with negotiations still underway, the decedent suffered a heart attack so severe that a doctor feared he had only months to live. At that time, the decedent began more aggressive estate planning.

Acting on the advice of counsel, the decedent established three trusts and a family limited partnership. The first trust was a standard revocable living trust, to which the decedent transferred all of his real property and intangible personal property. The living trust provided that upon the decedent's death, property remaining after the payment of debts and expenses would be allocated between a charitable lead annuity trust (CLAT) and a trust for the benefit of the decedent's four children. The share allocable to the CLAT was defined as "the smallest amount which … will result in the least possible federal estate tax being payable as a result of my death after allowing for the applicable exclusion amount … as finally determined for federal estate tax purposes." The balance would pass to the trust for the children. Why a CLAT? It looks like the decedent saw the CLAT as a route to rebuild relations between his children. Because the beneficiary of the CLAT was a foundation established by the decedent, the decedent hoped this gift would force the children, as the foundation's directors, to meet periodically and make decisions about what charities best promote the values of the family.

The second trust was an irrevocable "family management trust" for the benefit of the decedent. It named two of the children as trustees. The management trust was designed solely to be the 1-percent general partner of the family limited partnership. Speaking of which, let's talk about that partnership. Funded with an initial combined contribution of $10,000, the partnership started with six partners: the management trust (the 1-percent general partner), the living trust (a 95-percent limited partner), and each of the decedent's four children (each a 1-percent limited partner). The living trust then contributed a four-fifths interest (not 80-percent, mind you, but four-fifths) in the farmland to the partnership. Testimony from the children revealed that the purpose of the partnership was to "protect against liabilities, creditors, and bad marriages." Apparently, there was a perceived risk from the use of pesticides. The kids also testified that the partnership was also designed to help bring the family together. The partnership agreement required unanimous consent from all partners for the transfer of any partnership interest.

The third trust was an irrevocable trust for the benefit of the decedent's children. The decedent did not retain any direct beneficial interest in the trust or control over its assets, but the trust instrument did instruct the trustee to "distribute an amount equal to the value of any asset of this trust which is includible in [the decedent's] gross estate for federal estate tax purposes" to the living trust. Thus, this distribution would happen only if the Service successfully determined that at least some portion of this trust's assets was includible in the decedent's gross estate.

Within five days of the transfer of the four-fifths interest to the partnership, the farmland was under contract at a purchase price of just over $16.5 million. The decedent alone completed negotiations and signed the deal. The sale closed in February of 2005. Following the sale, the decedent continued to live on the property *and operate the farm*. When cash payments from the sale started coming in, the decedent paid $220,000 in legal fees to the lawyer who designed this structure, 80-percent of which came from the partnership and 20-percent of which came from the trust. In addition, the decedent had the partnership pay $500,000 to each child in exchange for a promissory note requiring repayment (plus 3.6 percent annual interest) five years later. None of the children ever made payments on these notes; indeed the lawyer who designed the transactions specifically told them no payments were required. Finally, the decedent directed the partnership to pay $2 million to the living trust, all but $144,000 of which was used to pay the decedent's federal and state income taxes in connection with the sale of the farm. Days later, the decedent gifted $500,000 cash from the living trust to the irrevocable trust.

In March of 2005, the living trust sold its entire limited partner interest to the irrevocable trust for $500,000 cash and a promissory note in the amount of $4.8 million. The note required the payment of annual interest at 4.5 percent and a balloon payment of principal five years later.

The decedent died about three weeks later. The living trust paid many of the decedent's final expenses, including another $475,000 to the lawyer for administration of the estate.

The decedent's federal estate tax return included the management trust's 1-percent interest in the partnership and the $4.8 million note from the irrevocable trust. The return claimed a $4.8 million charitable contribution deduction for the amount passing to the CLAT and a $475,000 deduction for the attorney fees in administration. The estate also filed a federal gift return for 2005 that reported the gift of the $500,000 to the irrevocable trust as four gifts of $125,000 to each child.

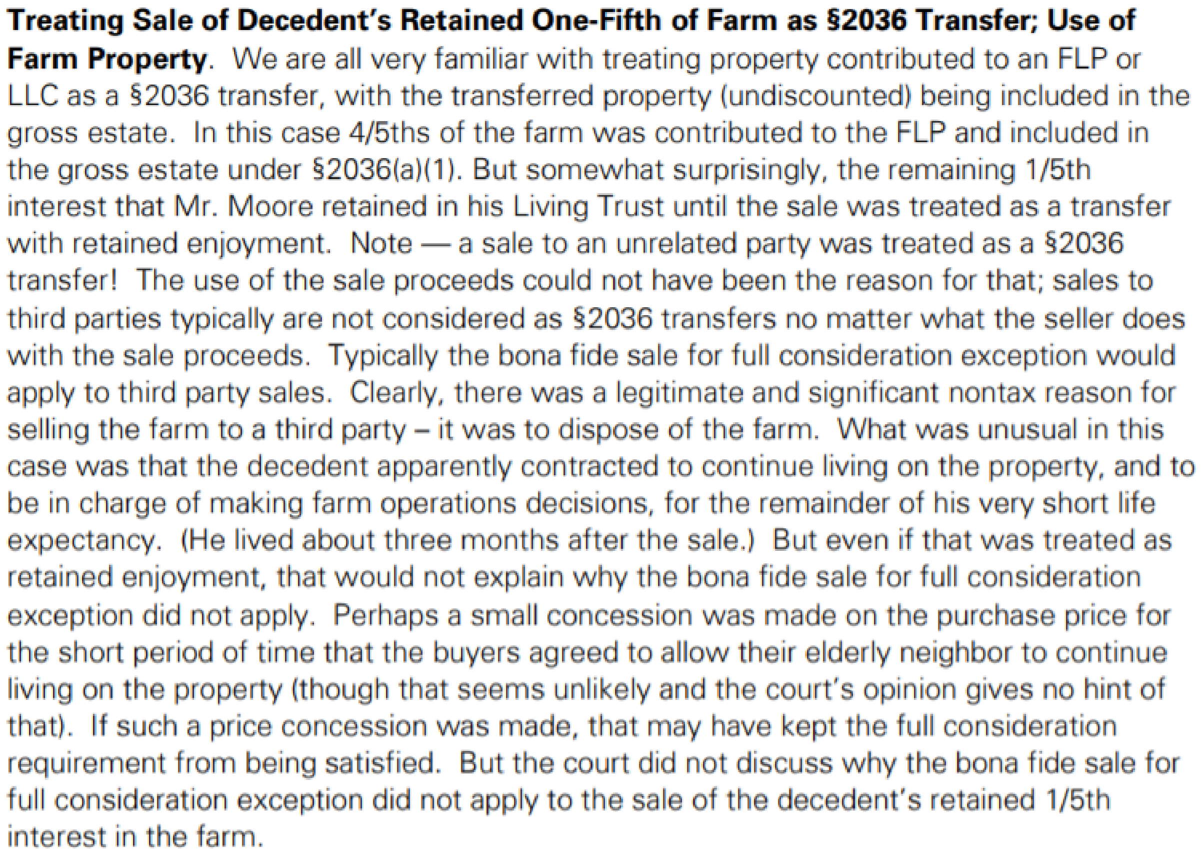
When the IRS determined an estate tax deficiency of almost $6.4 million and a gift tax deficiency of more than $1.3 million, the estate ran to Tax Court. The court determined it had to answer five questions:

1. Does §2036 require inclusion of the value of the farm in the decedent's gross estate even though it was sold through the partnership prior to his death? The court held that §2036 did require inclusion of the full value of the farmland. The court concluded the transfer of the four-fifths interest in the land to the partnership was not a bona fide sale because there was no legitimate and significant nontax reason for the creation of the partnership and the transfer of assets to it. The court rejected the proffered reasons for the entity's formation, finding that since there was no business for the family to run, "building family harmony" was a bogus justification for the arrangement. It also rejected the claim that the partnership protected against creditors since there was no credible evidence that anyone in the family had a legitimate concern as to possible creditor claims. The fact that all of this planning occurred following the decedent's heart attack "strongly supports a finding that the [partnership] was … part of an attempt to avoid federal gift and estate taxes." The court also did not like the fact that the decedent ran the whole show without input from other family members:

> We also can't ignore the testamentary essence of the whole plan. This was very far from a deal, even a deal within a family: There was no bargaining, no negotiating, not even any questioning. Instead, Moore unilaterally set up the [partnership]. He alone created the restrictions in the [partnership] agreement. None of Moore's children sought legal advice on the terms or so much as negotiated their percentage of shares. Moore's children each joined the [partnership] because Moore told them to--they did not have their own reasons. Moore's unilateral decision making tends to contradict any assertion of a bona fide sale.

Moreover, reasoned the court, the decedent retained possession and enjoyment of the farm after the transfer to the partnership (not to mention after the sale to the unrelated buyer). The decedent "continued to live on the property and continued to operate [the farm] as his own—he made all the decisions." Furthermore, the decedent "scooped into [partnership] assets to pay personal expenses" like the distribution to the living trust to pay federal and state income taxes and the distributions made to the children. The fact that two kids were trustees of the management trust made no difference, for the children "typically did things because [the decedent] asked them to, and giving them nominal 'power' was no different from [the decedent's] keeping that power."

It is interesting to note that the court required gross estate inclusion of the full value of the farmland and not just the four-fifths portion transferred to the partnership. Steve Akers and Ron Aucutt explain:



> **Treating Sale of Decedent's Retained One-Fifth of Farm as §2036 Transfer; Use of Farm Property**. We are all very familiar with treating property contributed to an FLP or LLC as a §2036 transfer, with the transferred property (undiscounted) being included in the gross estate. In this case 4/5ths of the farm was contributed to the FLP and included in the gross estate under §2036(a)(1). But somewhat surprisingly, the remaining 1/5th interest that Mr. Moore retained in his Living Trust until the sale was treated as a transfer with retained enjoyment. Note — a sale to an unrelated party was treated as a §2036 transfer! The use of the sale proceeds could not have been the reason for that; sales to third parties typically are not considered as §2036 transfers no matter what the seller does with the sale proceeds. Typically the bona fide sale for full consideration exception would apply to third party sales. Clearly, there was a legitimate and significant nontax reason for selling the farm to a third party – it was to dispose of the farm. What was unusual in this case was that the decedent apparently contracted to continue living on the property, and to be in charge of making farm operations decisions, for the remainder of his very short life expectancy. (He lived about three months after the sale.) But even if that was treated as retained enjoyment, that would not explain why the bona fide sale for full consideration exception did not apply. Perhaps a small concession was made on the purchase price for the short period of time that the buyers agreed to allow their elderly neighbor to continue living on the property (though that seems unlikely and the court's opinion gives no hint of that). If such a price concession was made, that may have kept the full consideration requirement from being satisfied. But the court did not discuss why the bona fide sale for full consideration exception did not apply to the sale of the decedent's retained 1/5th interest in the farm.

Steve R. Akers and Ronald D. Aucutt, *Estate of Howard Moore v. Commissioner, T.C. Memo. 2020-40*, Bessemer Trust Advisor Insights (April 2020) at 12.

2. Did the living trust's transfer of its limited partnership interest to the irrevocable trust do anything to remove the value of the farm from the decedent's gross estate? Section 2043(a) requires the value of property included in the gross estate by §2036 to be reduced by "the value of the consideration received therefor by the decedent." The court stated the operation of §2043(a) in formula form, which can be simplified even further to this:

Fair market value of the property included under §2036
Plus Date-of-death value of consideration received by decedent remaining in the gross estate
Minus Consideration received by decedent at the time of transfer
Equals Amount included in gross estate

The court holds that the fair market value of the property included under §2036 is the same as the sale price to the unrelated buyer given the sale occurred so close to death. The court then holds that the "consideration received by decedent at the time of transfer" is both the one-fifth value of the farm and the value of the decedent's partnership interest following the transfer of the four-fifths interest of the land to the partnership. Because there was such little time between the transfer and the decedent's death, though, the only difference between the consideration received at the time of transfer and the consideration remaining at death would be reflected in amounts paid by the living trust between the date of sale and the date of death. So the court ultimately simplified the formula even further:

Fair market value of the property included under §2036
Minus Money that left the estate between the date of sale and the date of death
Equals Amount included in gross estate

The court then left it to the parties to figure out the exact numbers, noting only that "We have no doubt that computations will be difficult."

3. May the estate claim a charitable contribution deduction for the amount the irrevocable trust might have to pay to the living trust in the future? Remember—though it was pages ago—the irrevocable trust is supposed to reimburse the living trust for any extra estate tax due as a result of the inclusion of the irrevocable trust's assets in the decedent's gross estate. The estate says that this provision has been triggered now that the court has held the farmland includible in the decedent's gross estate. And since a portion of the reimbursement from the irrevocable trust will be allocated to the CLAT, the estate wants a charitable contribution deduction for that amount.

The Tax Court rejected this argument, observing that the reimbursement clause is triggered only where an asset of the irrevocable trust is included in the decedent's gross estate—yet the farmland was not an asset of the irrevocable trust. But there's a bigger problem, notes the court: it is well established that an estate may not claim a deduction for a donation that turns upon the action of a beneficiary or fiduciary. The charitable donation must be made "by the decedent during his lifetime or by will," which was not the case here. Whether the irrevocable trust makes a transfer to the living trust and thus to the CLAT is not ascertainable at the decedent's death. It requires a successful determination by the IRS that more tax is due. The estate tried to argue that this was a charitable formula clause that has been approved in other cases, but the court easily distinguished a valid formula clause that gives some fixed transfer of unknown value to charity from the clause at issue here which gives a transfer to charity only upon the occurrence of a condition subsequent.

4. May the estate deduct the $475,000 in attorney fees? To be deductible, fees for administration must be reasonable. Here, there was a flat fee. There was never an accounting by the lawyer as to the time spent or the nature of the work performed in administration. At trial, the lawyer vaguely testified that "his work continues to this day." There was no evidence

of claims that would have to be settled in administration, and so much of the estate was already held by the living trust. "Absent any evidence that [the] fees were necessarily incurred in the administration of the estate, or if they were, why they were so high, we won' allow the estate to deduct them."

5. Were the $500,000 transfers made by the decedent to each child gifts or loans? The court initially says this issue does not matter much. "If the transfers were gifts, they would fall out of [the decedent's] gross estate but would still be subject to gift tax. If they were true loans, they would be assets of the estate subject to estate tax, but not gift tax." But the court goes on to hold that "more likely than not … these were gifts." The notes were unsecured and had no payment schedules, the kids never paid any interest, and there was no evidence the kids had the resources to repay the loans. Accordingly, the Service was right to treat these transfers as additional gifts. Moreover, because those gifts were made within three years of death, and gift tax paid on those gifts will be included in the decedent's gross estate under §2035(b).

Ultimately, then, the near-death planning did not work. What could have saved this plan, besides the decedent living longer? It likely would have helped if the decedent did not control every aspect of the land and its operations following the transfers. Legitimate partnership meetings and prudent decisions made by the trustees of the management trust would have helped. It certainly would have helped for the decedent to pay rent for the right to occupy the farm, and if the decedent wanted to keep farming it perhaps he should have done so as a salaried employee under an employment agreement negotiated at arms' length.

IX. DECEDENT'S REVOCABLE TRUST WAS A SUBSTITUTE LIMITED PARTNER AND NO MERE ASSIGNEE (*Estate of Streightoff v. Commissioner*, 5th Circuit, March 31, 2020).

Acting under a power of attorney, the decedent's daughter formed a Texas limited partnership. The general partner was a limited liability company managed by the daughter, and the limited partners were the decedent, his children, and an ex-daughter-in-law (she and the kids took their interests by gifts from the decedent). The partnership was funded in 2008 with marketable securities and fixed-income investment assets. On the same day, the decedent created a revocable living trust that named the daughter as sole trustee. The daughter then transferred the decedent's 88.99% limited partner interest to the trust.

The decedent died in 2011. The estate's federal estate tax return reported the partnership interest and valued it at nearly $4.59 million using the alternate valuation date election and applying a 37.2% blended discount for lack of marketability, control, and liquidity. The Service determined that the discount should have been limited to 18% instead, thus leading to a deficiency just under $500,000 that's at the heart of this case.

At the Tax Court, the estate took the position that the decedent's interest should be valued as an *assignee* interest rather than as a *limited partner* interest. Texas law provides that the assignee of a limited partner interest is entitled to distributions but cannot become or exercise the rights and powers of a partner. Texas law also states an assignee has no rights to information or accountings from the partnership. According to the estate, this justifies a larger discount. The Tax Court rejected this argument, finding that the interest transferred in this case was not a mere assignee interest. The partnership agreement provided that an assignee could become a substitute limited partner if (1) the general partner consents to the transferee's admission, (2) the transferee acquires the interest by means of a permitted transfer, and (3) the transferee agrees to be bound by the partnership agreement. The court observed that all three requirements were met here: the daughter signed the agreement as manager of the LLC-general partner, thus consenting to its terms, and the daughter, as trustee of the revocable trust, signed the assignment document which specifically stated that the trust agreed to abide by the terms of the partnership agreement. Thus the revocable trust was a limited partner and not a mere assignee.

The Tax Court then held that there should be no discount for lack of control since the decedent's 88.99% interest was sufficient to remove the general partner and, thus, dissolve the partnership. As to the marketability discount, the court adopted the analysis of the Service's expert concluding an 18% discount was appropriate.

On appeal, the Fifth Circuit affirmed the analysis of the Tax Court. It also observed that in this particular case there was no real difference between being an assignee and being a substitute limited partner. "Other than [the decedent's daughter], there is no record of [the partnership's] limited partners, the decedent's children, exercising their partnership rights or responsibilities. For example, this partnership held no meetings or votes, nor was there any attempt to remove [the general partner]. Without genuine nontax circumstances present, the Assignment is the functional equivalent of a transfer of limited partnership interest." The estate also argued that the deficiency notice was defective for inadequate notice of the reason for deficiency, but the Fifth Circuit rejected the argument, citing precedent that the notice need only inform the taxpayer that a deficiency exists and the amount of the deficiency.

X. PROPOSED REGULATIONS CLARIFY ITEMIZED DEDUCTIONS FOR ESTATES AND TRUSTS (Proposed Regulation §§1.67-4 and 1.642(h)-2, May 11, 2020)

Section 67(g), added by the 2017 Tax Cuts and Jobs Act, prohibits individuals from taking "miscellaneous itemized deductions" until 2026. Section 67(e), in effect before the 2017 Tax Cuts and Jobs Act, provides that deductions for costs paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such estate or trust are to be treated as above-the-line deductions and not as itemized deductions or miscellaneous itemized deductions. Section 67(e) likewise treats the deductions allowable under §642(b) (the personal exemption of an estate or nongrantor trust) and §§651 and 661 (the deductions for trust distributions of current and accumulated income) as above-the-line deductions.

Treasury has now issued proposed regulations clarifying that §67(g) does not affect the above-the-line status of the deductions described in §67(e) for an estate or nongrantor trust, including the so-called "S portion" of an electing small business trust. The proposed regulations expressly provide that such deductions are not “miscellaneous itemized deductions” and thus not suspended for estates and nongrantor trusts. They also make clear, however, that costs paid by estates and nongrantor trusts that “commonly or customarily would be incurred by a hypothetical individual holding the same property” are treated as “miscellaneous itemized deductions” and would be subject to §67(a)

At the same time, Treasury issued proposed regulations under §642(h). That section provides that if an estate or trust has, upon its termination: (1) a net operating loss carryover; (2) a capital loss carryover; or (3) deductions (other than the personal exemption and charitable contributions) in excess of gross income for its last year, then such carryover or excess shall be allowed as a deduction to the beneficiaries receiving the assets of the estate or trust at termination. Preexisting regulations make clear that the beneficiaries can take “inherited” NOL and capital loss carryovers as above-the-line deductions.

But preexisting regulations also state that the excess deductions upon termination of an estate or trust are treated as a single miscellaneous itemized deduction of the beneficiary, and thus are subject to temporary disallowance under §67(g). That’s not entirely fair, though, because this single deduction can theoretically consist of many different expenses that would otherwise be above-the-line deductions, regular itemized deductions, and miscellaneous itemized deductions. Accordingly, the proposed regulations offer a new regime under which each deduction comprising the §642(h)(2) excess deduction retains its separate character as either an above-the-line deduction, a regular itemized deduction, or a miscellaneous itemized deduction. The proposed regulations require that a fiduciary separately identify deductions that may be limited when claimed by the beneficiary as provided in the instructions to the Form 1041*. The proposed regulations also explain how the new separation regime works where* deductions are not directly attributable to a specific class of income, together with a new example.

The proposed regulations will apply to taxable years beginning after the date they are finalized, but estates, nongrantor trusts, and their beneficiaries may rely on the proposed regulations for taxable years beginning after 2017.

XI. DON’T LEAVE BLANK BLANKS IN AN APPRAISAL SUMMARY (*Loube v. Commissioner*, T.C. Memo. 2020-3, January 8, 2020)

In 2013, the taxpayers, a married couple, purchased a single-family home in Potomac, Maryland. They planned to demolish the existing home and build their dream house in its place. About two weeks after buying the property, the taxpayers donated the existing improvements, buildings, and fixtures on the land to Second Chance, Inc., a charitable organization dedicated to teaching marketable skills to persons facing barriers to employment through the deconstruction of homes and buildings. The taxpayers also agreed to donate $27,500 to Second Chance to cover the costs of deconstruction.

The taxpayers obtained an appraisal of the property that estimated the value of the deconstructed house to be $297,000. Accordingly, on their 2013 joint return, the taxpayers claimed a noncash charitable contribution deduction of $297,000, claiming this was the value of the improvements and fixtures that Second Chance would remove and keep for sale. They attached an appraisal summary to the return, but the summary omitted several items of requested information, including the date the donated property was acquired and the donor's cost basis in the property. The Service disallowed the deduction, claiming the taxpayers failed to comply with the requirements of furnishing all needed information. Alternatively, the Service concluded that the appraisal fails because it valued the entire house and not the several items of tangible personal property acquired by Second Chance.

The Tax Court held that the taxpayers did not substantially comply with the applicable substantiation requirements, and thus were not entitled to a deduction for the value of the donated improvements and fixtures. Citing two recent cases, the court held that "a failure to provide the 'cost or adjusted basis' on an appraisal summary is a failure to substantially comply" (sic) with the substantiation regulations, in part because "if cost basis is not explicity disclosed where it is required to be disclosed, the Commissioner will be handicapped in identifying suspicious charitable deductions and deterring taxpayers from 'continu[ing] to play the 'audit lottery.''"

XII. FULL INCLUSION REQUIRED WHERE GRAT ANNUITANT FAILS TO SURVIVE (*Badgley v. United States*, 9th Circuit, April 28, 2020)

In 1998, the decedent created a grantor-retained annuity trust ("GRAT") funded with her one-half interest in a family partnership and three parcels of rental property. The trust instrument provided that the decedent would receive annual annuity payments for 15 years or her prior death (payable quarterly) equal to 12.5% of the date-of-gift value of the property transferred to the GRAT. The trust instrument provided that upon termination of the decedent's annuity rights, the trust corpus would pass to her two daughters. Between 2002 and 2012, the GRAT's share of partnership income was larger than the annuity obligation owed to the decedent. The partnership made cash distributions to the GRAT during this time, all payable to a bank account in the name of the GRAT. The decedent controlled the account and used it to make the quarterly annuity payments to her personal accounts. The decedent transferred the excess funds to other investment accounts.

The decedent died late in 2012, before the expiration of her annuity interest. Her federal estate tax return originally reported a total gross estate of about $36.8 million, a figure that included the value of the assets held in the GRAT. But the executor then filed a $3.8 million refund claim, maintaining that the full value of the GRAT was not includible in the decedent's estate. When the Service took no action on the claim, the executor brought a refund suit.

The executor first argued that §2036(a) did not apply because the statute is limited to cases where the decedent retained the right to "income" (or possession or use or enjoyment) from gifted property. The executor argued that there is a difference between "a fixed annuity payment payable out of transferred property" on the one hand, and the retention of a "right to income" on the other. Income fluctuates, but a fixed annuity payment does not. Moreover, the decedent's annuity could have been satisfied from principal instead of income, meaning the two concepts are distinct. The Service replied that §2036(a) applied, both because the decedent died with rights to (or control over) income through her right to annual annuity payments from the GRAT, and because she possessed and enjoyed the property through her "other interests and powers" in the family partnership.

In a 2018 decision, the federal district court sided with the Service. The decedent's annuity, it concluded, comprised some possession, enjoyment, or right to income from the transferred property. There was no evidence that any of the three rental properties were ever sold to fund the annuity. Thus, the annuity necessarily drew either from the GRAT's current or accumulated income.

The executor then argued that the regulation requiring full inclusion in the decedent's gross estate was invalid. The district court upheld the regulation after performing the two-part *Chevron* test. The regulation's approach was a reasonable interpretation of an issue not clearly answered by Congress. The lower court thus denied the estate's refund claim, granting the Service's motion for summary judgment.

On appeal, the Ninth Circuit affirmed. Just because §2036(a) refers to "income" and not to an "annuity" does not mean that decedents escape gross estate inclusion through a GRAT. "The fact that §2036(a)(1) does not include the term 'annuity' does not exclude annuities from its ambit. This is consistent with the decisions of the Supreme Court and our sibling circuits, which have concluded that interests such as reversionary interests, the power of appointment, and rent – also not listed in §2036(a) – nevertheless fall into one of the three categories," i.e., "possession, enjoyment, or a right to income therefrom." No matter whether the decedent's annuity was paid from current income, accumulated income, or other principal, the decedent "enjoyed" the benefit of the GRAT assets for life, enough to warrant full inclusion of the GRAT assets in her gross estate.

XIII. DEVELOPMENTS AFFECTING CONSERVATION EASEMENTS

Conservation easements continue to be a popular method for generating large charitable contribution deductions at little to no real cost to the donor. In the typical case, a landowner grants a "conservation easement" to a charitable organization related to environmental or historical preservation. The easement is effectively a covenant whereby the existing use of the underlying real property cannot change without the consent of the easement holder.

The amount of the charitable contribution deduction equals the difference between the value of the underlying real property without the easement and value of such real property with the easement attached. Because this value is determined by appraisals, litigation over the amount of the deduction often ensues. In some cases, the Service disallows a deduction altogether when it concludes that some of the requirements for the deduction are not met. For example, the Service has successfully disallowed deductions where the underlying real property is subject to a mortgage and the lienholder has not agreed to subordinate its interest to the charity's easement. The Service has also disallowed deductions where the parties have failed to ensure that the easement will last in perpetuity.

Several cases involving conservation easements have worked their way through the courts, and here is a summary of some of the more significant and interesting decisions.

***Carter v. Commissioner*, T.C. Memo. 2020-21 (February 3, 2020) – Retained Right to Build in Area to be Designated.** Through their partnership, the taxpayers, a married couple, donated a conservation easement to the North American Land Trust that prohibited the construction or occupancy of any dwellings. But the taxpayers retained the right to build single-family dwellings in specified "building areas" that would be determined later with the consent of the North American Land Trust. The Tax Court agreed with the Service that this arrangement is "antithetical to the easement's conservation purposes." It held the taxpayers could claim no deduction at all.

***Railroad Holdings, LLC v. Commissioner*, T.C. Memo. 2020-22 (February 5, 2020) – Charity Not Assured Proportionate Value Upon Extinguishment.** The taxpayer, a Georgia limited liability company, donated a conservation easement on 454 acres of land in Aiken County, South Carolina, to the Southeast Regional Land Conservancy, a charitable organization. The deed conveying the easement stated that if changed circumstances made the easement impossible or impractical, the easement could only be extinguished by a court. The deed further provided that if the subject property was ever sold, exchanged, or involuntarily converted as a result, the proceeds would be divided in such a way that the charity would receive an amount "at least equal to the fair market value of the Conservation Easement … as of the date of this Conservation Easement." The Service claimed that the taxpayer could not claim a charitable contribution deduction because there was no assurance the charity would be entitled to a proportionate share of any sale proceeds. The deed language only guaranteed that the charity would receive an amount equal to the current value of the easement and not its value at the time of extinguishment. The Tax Court agreed, holding this language effectively violated the "protected in perpetuity" requirement in that it did not guarantee the charity a proportionate share of the proceeds based on date-of-sale values instead of date-of-donation values.

The court explained the flaw in the deed's language with an example:

> If the easement contributed by [the taxpayer] were, at the time of the contribution, worth 10% of the value of a $10 million property, then the "proportionate value" of the easement (as the deed uses that term) would be $1 million, and that dollar value – rather than the fraction of value it did represent – "shall remain constant." Thus, if a court extinguished the easement many years later after the property had appreciated to $20 million, the donee's share of extinguishment proceeds would be not 10% of $20 million (i.e., … $2 million) but rather the "constant" $1 million. [Regulation §1.170A-14(g)(6)(ii)] requires that

> the donee "must be entitled to a portion of the proceeds at least equal to that proportionate value" (in this example, 10% of $20 million, or $2 million), … but [the taxpayer]'s deed would give the donee only "at least" a constant 10% of the $10 million value "as of the date of" the contribution, or $1 million.

***Oakbrook Land Holdings, LLC v. Commissioner*, T.C. Memo. 2020-54 (May 12, 2020) – Charity Not Assured Proportionate Value Upon Extinguishment—Again.** The taxpayer acquired a 143-acre parcel outside Chattanooga in December, 2007, for $1.7 million. With the intent to develop the property, the taxpayer made some improvements to the land, including building a bridge, installing a sewer-pump station, and rezoning the property. After conveying 37 acres to various related entities in December, 2008, the taxpayer then placed a conservation easement for the benefit of the Southeast Regional Land Conservancy on the remaining 106 acres. Based on an appraisal, the taxpayer claimed a $9.545 million charitable contribution deduction on its 2008 return. The Service disallowed the deduction, pointing to a provision in the deed granting the easement that if the easement is extinguished by judicial proceeding, the Conservancy would receive "a portion of the proceeds equal to the fair market value of the Conservation Easement." The deed also provided that the amount payable to the Conservancy would be reduced by the value of any improvements made by taxpayer after the date of the gift.

Regulation §1.170A-14(g)(6)(ii) requires that upon judicial extinguishment and sale of the underlying property, the charity "must be entitled to a portion of the proceeds at least equal to [the] proportionate value of the conservation restriction." A 2019 case interpreted this language to mean that a charity's share upon extinguishment is that percentage determined by a fraction, the numerator of which is the value of the conservation easement *on the date of the gift* and the denominator of which is the value of the whole property *on the date of the gift*. The IRS concluded that since the deed in this case limits the charity's share to a fixed dollar amount (the value of the easement at contribution) and not the percentage required by the regulation, the deed violates the regulation and thus the deduction is disallowed entirely. The IRS also challenged the language reducing the amount payable to the charity by the value of post-contribution improvements made by the taxpayer.

In this Memorandum decision, the Tax Court agreed with the IRS, finding that it does not matter that the fixed value provided for in the deed would almost certainly be more than the percentage of proceeds to which the Conservancy would be entitled under the regulation. But the court also held that the taxpayer was not liable for a substantial understatement penalty since the taxpayer's manager reasonably relied on language pulled from a favorable private ruling in crafting the deed.

***Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. No. 10 (May 12, 2020) – And That Regulation is Valid.** So the taxpayer in the last case argued that the regulation is invalid. In a reviewed opinion, the Tax Court (16-1) upheld the regulation's validity, finding it was properly promulgated under the Administrative Procedure Act (the "APA") and that the regulation's interpretation of the statute was entitled to "*Chevron* deference."

The majority concludes that the regulation at issue is a legislative regulation because it imposes a requirement not expressly stated in the statute, namely that the charity and the donor agree to a proportionate division of proceeds following judicial extinguishment of an easement. The taxpayer argued that when Treasury issued the regulation in final form, it failed to provide a "concise general statement of [the] basis and purpose" for the new rule. But the majority observed that "No court has ever construed the APA to mandate that an agency explain the basis and purpose of each individual component of a regulation separately." The provision at issue here was one "of a regulation project consisting of 10 paragraphs, 23 subparagraphs, 30 subdivisions, and 21 examples." Since Treasury adequately stated the general purpose of the substantiation regulations for conservation easements, the regulation was properly enacted.

The majority also concluded that Treasury's requirement of proportionate division of proceeds was not arbitrary, capricious, or manifestly contrary to the statute, the standard for invalidating agency interpretations adopted in *Chevron v. National Resources Defense Council*, 467 U.S. 837 (1984). "If the donee's share were (sic) limited to the easement's historical [value], its property right could be eviscerated in real dollar terms. … That outcome would be at odds with the regulation's central purpose: to ensure satisfaction of the statute's 'protected in perpetuity' requirement by supplying the donee with an asset that replaces, in real terms, the easement that has been lost."

The dissent (Judge Holmes, the judge who tried the case and issued the Memorandum decision described above) concludes that the majority's decision means "the Treasury Department can get by with the administrative-state equivalent of a quiet shrug, a knowing wink, and a silent fleeting glance from across a crowded room." Judge Holmes observed that a number of commentators expressed concern with the regulation related to the perpetuity requirement and judicial extinguishments in its proposed form, but neither the final regulation nor its preamble addressed these concerns. "What we hear is the chirping of crickets." The dissent contends it is not enough that Treasury states "After consideration of all the comments, the proposed regulations are adopted as amended." He argues this is simply form language that can't be used to excuse oversight of significant issues raised during the notice-and-comment phase of rulemaking.

***Woodland Property Holdings, LLC v. Commissioner*, T.C. Memo. 2020-55 (May 13, 2020) – Court follows *Oakbrook Land Holdings* in Summary Judgment Motion.** In December, 2012, the taxpayer acquired 980 acres in South Carolina. Eight days later, it gave a conservation easement on the land to the Southeast Regional Land Conservancy. Here too the deed provided that upon judicial extinguishment of the easement, the Conservancy would be entitled to "at least" the value of the easement as of the date of the gift. The taxpayer claimed an $8.7 million deduction on its 2012 return, which the IRS disallowed. Following the precedents explained above, the Tax Court upheld the IRS's summary judgment motion, concluding that the taxpayer could not claim a deduction because the deed failed to give the charity a proportionate share of the proceeds following extinguishment and sale.

***Johnson v. Commissioner*, T.C. Memo. 2020-79 (June 8, 2020) – Battle of the Experts.** The taxpayer purchased a vacant lot in Colorado for $200,000 in 2002 and turned it into a ranch. In 2007, the taxpayer granted a conservation easement on the property to Colorado Open Lands and claimed a $610,000 charitable contribution deduction on his federal income tax return. Because the taxpayer could not deduct the entire amount of the donation on the 2007 return, the taxpayer carried the deduction over to 2008, 2009, 2010, 2011, 2012, 2013, and 2014.

The IRS did not contest the merits of the deduction but claimed that the taxpayer had already deducted more than the value of the easement by the time it got to the years at issue in the case (2012, 2013, and 2014). So the case turned on the value of the donated easement. As the Tax Court explained, the value of a conservation easement is equal to the amount of the difference between the fair market value of the underlying real property immediately before donation of the easement and such property's fair market value immediately after the easement's donation. The taxpayer's expert concluded that the value of the property before the donation was $1.15 million and the value of the property after the easement was $565,000, resulting in a difference of $585,000. Thus, said the taxpayer's expert, the value of the easement was $585,000. The IRS's expert concluded that the pre-easement value of the property was only $840,000 and that the post-easement value of the property was $555,000, resulting in a difference (and deduction) of $285,000.

The Tax Court was not especially enamored with the approach used by either expert. The IRS's expert eschewed reliance on sales of comparable properties, finding the market data was too inconsistent to be reliable. Instead, the IRS's expert used a "qualitative approach" that took account of the relative superiority or inferiority of the comparables and not just their sale prices. But the Tax Court held that the market data was not nearly as unreliable as the IRS's expert claimed. The court cited other decisions involving properties in neighboring counties. In those cases, sales of comparable properties were sufficient to determine the values of the subject properties. Ultimately, the court determined that the value of the ranch before the donation of the easement was $1.022 million.

The parties were not far apart in their valuation of the now-encumbered ranch. Nonetheless, the court used the average of the discounts claimed by the parties' experts to reach its own conclusion that the value of the ranch with the easement immediately after donation was $649,000. This resulted in a value for the conservation easement in the amount of $373,000, a number ultimately closer to the value determined by the IRS.

***Hewitt v. Commissioner*, T.C. Memo. 2020-89 (June 17, 2020) – Stop Me If You've Heard This Before: Charity Not Assured Proportionate Value Upon Extinguishment.** The taxpayer in 2012 donated to the Atlantic Coast Conservancy a conservation easement on a portion of farmland that has been in the family for almost 60 years. The taxpayer claimed a $2.8 million charitable contribution deduction on the 2012 federal income tax return and carried it over to 2013 and 2014.

The IRS did not challenge the 2012 return but disallowed the carryover deductions on the 2013 and 2014 returns. Before the Tax Court, the IRS argued that the easement granted to the Conservancy failed the regulatory requirement that the easement be "protected in perpetuity" because the deed granting the easement provides that upon judicial extinguishment of the easement and resulting sale of the property the Conservancy will only receive an amount equal to the value of the easement at contribution. The taxpayer argued for an interpretation of the regulations that would support the taxpayer's claim that a charity need only be entitled to an amount equal to the value of the easement at contribution, but the court quickly and easily dispensed with the argument, citing a number of precedents.

The taxpayer tried to rely on a favorable private ruling from 2008, but the court said the ruling "is neither persuasive nor relevant." The ruling did not expressly consider the validity of the easement deed that subtracted the value of post-easement appreciation from extinguishment proceeds, so it does not have any bearing on the issue posed here.

Valuation was also an issue in this case because it determined whether the taxpayer was liable for an accuracy-related penalty. The IRS's expert valued the easement on the basis of the highest and best use of the entire farmland and not just the highest and best use of the property subject to the easement. The court found this improper given the significant differences in the topography and public access between the portion encumbered by the easement and the unencumbered portion. The court instead preferred the analysis from the several experts hired by the taxpayer. Although the court did not determine the exact value of the easement (why bother, since the deduction is disallowed anyway), it did conclude that the value was at least sufficient to avoid application of the accuracy-related penalty.

***Plateau Holdings, LLC v. Commissioner*, T.C. Memo. 2020-93 (June 23, 2020) – This is Getting Old: Charity Not Assured Proportionate Value Upon Extinguishment.** The taxpayer in 2012 donated to the Foothills Land Conservancy conservation easements on two separate 1,000+-acre parcels of Tennessee property that had previously been used for mining. The two nearly identical deeds conveying the easements provided that following judicial extinguishment of the easements, the Conservancy would be entitled to a fixed amount of the proceeds equal to the percentage of the easement's value *at the time of the donation* relative to the value of the subject properties *at the time of donation*. The deeds expressly state that the charity's share is to be determined without regard to any post-easement improvements made to the property. This violates the perpetuity requirement identified above because it does not give the charity a proportionate share of the proceeds based on the values at the time of extinguishment. But that did not stop the taxpayer from claiming a combined charitable contribution deduction in excess of $25.4 million.

Unsurprisingly (if you've read the case summaries before this), the Tax Court upheld the IRS's disallowance of the deduction. The charity's share of extinguishment proceeds is improperly reduced by the appreciation in value of improvements existing at the time of the donation and by the value of any improvements made by donor after the donation. The taxpayer argued that the deeds contained a savings clause, providing that the charity's share of extinguishment proceeds shall be determined in accordance with the formula discussed above "or Section 1.170A-14, if different." But the court noted that this "constitutes a 'condition subsequent' saving clause that we and other courts have consistently declined to enforce" because it would require a tribunal to hold first that the formula contained in the deed was noncompliant before it could ever take effect. Perhaps if the deed provided that the amount payable to the charity was "the greater of" the formula amount or the amount required under the regulation, the result would have been different.

The court went on to uphold the application of penalties too, finding that the claimed value of the easement on one parcel was 852% of its correct value and the claimed value of the easement on the other parcel was 1,031% of its correct value (gulp).

***Lumpkin One Five Six, LLC v. Commissioner*, T.C. Memo. 2020-94 (June 23, 2020), and *Lumpkin HC, LLC v. Commissioner*, T.C. Memo. 2020-95 (June 23, 2020) – Attack of the Clones: Charity Not Assured Proportionate Value Upon Extinguishment.** These two cases, decided by the same judge on the same day in opinions that are nearly verbatim, involve the perpetuity requirement yet again. The cases involved conservation easements on two parcels of Georgia real property and combined deductions of over $10.7 million. Both deeds contained the now-infamous formula provision for dividing extinguishment proceeds:

> [T]his Easement shall have at the time of Extinguishment a fair market value determined by multiplying the then fair market value of the Easement Area unencumbered by the Easement (minus any increase in value after the date of this grant attributable to improvements) by the ratio of the value of the Easement at the time of this grant to the value of the Easement Area, without deduction for the value of the Easement, at the time of this grant.

As we have seen from the earlier cases, this is fatal because the formula provides that the portion of the proceeds required to be paid to the charity upon extinguishment is to be reduced by the value of improvements to the property made by the taxpayer after grant of the easement. The taxpayers tried to argue the regulation's rule on extinguishments was invalid, but the court rejected the argument, citing *Oakbrook Land Holdings*.

***Village at Effingham, LLC v. Commissioner*, T.C. Memo. 2020-102 (July 9, 2020), *Riverside Place, LLC v. Commissioner*, T.C. Memo. 2020-103 (July 9, 2020), *Maple Landing, LLC v. Commissioner*, T.C. Memo. 2020-104 (July 9, 2020), and *Englewood Place, LLC v. Commissioner*, T.C. Memo. 2020-105 (July 9, 2020) – These Clones are Growing Exponentially: Charity Not Assured Proportionate Value Upon Extinguishment.** Here we have four cases tried by the same judge with near-verbatim opinions issued on the same day, each involving yet another botched conservation easement because of deed language that violates the perpetuity requirement discussed above. The cases involved conservation easements on various parcels of Georgia real property and combined deductions of over $20.7 million.

In addition to holding that the deeds violated the regulatory requirement ensuring that the charity would receive a proportionate share of the value of the whole property at the time of extinguishment, the court also held that the deduction is disallowed for lack of substantial compliance with the substantiation requirements. In each case, the taxpayer failed to disclose the basis of the donated property, claiming in an attachment to the return that such information would not be provided “because of the fact that the basis of the property is not taken into consideration when computing the amount of the deduction.” Yeah, good luck with that.

***Smith Lake, LLC v. Commissioner*, T.C. Memo. 2020-107 (July 13, 2020) – You Guessed It, Charity Not Assured Proportionate Value Upon Extinguishment.** The taxpayers conveyed a conservation easement on a 21.89-acre parcel of real property located in Alabama to a subsidiary of Atlantic Coast Conservancy and claimed a charitable contribution deduction in excess of $6.5 million representing the value of the easement. The deed granting the easement contained language nearly identical to the ones quoted above in earlier cases regarding the disposition of sale proceeds following judicial extinguishment of the easement. When the IRS disallowed the deduction, the taxpayer made the same arguments as those discussed above, including that the regulation requiring a proportionate division of the sale proceeds is invalid. Unsurprisingly, the Tax Court stuck to its newly-established guns in upholding the regulation’s validity and denying the taxpayer’s deduction.

***Belair Woods, LLC v. Commissioner*, T.C. Memo. 2020-112 (July 22, 2020) – IRS Not Bound by Concession Regarding Extinguishment Clause in Unrelated Case.** The taxpayer purchased 145 acres of Georgia real property in 2008 for just over $382,000. The next year, the taxpayer donated a conservation easement on 141 acres of the land to the Georgia Land Trust. The taxpayer claimed a $4.7 million charitable contribution deduction for its contribution. Sadly, the deed conveying the easement stated that upon judicial extinguishment, the share of sale proceeds allocable to the Georgia Land Trust would be determined by subtracting all claims against the property (and not just a share of those claims), as well as the value of any improvements made by the taxpayer after contribution of the easement.

Consistent with all the cases already described, the Tax Court upheld the Service’s disallowance of the deduction because the purpose of the easement was not protected "in perpetuity" because the charity was not assured of its proportionate share of any extinguishment proceeds. The taxpayer pointed out that in a 2016 case from the Federal District of Arizona, the IRS stipulated that a deed containing a similar extinguishment clause satisfied the regulation. Thus said the taxpayer, the IRS was judicially estopped from challenging the extinguishment clause here. The Tax Court rejected this argument, noting that the IRS’s position in the prior case was simply a tactical concession made so that the IRS could pursue another theory on a summary judgment motion.

XIV. LEGAL FEES IN CONNECTION WITH FDA APPLICATIONS ARE CAPITAL EXPENDITURES, BUT LEGAL FEES TO DEFEND PATENT INFRINGEMENT SUITS ARE DEDUCTIBLE (*Mylan, Inc. v. Commissioner*, 156 T.C. No. 10, April 27, 2021)

The taxpayer makes brand name and generic pharmaceutical drugs. During the years 2012 to 2014, the taxpayer incurred legal fees in connection with applications submitted to the Food & Drug Administration for approval to market and sell generic versions of brand name drugs, including Celebrex, Lunesta, and Nexium. As part of the application process, the taxpayer had to provide certification regarding the status of any patents listed by the FDA as covering the respective brand name drug. Before the taxpayer can certify that listed patents covering a brand name drug were invalid or would not be infringed by the manufacture of the taxpayer's generic version, the taxpayer must send notice letters to the brand name drug manufacturer and any patentees. This certification also constituted an act of patent infringement, giving the brand name manufacturer and any patentees the right to bring a patent infringement suit against the taxpayer.

On its federal income tax returns, the taxpayer deducted both the legal expenses incurred to prepare notice letters and the legal expenses incurred in defending against the associated patent infringement suits as ordinary and necessary business expenses. But the Service determined that these costs were nondeductible capital expenditures that could be amortized over 15 years under §197 but not deducted when paid or incurred. The Service thus determined a $16.4 million deficiency for 2012, a $12.6 million definiciency for 2013, and a $21 million deficiency for 2014.

The Tax Court, in a reviewed opinion, unanimously held that the legal expenses incurred to prepare the notice letters are required to be capitalized because they were necessary to obtain FDA approval of the taxpayer's generic version. Specifically, they facilitated the creation of an intangible asset, the FDA license. "Although [the taxpayer] argues that the notice serves to facilitate patent litigation, Congress has made the notice a prerequisite for [FDA] approval. Consequently, the legal expenses ... incurred to prepare, assemble, and transmit such notice letters constitute amounts incurred 'investigating or otherwise pursuing' the transaction of creating FDA-approved [drug applications]." The court found this situation nearly identical to an Example in Regulation §1.263(a)-4(e)(3), in which payments to outside counsel to prepare license application were held to have facilitated the creation of an intangible.

But the Tax Court also held that the legal expenses incurred to defend patent infringement suits are deductible as ordinary and necessary business expenses because the patent litigation was distinct from the FDA approval process. "Although Congress erected a framework that promotes the prompt resolution of patent issues, ... the Commissioner fails to demonstrate how encouraging early and expeditious patent litigation shows that such litigation is an element of acquiring effective FDA approval. ... Although litigation usually occurs before marketing and sale of the generic drug, the purpose of the suit remains to protect future business profits."

XV. LIFETIME LOAN TRANSFERS BECOME GIFTS WHEN CONVERTED TO ADVANCEMENTS (*Estate of Bolles v. Commissioner*, T.C. Memo. 2020-71, June 1, 2020)

Over many years, the decedent made cash transfers of varying amounts to her five children, each time recording the transfers as loans. It was her practice each year to forgive each child's outstanding debt to the extent of the federal gift tax annual exclusion. The total cash transfers to her oldest son, Peter, an architect with a struggling practice, were larger than those made to the other kids (the total amount transferred to him over a 20-year period exceeded $1 million). When the decedent created a revocable living trust in 1989, she expressly excluded Peter from any distributions upon her death. In 1995, the decedent executed a new revocable living trust that included Peter as an equal beneficiary with his siblings. In 1996, Peter signed an acknowledgment that the total outstanding debt owed to the decedent (totaling over $700,000 at the time) "shall be taken into account for purposes of any and all calculations to be made" in determining his share of the trust upon the decedent's death.

The issue in this case is whether the amounts paid to Peter were loans or gifts. The IRS determined that the amounts were gifts, while the estate maintained that the amounts were at all times loans. The Tax Court took a middle ground, finding that the transfers made prior to the execution of the 1989 revocable trust were loans. Although there were no loan agreements or efforts to collect payments, the court concluded that the decedent expected Peter to repay the loans. But that changed by 1989 when her trust made no provision for Peter. At that time, "the 'loans' lost that characterization for tax purposes and became advances on Peter's inheritance. … [T]he advances to Peter were loans through 1989 but after that were gifts. We … find that [the decedent] did not forgive the loans but rather accepted that could not be repaid on the basis of Peter's financial distress." Indeed, the later acknowledgment Peter signed in 1996 confirms the conclusion that the amounts paid to Peter over the years were really advances on his inheritance.

The court's conclusion means that the estate lost over $1 million of applicable exclusion amount through the lifetime taxable gifts. But it also means the estate avoided gross estate inclusion of the value of the amount that would have been owed to the estate (plus interest) had the transfers been respected as loans. So while the IRS prevailed in its argument that there was a gift, the estate might have been happy to lose this one.

XVI. TAXPAYER PREVAILS IN BATTLE OF THE EXPERTS OVER VALUATION OF NONVOTING LLC INTERESTS (*Grieve v. Commissioner*, T.C. Memo. 2020-28, March 2, 2020)

In 2013 the taxpayer made two gift transfers. The first was a transfer of a 99.8-percent nonvoting interest in Rabbit LLC, an entity that owned just over $9.1 million in cash and marketable securities, to a two-year grantor-retained annuity trust (GRAT). The second was a transfer of a 99.8-percent nonvoting interest in Angus LLC, a different entity that owned over $31.9 million in cash and marketable securities, to an irrevocable trust in exchange for a private annuity worth just over $8 million.

On his 2013 federal gift tax return, the taxpayer reported a taxable gift of zero for the transfer of Rabbit units and a taxable gift of nearly $10 million for the transfer of Angus units. These numbers were based on appraisals that valued the nonvoting units in Rabbit at just over $5.9 million and the nonvoting interests in Angus at nearly $20.9 million. But the Service determined that the nonvoting interests in Rabbit were worth just over $9 million and the nonvoting interests in Angus were worth nearly $31.9 million.

The valuation adjustment for the Rabbit units was no big deal since the Service agreed that no gift tax would be due if the size of the annuity payments from the GRAT is adjusted to reflect the higher valuation. But the valuation adjustment to the Angus units changed the value of the net gift from nearly $10 million to about $17.8 million.

The taxpayer challenged this determination in the United States Tax Court. Both sides came equipped with new and improved appraisals at their sides. The taxpayer's expert concluded the value of the transferred Rabbit interest was in fact only $5.88 million and the value of the transferred Angus interest was $19.85 million. But the Service's expert claimed the value of the transferred Rabbit interest was $8.9 million and the value of the transferred Angus interest was just over $31.4 million. It was thus up to the court to figure out the "true" values.

The Tax Court did not like the reasoning of the Service's expert that a willing buyer of a 99.8-percent nonvoting interest would necessarily also purchase the 0.2-percent voting interest in order to protect the investment in the large nonvoting interest. The court believed testimony from the taxpayer's daughter, the sole shareholder and manager of the corporation that owned the voting interests in each entity, that she has no plan to sell her interest and that if she ever did she would demand a substantial premium. She also testified that if the nonvoting interests were ever sold outside the family, she would demand a fee for managing the entities. The court held it was thus improper to factor in the value of the 0.2-percent voting interest. It went on to find that the taxpayer's expert used an appropriate valuation method that had been approved in prior cases and that the discount ranges used by the taxpayer's expert were also in line with those used by the court in earlier cases. It thus adopted the valuations reported by the taxpayer's expert.

XVII. EYEGLASS DONATION SCHEME LACKED FOCUS (*Campbell v. Commissioner*, T.C. Memo. 2020-41, April 7, 2020)

The taxpayer's accountant recommended that the taxpayer participate in a scheme operated by ZD Products, Inc. (ZD). For reasons unexplained, ZD had over 170,000 designer eyeglass frames in its possession. ZD packaged the frames into units of about 3,400 frames each and then sold each unit for $50,000 to buyers. Here's the gimmick: a buyer would hold the 3,4,00 eyeglasses for over one year, donate them to a charitable organization (Lions in Sight was the preferred one), then claim a charitable contribution deduction for the fair market value of the frames. The taxpayer bought a unit of frames on December 22, 2006, and the frames were donated to Lions in Sight on December 28, 2007. An appraisal concluded that the value of some 349,629 frames donated to Lions in Sight was just over $24 million.

Using this figure, the taxpayer's 2007 return showed a charitable contribution deduction of just over $225,000. Since the taxpayer also had a net operating loss carryforward of over $897,000, though, the taxpayer carried the donation over to 2008. In its examination of the 2008 return, the Service disallowed the carryforward on a variety of grounds. It concluded the contribution lacked donative intent, the appraisal was not a "qualified appraisal," and the letter received by the taxpayer from Lions in Sight was not a proper contemporaneous written acknowledgment.

The Tax Court held that the taxpayer did not comply with the substantiation requirements, so it did address the arguments regarding donative intent. The court observed that the appraisal related to 349,629 eyeglass frames and not the 3,400 frames donated by the taxpayer. Although the frames donated by the taxpayer were included in the aggregate appraisal, "we (and the IRS) have no way to determine whether what he alone contributed was overvalued." Given that the individual frames had values between $37 and $80, there was no way to determine the value of the taxpayer's donation with any degree of confidence. The taxpayer argued he contributed a fractional share of the 349,629 frames, but the court rejected the argument, finding "the record unmistakably belies this." The taxpayer purchased a block of frames, not a share of a larger lot.

The court also held that the letter furnished by the charity was not a contemporaneous written acknowledgment. "The letter merely acknowledged his 'generous gift of prescription eyeware (sic)' and how his contribution would assist Lions in Sight; it made no mention of whether Lions in Sight provided any goods or services in consideration for [the taxpayer's] contribution." The taxpayer argued there was substantial compliance with the substantiation rules, but the court concluded that the defects in the documents "are not (in the words of [the taxpayer]) 'ridiculously trivial and inconsequential.'"

XVIII. THERE'S NO DISPUTE THERE WAS NEVER A DISPUTE OVER THE LAWYER'S PORTION OF A SETTLEMENT AWARD (*Isaacson v. Commissioner*, T.C. Memo. 2020-17, January 23, 2020)

Before he was disbarred in 2013, the taxpayer was a litigator. In 2007, the taxpayer represented four individuals who had been sexually abused as children by Catholic priests. When the Archdiocese of Los Angeles offered over $660 million to resolve all pending cases, the taxpayer appeared at an informal settlement conference and secured a total settlement of $12.75 million for his four clients. The taxpayer charged the clients a 60-percent contingent fee, which two of the four clients accepted. But the other two clients claimed the taxpayer's share should have been closer to 40-percent or 50-percent. Still, those objecting clients never made a formal request for arbitration, as provided in their fee agreements.

The taxpayer included no portion of the fee in his gross income for 2007. When his return was selected for examination, he argued that the bank charged with holding the funds invested them without his authorization. This proved to be inaccurate. Before the Tax Court, he claimed that the funds were not gross income because two of his clients disputed the fee. As a result, he said, rules of professional conduct prohibited him from claiming any rights to the funds until the dispute resolved itself. But the court applied the doctrine of judicial estoppel to defeat his position. “Petitioner argues that he could not recognize income from the clergy lawsuit settlement because clients disputed his fees and [because] he was barred from disbursing his fee until that fee dispute was resolved. In prior proceedings, however, petitioner took precisely the opposite track; he repeatedly represented, and earlier tribunals accepted as true, that no fee dispute existed between him and his clients.”

Furthermore, said the Tax Court, even if two of the clients had disputed the fee, there was no dispute as to the taxpayer’s portion of the award made to the other two clients—so at least that amount would have been gross income to the taxpayer in 2007. Moreover, the court held, the taxpayer exercised dominion and control over the entire settlement amount through his improper investing of those funds. It is inconsistent for the taxpayer to argue only now that there was a restriction on his use of the funds when in fact no such restriction was ever in place. The court upheld a 75-percent fraud penalty on top of the understatement.