

2025 FEDERAL TAX UPDATE

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

**Samuel A. Donaldson
Professor of Law
Georgia State University
Atlanta, GA**

These materials summarize important developments in the federal income, estate and gift tax laws affecting individual taxpayers and small businesses from August, 2024, through August, 2025, with occasional references to older items where relevant. The materials are organized roughly in order of significance. These materials generally do not discuss developments in deferred compensation or the taxation of business entities (except to a very limited extent).

I. ONE BIG BEAUTIFUL BILL ACT MAKES 2017 ACT MOSTLY “PERMANENT” AND EVEN ADDS ADDITIONAL, TEMPORARY RULES

Beauty is indeed in the eye of the beholder. Signed by President Trump on July 4, 2025, Public Law 119-21, formally titled “An Act to provide for reconciliation pursuant to title II of H. Con. Res. 14” but commonly known as the “One Big Beautiful Bill Act,” (“the OB3 Act”), brings to life much of the Republican party’s 2025 project, er, platform for domestic policy. Clocking in at 330 pages, the OB3 Act covers a lot of ground. Given that amendments to the Internal Revenue Code consume 175 of those 330 pages, it is fair to say that taxation was at the heart of the OB3 Act.

A. The Big Picture

In December, 2017, Congress enacted the 2017 Tax Cuts and Jobs Act (“the 2017 Act”), the most dramatic change to the Internal Revenue Code since passage of the Tax Reform Act of 1986. Earlier that year, Senate leadership indicated it would not seek to produce “permanent” legislation with bipartisan support.

To prevent a Democratic filibuster, Senate procedural rules generally required that tax legislation be revenue-neutral over a 10-year timeframe. That led observers to believe any tax reform would “sunset” after 10 years, as was the case with the Economic Growth and Tax Relief Reconciliation Act of 2001. But achieving long-standing tax reform goals proved to be a costly endeavor, even with the potential of a sunset. When it became clear that the hoped-for package of tax cuts would generate a considerable deficit over the next 10 years, leadership in

both houses scrambled to get the votes required to pass budget resolutions that allowed a cumulative 10-year deficit not to exceed \$1.5 trillion. Passage of those resolutions late in October, 2017, facilitated the final legislation.

While cuts to corporate taxes and a handful of other provisions were made without expiration dates, the lion's share of the reforms contained in the 2017 Act were set to expire at the end of 2025. When the 119th Congress convened on January 3, 2025, leadership confirmed that extending most of the expiring provisions of the 2017 Act was a top legislative priority.

1. The Budgetary Dance

At the start of 2025, observers expected Congress simply to extend most (if not all) of the 2017 Act provisions set to expire at year's end. The only question was the length of the extension. Early forecasts from the Congressional Budget Office and other sources suggested that the cost of extending the 2017 Act for 10 years could reach over \$4.6 trillion in lost revenues and additional interest expense. The hefty price tag was a problem, given that early in 2025 the House and Senate approved a budget resolution that allowed \$4.5 trillion in lost revenues over 10 years accompanied by \$2 trillion in spending cuts over 10 years. That led most observers to predict that Congress would extend the 2017 Act for a much shorter period, perhaps 3 or maybe 5 years.

2. Surprise! Permanent Extensions

But the OB3 Act proved to be more than just a short-term extension. As explained herein, most of the tax cuts from the 2017 Act were made permanent in that there is no longer a scheduled sunset date.

How in the world could Congress make most of the 2017 Act permanent when the projected 10-year cost of extension exceeded the budget framework? The answer was in the definition of the budget baseline.

Traditionally, in forecasting lost revenue from legislation, scorers would use a "current law" baseline. Under this approach, lost revenue is based off what the law would be over the next 10 years if no legislation was passed. In this case, then, one would assume that for 2026 through 2035, for example, the highest marginal rate of tax on ordinary income would return to 39.6 percent, the federal wealth transfer tax exclusion would drop from \$10 million adjusted for inflation to \$5 million adjusted for inflation, and the deduction for personal state and local taxes would no longer be limited to \$10,000. As mentioned above, forecasts under a current law baseline estimated the 10-year revenue loss from extending the 2017 Act to be \$4.6 trillion, an amount in excess of the budget resolution.

Normally, that would lead Congress to consider extending the 2017 Act for a shorter period. Instead, Congress opted to shift the scoring paradigm from a “current law” baseline to a “current policy” baseline. Under a current policy baseline approach, lost revenue is based off what the law is in 2025 (i.e., when the 2017 Act is still in place). Because the current policy includes the 2017 Act, there is no cost to extending the 2017 Act. As one commentator says:

That’s like saying that when I go to the grocery store this week and put milk and ice cream in my cart, I don’t have to pay for milk and ice cream this week because I bought those items last time I came to the store.

Beth Shapiro Kaufman, [*Capital Letter No. 63: One Big Beautiful Bill*](#) (July 7, 2025). Switching to this approach effectively allowed Congress to make most of the 2017 Act permanent without dipping into the \$4.5 trillion in revenue cuts authorized by the budget resolution. Through this budgetary hocus-pocus, then, Congress found a mechanism for making most of the 2017 Act permanent.

3. New Provisions

And because, under a current policy baseline, extending the *status quo* had no revenue cost, there was room for additional tax benefits promised by President Trump while campaigning for office in 2024. These promises included restoring the immediate expensing of certain items of otherwise-depreciable property, excluding social security benefits from gross income, and excluding tips and overtime pay from gross income. One estimate pegged the 10-year cost of enacting all of these additional promises at \$6 trillion. Penn Wharton Budget Model, [*The FY2025 House Budget reconciliation and Trump Administration Tax Proposals: Budgetary, Economic, and Distributional Effects*](#) (February 27, 2025). Ultimately, then, a pared-down version of these promises survived the final cut, as discussed below.

The final tab for the OB3 Act comes to about \$4.5 trillion in tax cuts, spending cuts of \$1.7 trillion, and \$450 billion in increased spending. Congressional Budget Office, [*Estimated Budgetary Effects of an Amendment in the Nature of a Substitute to H.R. 1, the One Big Beautiful Bill Act, Relative to CBO's January 2025 Baseline*](#) (June 27, 2025). These estimates, created using a current law baseline instead of the new-fangled current policy baseline, are supported by the Joint Committee on Taxation, which estimates that the tax cuts in the OB3 Act will cost \$4.475 trillion over the next 10 years (again, using a current law baseline approach). Joint Committee on Taxation, [*Estimated Revenue Effects Relative to the Present Law Baseline of the Tax Provisions in “Title VII – Finance” of the Substitute Legislation as Passed by the Senate to Provide for Reconciliation of the Fiscal Year 2025 Budget*](#), JCX-35-25 (July 1, 2025). In explaining the projected effects of a particular provision over the next 10 years, these materials will use the projections from the Joint Committee on Taxation’s report.

4. Provisions Still Set to Expire at the End of 2025

The OB3 Act did not extend all of the provisions from the 2017 Act that are scheduled to sunset at the end of 2025. Here is a partial list of provisions set to expire at the end of 2025:

- The §51 work opportunity credit;
- The §108(a)(1)(E) exclusion from gross income of discharge of indebtedness on a principal residence;
- The 7-year recovery period for motorsports entertainment complexes under §168(e); and
- Several of the empowerment zone tax incentives, including empowerment zone tax-exempt bonds under §1394 and the empowerment zone employment credit in §1396.

5. Republicans Take a Victory Lap

The OB3 Act is a significant legislative victory for Republicans. No provision of the Code is ever “permanent,” of course, as this or a future Congress can always change it at any point through new legislation. But the absence of an expiration date makes it harder for Democrats to use a pending sunset as leverage to effect other changes. If rates and brackets were again scheduled to expire at some future point, Democrats could use the scheduled sunset to coerce a compromise under which the scope of a particular tax cut could be narrowed so as to benefit only taxpayers with low or moderate incomes. But now, by making most of the cuts from the 2017 Act immune to sunset, the only way to undo tax cuts is through new legislation. This will require Democrats to regain control of the executive and legislative branches, and even then, some Democrats may not be completely on board with eliminating this or other tax cuts.

But the OB3 Act may have political costs in addition to revenue costs. Early polling suggests that voters are skeptical of the legislation. A [Pew Research Center poll](#) showed nearly half of over 5,000 Americans polled opposed the OB3 Act while about 30 percent favored it (about 20 percent unsure). A majority of those polled felt the OB3 Act would help high-income people and hurt lower-income people. Even a [Fox News poll](#) showed overall opposition to the OB3 Act, though the results were deeply partisan, with 73 percent of Republicans favoring it while 89 percent of Democrats and 73 percent of independent voters opposed it.

B. Provisions Affecting Individuals, Estates, and Trusts

1. Ordinary Income Tax Brackets for Individuals, Estates, and Trusts

For many years prior to 2018, there were seven tax brackets applicable to ordinary income. Here, for example, were the ordinary income tax rates and brackets in play for 2017:

2017 Taxable Income Exceeding			
Single	Married	Trusts and Estates	Rate
\$0	\$0		10%
\$9,325	\$18,650	\$0	15%
\$37,950	\$75,900	\$2,550	25%
\$91,900	\$153,100	\$6,000	28%
\$191,650	\$233,350	\$9,150	33%
\$416,700	\$416,700		35%
\$418,400	\$470,400	\$12,500	39.6%

In the early stages of producing the 2017 Act, Republican leadership sought to reduce both the number of brackets and the tax rates. Ultimately, the 2017 Act preserved the 7-bracket regime, though it reduced the rates in five of the brackets and widened the sizes of the top four brackets. The 2017 Act also cut the number of tax brackets applicable to trusts and estates from five to four, but it retained the super-thin lower brackets. Thus, these were the ordinary income tax rates and brackets that took effect in 2018:

2018 Taxable Income Exceeding			
Single	Married	Trusts and Estates	Rate
\$0	\$0	\$0	10%
\$9,525	\$19,050		12%
\$38,700	\$77,400		22%
\$82,500	\$165,000	\$2,550	24%
\$157,500	\$315,000		32%
\$200,000	\$400,000	\$9,150	35%
\$500,000	\$600,000	\$12,500	37%

The 2017 Act called for these rates and brackets to expire at the end of 2025. But the OB3 Act extends the current rate structure and brackets indefinitely. While it is too early to know the tax brackets for 2026, the 2025 brackets give some indication of how the now-permanent regime works:

INFLATION-ADJUSTED FEDERAL INCOME TAX BRACKETS FOR 2025 (from Rev. Proc. 2024-40)

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%
\$11,925	\$23,850	12%			
\$48,350	\$96,700				
\$48,475	\$96,950	22%			
\$103,350	\$206,700	24%			
\$197,300	AGI over \$250,000	32%	15%	3.8%	3.8%
AGI over \$200,000	\$394,600				
\$250,525	\$501,050	35%			
\$533,400	\$600,050				
\$626,350	\$751,600	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 2025

(Adapted from Rev. Proc. 2024-40)

Taxable Income Exceeding	Ordinary Income	Adjusted Net Cap Gain* & Qualified Dividends	Medicare Surtax on Net Investment Income
\$0	10%	0%	0%
\$3,150	24%		
\$3,250		15%	
\$11,450	35%		
\$15,650	37%	20%	3.8%
\$15,900			

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

The Joint Committee on Taxation estimates the projected 10-year revenue loss from making the current brackets and rates permanent to be \$2.19 trillion, by far the most expensive provision of the OB3 Act.

2. Zero-Bracket Provisions: Standard Deduction, Personal Exemptions, and Child Credit

Prior law achieved a so-called “zero-bracket” through a holy trinity: the standard deduction, the deduction for personal and dependency exemptions, and the child tax credit. In an effort to simplify this regime, the 2017 Act temporarily repealed the deduction for personal and dependency exemptions while expanding both the standard deduction and the child tax credit. These modifications were set to expire at the end of 2025 but have now been extended without expiration. Furthermore, the standard deduction for 2025 will be even larger and a new, temporary *faux* personal exemption for older taxpayers will debut in 2025.

a. Standard Deduction

The 2017 Act substantially increased the amount of the standard deduction, and the OB3 Act preserves and enhances this increase, as shown in the following table:

Filing Status	2017 Standard Deduction	2018 Standard Deduction	2025 Standard Deduction (Pre-OB3 Act)	2025 Standard Deduction (Post-OB3 Act)
Married Filing Jointly	\$12,700	\$24,000	\$30,000	\$31,500
Head of Household	\$9,350	\$18,000	\$22,500	\$23,625
Unmarried	\$6,350	\$12,000	\$15,000	\$15,750
Married Filing Separately	\$6,350	\$12,000	\$15,000	\$15,750

The OB3 Act makes no changes to the inflation-adjusted additional standard deduction amount available to blind taxpayers and those age 65 and over. Thus, for 2025, the additional standard deduction amount for “the aged or the blind” is \$1,600, or \$2,000 if the taxpayer is also unmarried and not a surviving spouse.

b. Personal Exemptions (and the New Temporary Senior Deduction)

Prior to 2018, a taxpayer could claim a personal exemption deduction of \$2,000, though this amount was adjusted for inflation (the 2018 inflation-adjusted exemption was set to be \$4,150, and the amount would have been \$5,200 for 2025). Married couples filing jointly could claim two exemptions. In addition, a taxpayer could claim an exemption deduction for each of the taxpayer’s dependents, generally defined as either “qualifying children” or “qualifying relatives.” Thus, for example, a married couple with two qualifying children could claim four personal exemptions on their joint return, a total deduction that would have been \$16,600 in 2018 (\$20,800 in 2025). But if the couple’s adjusted gross income exceeded an inflation-adjusted threshold amount (what was to be \$320,000 in 2018), the amount of the deduction

would be gradually reduced (reaching zero if the couple's 2018 adjusted gross income was \$442,000 or more).

The 2017 Act effectively repealed the deduction for personal and dependency exemptions for the years 2018 through 2025 by reducing the exemption amount in those years to zero. The 2017 Act expressly retained the regular personal exemption for so-called "qualified disability trusts," and the nominal personal exemptions currently in play for estates (\$600) and trusts (\$100 or \$300, depending on whether the trust is required to distribute its income) also survived.

The OB3 Act generally extends the repeal without expiration, but it grants to a "qualified individual" (one who has attained the age of 65 before the end of the taxable year) a personal exemption deduction of \$6,000. A married couple can claim two exemptions on a joint return if both spouses have reached age 65 before the close of the taxable year. This "temporary senior deduction" will be in effect from 2025 through 2028.

The temporary senior deduction comes with three important limitations. First, where a qualified individual is married, the deduction is only available if the couple files jointly. If the spouses file separately, neither one can claim the temporary senior deduction.

Second, as written, the OB3 Act does not allow a taxpayer to claim a temporary senior deduction for a dependent who has reached age 65 before the end of the taxable year. In other words, the deduction is limited to the taxpayer and, in the case of a joint return, the taxpayer's spouse.

Third, the amount of the temporary senior deduction is reduced once the taxpayer's "modified adjusted gross income" (generally, the taxpayer's adjusted gross income increased by amounts of excluded foreign earned income) exceeds \$75,000, a threshold that does not appear to adjust for inflation. (The non-indexed threshold for a married couple filing a joint return is \$150,000.) The temporary senior deduction reduces to zero once the taxpayer's modified adjusted gross income exceeds \$175,000 (\$250,000 for married couples filing jointly).

c. Child Tax Credit

The 2017 Act generally doubled the amount of the child tax credit and added a temporary, smaller credit for dependents that are not qualifying children of the taxpayer. It also made the credit more available to upper-middle-class taxpayers by increasing the thresholds before phaseout of the credit begins. The 2017 Act also increased the refundable portion of the credit. The OB3 Act extends these rules without expiration and also increases the amount of the credit to \$2,200, a figure set to be adjusted for inflation starting in 2026. The following table summarizes these changes:

Child Credit Feature	2001 – 2017	2018 – 2024*	2025 – beyond
Credit Amount	\$1,000 per child	\$2,000 per child; \$500 per other dependent	\$2,200 per child (as adjusted for inflation); \$500 per other dependent
Phaseout Begins when AGI exceeds...			
Unmarried & Head of Household	\$75,000	\$200,000	\$200,000
Joint Filers	\$110,000	\$400,000	\$400,000
Phaseout Complete when AGI hits...			
Unmarried & Head of Household	\$95,000	\$240,000	\$240,000
Joint Filers	\$130,000	\$440,000	\$440,000
Refundable Portion	15% of earned income in excess of \$3,000	15% of earned income > \$2,500, not to exceed \$1,400 per child (as adjusted for inflation)	15% of earned income > \$2,500, not to exceed \$1,400 per child (as adjusted for inflation)

* Does not include 2021, when the American Rescue Plan Act of 2021 increased the credit to \$3,000 per child (\$3,600 in the case of a child under age 6) and made the credit fully refundable.

The Joint Committee on Taxation concludes that the combination of the enhanced standard deduction, the repeal of the personal exemption deduction other than the temporary senior deduction, and the enhanced child tax credit will result in a net revenue loss over 10 years of over \$434 billion:

<u>Provision</u>	<u>Estimated Revenue Effect, 2025 – 2034</u>
Extended, enhanced standard deduction	(\$1,424,682,000,000)
Repealed deduction for personal exemptions other than temporary senior deduction	\$1,807,074,000,000
Extended, enhanced child tax credit	<u>(\$816,846,000,000)</u>
<i>Net Revenue Gain or (Loss)</i>	<i>(\$434,454,000,000)</i>

3. Qualified Business Income Deduction

The 2017 Act introduced §199A, which generally gives a qualifying taxpayer a deduction equal to 20 percent of the taxpayer's "qualified business income" ("QBI"). To qualify for the deduction, one must be a partner in a business entity taxed as a partnership, a shareholder of an S corporation, or a sole proprietor engaged in a trade or business. C corporations and their shareholders do not qualify for the deduction, nor do employees.

Generally, "qualified business income" is the net amount of the items of income, gain, loss, and deduction from an eligible trade or business, excluding items of capital gain and loss, as well as certain dividends from REITs, cooperatives, and publicly-traded partnerships.

Compensation paid to the taxpayer from a business (and guaranteed payments paid to a partner by a partnership) are not qualified business income.

Two restrictions on the QBI deduction kick in once a taxpayer's taxable income exceeds a certain threshold. In 2025, that threshold is \$197,300 (\$394,600 for married couples filing a joint return). The first restriction is that if the business is a "specified service business" (one that (1) involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services; (2) has as its principal asset the reputation or skill of one or more of its employees or owners; or (3) involves the performance of services consisting of investing and investment management, trading, or dealing in securities, partnership interests, or commodities), then the deduction is subject to a phaseout. The deduction is reduced to zero once the taxpayer's taxable income is more than \$50,000 over the threshold (or more than \$100,000 over the threshold in the case of a married couple filing jointly).

The second restriction applies if the amount of the deduction exceeds the "wage-basis limitation." That limitation is the greater of: (1) 50 percent of the W-2 wages paid by the business, or (2) 25 percent of the W-2 wages paid by the business plus 2.5 percent of the unadjusted basis immediately after acquisition of all depreciable property used in the business still on hand at the close of the taxable year. In fact, once the taxpayer's taxable income is more \$50,000 over the threshold (or more than \$100,000 over the threshold in the case of a married couple filing jointly), then the deduction is limited to the wage-basis limitation.

The OB3 Act increases the taxable income limitations described above, generally allowing for a greater deduction amount. Starting in 2026, the phaseout for specified service businesses does not completely erase the deduction until taxable income is more than \$75,000 over the threshold (or more than \$150,000 over the threshold in the case of a married couple filing jointly). Likewise, the deduction amount is not limited to the wage-basis limitation unless the taxpayer's taxable income is more than \$75,000 over the threshold (or more than \$150,000 over the threshold in the case of a married couple filing jointly).

But wait, there's more! Under a new §199A(i), a taxpayer will be allowed a minimum QBI deduction of \$400 as long as the aggregate QBI from all trades or businesses in which the taxpayer materially participates (as defined in the passive loss rules in §469) is at least \$1,000. Both the \$400 minimum deduction and the \$1,000 aggregate threshold amounts are to be adjusted for inflation. This means, for example, that a high-income taxpayer who materially participates in a specified service business can still claim a \$400 deduction under §199A even though other provisions of the statute would reduce the deduction to zero. It ain't much, but for the affected taxpayer it's better than no deduction at all.

Earlier drafts of the OB3 Act also provided for an increase in the amount of the deduction, from 20 percent of a taxpayer's QBI to 23 percent of QBI. The final OB3 Act, though,

keeps the deduction at 20 percent of QBI. Still, the Joint Committee on Taxation lists the 10-year revenue cost from these changes to the QBI deduction at over \$736 billion.

4. Alternative Minimum Tax Exemptions for Individuals, Estates, and Trusts

Individuals, estates, and trusts are subject to the alternative minimum tax (AMT). The minimum tax imposed is the amount by which tentative minimum tax exceeds the regular income tax liability for the year. There is a “tentative minimum tax” when “alternative minimum taxable income” (AMTI) exceeds the exemption amount. Taxpayers with high AMTIs face a phaseout of the exemption amount.

The 2017 Act temporarily increased both the exemption amount and the phaseout threshold, with the increased dollar amounts adjusted for inflation. But these higher exemptions and thresholds were scheduled to expire at the end of 2025. The OB3 Act extends the higher exemptions and phaseouts indefinitely, making minor tweaks to the inflation adjustments starting in 2026. Although the 2026 amounts are yet to be determined, the following table indicates the effect of the extensions:

	2017			2018			2025		
Taxpayer	Joint Filers	Single	Estates and Trusts	Joint Filers	Single	Estates and Trusts	Joint Filers	Single	Estates and Trusts
AMT Exemption Amount	\$84,500	\$54,300	\$24,100	\$109,400	\$70,300	\$24,600	\$137,000	\$88,100	\$30,700
Exemption phaseout begins when AMTI exceeds	\$160,900	\$120,700	\$80,450	\$1,000,000	\$500,000	\$82,050	\$1,252,700	\$626,350	\$102,500

The Joint Committee on Taxation estimates the total amount of lost revenue over the next 10 years from this extension to be over \$1.36 trillion.

5. Wealth Transfer Tax Basic Exclusion Amount

The American Taxpayer Relief Act of 2012 made permanent the \$5,000,000 basic exclusion amount for federal estate, gift, and generation-skipping transfer taxes that was introduced in the Tax Relief and Unemployment Insurance Reauthorization and Job Creation Act of 2010. The 2012 Act also called for the basic exclusion amount to continue to be adjusted for inflation after 2011.

The 2017 Act doubled the basic exclusion amount under §2010(c)(3) from \$5 million to \$10 million, still with adjustments for inflation after 2011. But the 2017 Act also provided that the basic exclusion amount would revert to \$5 million (adjusted for post-2011 inflation) after 2025. The OB3 Act prevents the reduction by resetting the basic exclusion amount to \$15 million starting in 2026, with adjustments for inflation after 2026.

<u>For decedents dying in</u>	<u>The basic exclusion amount is</u>	<u>For decedents dying in</u>	<u>The basic exclusion amount is</u>
2011	\$5,000,000	2018	\$11,180,000
2012	\$5,120,000	2019	\$11,400,000
2013	\$5,250,000	2020	\$11,580,000
2014	\$5,340,000	2021	\$11,700,000
2015	\$5,430,000	2022	\$12,060,000
2016	\$5,450,000	2023	\$12,920,000
2017	\$5,490,000	2024	\$13,610,000
		2025	\$13,990,000
		2026	\$15,000,000

Importantly, for the first time since 2001, there is no scheduled reduction in the basic exclusion amount. Further, the OB3 Act makes no changes to the application of §1014, which provides a fair-market-value-at-date-of-death basis for property acquired from a decedent.

Even if the basic exclusion amount had reverted to a \$5 million base in 2026, Congress would not have seen a huge surge in revenue. It is not too surprising, then, that the Joint Committee on Taxation projects a 10-year revenue loss from the new \$15 million base for the basic exclusion amount at “just” about \$211 billion.

6. Charitable Contributions

The OB3 Act makes three significant changes to the rules for deducting charitable contributions, all taking effect in 2026. Two of the changes are favorable for donors; the last is projected to raise revenues by limiting the deduction.

a. Up to \$1,000 Deduction for Cash Donations by Non-Itemizers

First, the OB3 Act restores the special rule from 2021 that allows individuals who do not itemize their deductions to claim a “partial” deduction for charitable contributions of cash to public charities in the computation of taxable income. While the 2021 rule allowed a maximum deduction of \$300 (\$600 for joint filers), the new rule permits a deduction of up to \$1,000 (\$2,000 for joint filers). This reinstatement of a limited charitable contribution deduction for standard deduction taxpayers is predicted to cost over \$73.7 billion over 10 years.

b. Permanent Increase in Cap on Cash Contributions

Second, the OB3 Act makes permanent the increase in the deduction limit for cash contributions to charitable organizations. Under prior law, a taxpayer could not deduct cash contributions in excess of 50 percent of the taxpayer's "contribution base" (in most cases, an amount equal to the taxpayer's adjusted gross income). Thus, for example, if a taxpayer donated \$100,000 cash to a qualified charitable organization in a year in which the taxpayer's contribution base was \$150,000, the taxpayer could deduct only \$75,000 of the contribution in the year of donation. The remaining \$25,000 would carry over to the next year as though the cash contribution was made in that year.

The 2017 Act provided that, for cash donations made from January 1, 2018, through December 31, 2025, the applicable limit would be 60 percent of the donor's contribution base. In the prior example, then, the taxpayer could deduct \$90,000 of the \$100,000 cash contribution under the new rule, with only \$10,000 carrying over to the next year. Further, cash contributions are deemed to happen before all other contributions, maximizing the chance of their deduction. This rule is now made permanent.

c. Charitable Contribution Floor

Finally, new §170(b)(1)(I) imposes a 0.5-percent floor on donations by individuals. Specifically, an individual can only deduct otherwise allowable charitable contributions to the extent such contributions, in the aggregate, exceed 0.5 percent of the taxpayer's contribution base. For example, if an individual taxpayer with a 2026 contribution base of \$100,000 donates \$10,000 to charity, the taxpayer can only deduct \$9,500 in 2026 (0.5 percent of \$100,000 = \$500). Amounts disallowed under this rule carry over for up to five taxable years.

The 0.5-percent floor does not apply to standard deduction taxpayers (meaning the \$1,000 deduction described above is not affected by this new rule). The OB3 Act provides ordering rules for determining which contributions are disallowed under this new rule, generally sacrificing deductions that are more limited (like donations of capital gain property to private foundations and other non-public charities) before turning to preferred donations like contributions to public charities. This new floor on charitable contribution deductions is expected to raise over \$16.6 billion in revenue over 10 years.

7. Home Mortgage Interest Deduction

Before 2018, a taxpayer could deduct "qualified residence interest," generally defined as the interest paid on either "acquisition indebtedness" or "home equity indebtedness." Acquisition indebtedness is debt incurred to buy, build, or improve either the taxpayer's principal residence or one other residence selected by the taxpayer (a taxpayer thus cannot have acquisition debt on three or more homes), provided the subject home secures the debt.

Home equity indebtedness is any other debt secured by the residence, regardless of how the loan proceeds are used by the taxpayer. Prior law limited the amount of acquisition indebtedness to \$1 million (half that amount for a married individual filing separately) and the amount of home equity debt to \$100,000. Thus, for example, if an unmarried taxpayer borrowed \$1.5 million to purchase the taxpayer's only home and gave the lender a mortgage on the home, the taxpayer could deduct 11/15 of the interest paid to the lender (\$1 million of the \$1.5 million loan is acquisition debt and another \$100,000 of the loan qualified as home equity debt).

The 2017 Act temporarily limited the amount of acquisition debt to \$750,000 (\$375,000 for a married individual filing separately) and temporarily suspended the deduction for interest paid on home equity debt. In the above example, then, the taxpayer could only deduct half of the interest paid to the lender (\$750,000 of the \$1.5 million loan is acquisition debt and none of it qualifies as home equity debt).

Importantly, the limit on acquisition debt only applied to debt incurred after December 15, 2017; preexisting acquisition debt was (and is) subject to the original \$1 million cap. The 2017 Act also applied the old \$1 million acquisition debt cap to taxpayers who made a binding contract before December 15, 2017, to close on the purchase of a principal residence before 2018 and who actually purchased such residence by the end of March, 2018. There was no similar exception for home equity debt—the deduction for interest on home equity debt was suspended regardless of when such debt was incurred.

All of the foregoing was set to expire at the end of 2025, but the OB3 Act extends these rules indefinitely. It also makes clear that qualified mortgage insurance premiums will continue to be treated as qualified residence interest. By continuing to limit the deductibility of home mortgage interest, the Joint Committee on Taxation projects a 10-year revenue gain of over \$39.5 billion.

8. Casualty Loss Deduction

Prior to 2018, individuals could deduct losses unrelated to a business or investment activity when such losses arose from fire, storm, shipwreck, or other casualty, or from theft, but only to the extent any such loss exceeded \$100 and only to the extent the net personal casualty loss for the year exceeded 10 percent of an individual's adjusted gross income. Under the 2017 Act, such losses in 2018 through 2025 were deductible only if they were attributable to Presidentially-declared disasters under §401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

The OB3 Act extends this disaster requirement indefinitely, but with one modification. Starting in 2026, both losses attributable to Presidentially-declared disasters and "State declared disasters" will be deductible. New §165(h)(5)(C) defines a state declared disaster as:

any natural catastrophe (including any hurricane, tornado, storm, high water, wind-driven water, tidal wave, tsunami, earthquake, volcanic eruption, landslide, mudslide, snowstorm, or drought), or, regardless of cause, any fire, flood, or explosion, in any part of the State, which in the determination of the Governor of such State (or the Mayor, in the case of the District of Columbia) and the Secretary causes damage of sufficient severity and magnitude to warrant the application of the rules of this section.

Even with the addition of a deduction for state-declared disasters, extension of the disaster requirement for casualty losses is expected to raise \$1.3 billion in revenue over the next 10 years, according to the Joint Committee on Taxation.

While the impact of the new rules for casualty losses is clear, it is uncertain to what extent these limitations apply to theft losses. Section 165(c)(3) allows a deduction for both casualty losses and theft losses. A limitation requiring a disaster declaration makes sense for casualties, but, save for post-disaster looting, thefts do not arise from disasters. Does the limitation mean that losses from non-disaster thefts are entirely non-deductible, or does the limitation have no effect on theft losses (making them deductible to the extent they survive the other limitations in §165(h))? Some clarification would have been helpful.

9. Miscellaneous Itemized Deductions

Prior law allowed an individual to deduct “miscellaneous itemized deductions” to the extent that they, in the aggregate, exceeded two percent of the individual’s adjusted gross income. Section 67 defines a “miscellaneous itemized deduction” as any itemized deduction other than one listed in §67(b). Common examples of miscellaneous itemized deductions include safe deposit box rentals for storing investment assets, net hobby expenses, fees paid for appraisals in connection with casualty loss and charitable contribution deductions, fees paid to accountants and attorneys for tax advice and tax return preparation, and the unreimbursed business expenses of an employee.

Practitioners used to refer to §67 as the “two-percent haircut.” The 2017 Act turned a haircut into a decapitation: it flat out disallowed all miscellaneous itemized deductions from 2018 through 2025. Notably, the 2017 Act did not affect the above-the-line deduction of up to \$250 for unreimbursed expenses paid by an elementary or secondary school educator under §62(a)(2)(D).

The OB3 Act makes permanent the suspension of miscellaneous itemized deductions, while at the same time treating the deduction for “educator expenses” as a regular, non-miscellaneous itemized deduction. New §67(g), effective in 2026, defines “educator expenses” as those which would be described in §62(a)(2)(D) without regard to the \$250 limitation,

without regard to the exception in §62(a)(2)(D) for “nonathletic supplies for courses of instruction in health or physical education” (read: condoms), and without regard to the limitation that such costs relate to supplies used in a classroom.

To illustrate the new rule, suppose an elementary school teacher in 2026 spends \$2,000 out of pocket on supplies used in the classroom but the school district does not reimburse the teacher for this cost. Under §62(a)(2)(D), the teacher can deduct \$250 of the cost in computing the teacher’s adjusted gross income, regardless of whether the teacher itemizes or claims the standard deduction. If the teacher itemizes, the teacher can claim the extra \$1,750 cost as deductible “educator expenses,” reducing taxable income. If the teacher takes the standard deduction, however, the extra \$1,750 cost is not deductible, which is the case under current (2025) law.

The Joint Committee on Taxation concludes that the revenue gain from the permanent disallowance of miscellaneous itemized deductions will exceed \$231 billion over 10 years. One suspects the new deduction for educator expenses likely did not reduce this total by very much.

10. New Overall Limit on Itemized Deductions

Prior to 2018, §68 generally reduced the amount of otherwise allowable itemized deductions once a taxpayer’s adjusted gross income exceeded a certain inflation-adjusted threshold. (That threshold, for example, was set to be \$320,000 for married couples and \$266,700 for unmarried individuals in 2018.) For taxpayers with very high adjusted gross incomes, up to 80 percent of itemized deductions could be lost under this rule. But the 2017 Act suspended the application of this phaseout for the years 2018 through 2025.

The OB3 Act does not extend the suspension. Rather, it replaces the old overall limitation with a new one applicable only to taxpayers in the highest ordinary income tax bracket. Starting in 2026, the amount of itemized deduction otherwise allowable for the taxable year shall be reduced by, get this, 2/37 of the lesser of: (1) the amount of such itemized deductions, or (2) the amount by which the taxpayer’s taxable income (increased by the amount of itemized deductions) exceeds the dollar amount at which the 37-percent bracket begins with respect to the taxpayer.

Suppose, for example, that an unmarried individual in 2026 has an adjusted gross income of \$1,000,000 and otherwise allowable itemized deductions of \$100,000. Assume too that, in 2026, the 37-percent bracket for unmarried individuals starts once taxable income exceeds \$650,000. Under new §68, the individual’s itemized deductions would be reduced by \$5,405, computed as follows:

Lesser of –

<i>(1) 2/37 of \$100,000 in itemized deductions:</i>	<i>\$ 5,405</i>
<i>or (2) 2/37 of \$350,000 excess of</i>	
<i>\$1,000,000 taxable income over \$650,000</i>	
<i>threshold for 37% tax bracket</i>	<i><u>\$18,919</u></i>
	<i>\$5,405</i>

Thus, in this example, the individual's itemized deductions would be reduced to \$94,595 (\$100,000 less the \$5,405 reduction under §68), resulting in a 2026 taxable income of \$905,405.

If the individual's adjusted gross income was only \$700,000, §68 would reduce the itemized deductions by only \$2,703:

Lesser of –

<i>(1) 2/37 of \$100,000 in itemized deductions:</i>	<i>\$5,405</i>
<i>or (2) 2/37 of \$50,000 excess of</i>	
<i>\$700,000 taxable income over \$650,000</i>	
<i>threshold for 37% tax bracket</i>	<i><u>\$2,703</u></i>
	<i>\$2,703</i>

In this modified example, the individual's itemized deductions would be reduced to \$97,297 (\$100,000 less the \$2,703 reduction under §68), resulting in a 2026 taxable income of \$902,703.

The new limitation is less onerous than the old one, as evidenced by the Joint Committee on Taxation's estimate that the 10-year revenue loss from the new regime will be over \$255 billion.

11. Exclusion for Qualified Bicycle Commuting Reimbursements

Former §132(f)(1)(D) allowed an employee to exclude from gross income any "qualified bicycle commuting reimbursement," defined generally in §132(f)(5)(F)(i) as a reimbursement paid to an employee to cover reasonable expenses "for the purchase of a bicycle and bicycle improvements, repair, and storage, if such bicycle is regularly used for travel between the employee's residence and place of employment." The exclusion was limited to \$20 per "qualified bicycle commuting month," defined generally as a month in which the employee uses the bike for a substantial portion of the commute to and from work and during which the employee receives no other qualified transportation fringe.

The 2017 Act suspended the exclusion for qualified bicycle commuting reimbursements from 2018 through 2025. The OB3 Act makes the suspension permanent. At the same time, the OB3 Act changes the basis for inflation adjustments to the dollar amounts applicable to other qualified transportation fringes like transit passes and transportation in a commuter highway

vehicle. Going forward, adjustments will be based on post-1997 inflation rather than post-1998 inflation. That may explain why the Joint Committee on Taxation concludes that the changes to qualified transportation fringes will not raise revenues over a 10-year period but, in fact, result in a 10-year revenue loss of over \$1.9 billion.

12. Deduction for Moving Expenses

Subject to certain requirements related to the distance moved and the amount of work time spent at the new location, §217 generally permits a deduction for moving expenses (costs of moving household goods plus traveling expenses except meals) paid or incurred during the taxable year in connection with starting work as an employee or as a self-employed individual at a new principal place of work. The 2017 Act suspended the deduction from 2018 through 2025, except in the case of members of the United States Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station.

The OB3 Act both makes the suspension permanent and expands the scope of the exception for members of the United States Armed Forces to include “members of the intelligence community,” as defined in Section 3 of the National Security Act of 1947, who move pursuant to a change in assignment. The OB3 Act makes a corresponding change to §132(g), under which both members of the United States Armed Forces and members of the intelligence community can exclude moving expense reimbursements from gross income, while other employees who receive moving expense reimbursements must continue to include such amounts in gross income. The permanent suspension of the moving expense deduction for most taxpayers is expected to raise over \$13.5 billion in revenue over the next 10 years, according to the Joint Committee on Taxation.

13. Wagering Losses

For decades, §165(d) has limited the deduction for losses from wagering transactions to the extent of the gains from such transactions. Suppose, for example, an individual had gambling gains of \$9,500 and gambling losses of \$10,000 in a single taxable year. Under prior law, the individual would include the \$9,500 of gambling gains in gross income and deduct \$9,500 of the \$10,000 in gambling losses; the excess \$500 loss would not be deductible and would not carry over to the next taxable year.

Prior to 2018, an additional rule applied to professional gamblers, those for whom gambling was a “trade or business.” Professional gamblers, like other taxpayers engaged in business, could also deduct under §162 the ordinary and necessary expenses paid or incurred in carrying on the gambling business. So while gambling *losses* were subject to the limit in §165(d), gambling *expenses* (travel away from home, supplies, and the like) were deductible without limitation.

The 2017 Act effectively provided that, for the years 2018 through 2025, the business expenses of professional gamblers would be treated as gambling losses, subjecting them to the §165(d) limitation. The OB3 Act makes this rule permanent, and goes one step further. Taking effect in 2026, new §165(d) provides that only 90 percent of losses from wagering transactions shall be allowed, and even then the allowable portion can be deducted only to the extent of gains from wagering transactions.

To illustrate, suppose the facts in the example above take place in 2026 or later. The \$10,000 in gambling losses would first be reduced to \$9,000 (90 percent of the total wagering losses for the year). Because that amount is less than the \$9,500 in gambling gains, the full \$9,000 would be deductible. But that is \$500 less than the amount that the individual would have been able to deduct if the gains and losses occurred in 2025. The new 10-percent vigorish is a bad beat for gamblers, but the Joint Committee on Taxation concludes it will raise over \$1.1 billion in revenue over the next 10 years.

14. ABLE Accounts

In 2014, Congress created §529A, which authorized states to create so-called “qualified ABLE programs” under which one could make contributions to a tax-exempt account for the benefit of a disabled individual. A disabled person (defined as one who would qualify as blind or disabled under Social Security Administration rules) may have a single account to which total annual contributions may not exceed the federal gift tax annual exclusion amount (\$14,000 at the time, but now \$19,000). Income from the account is exempt from federal income tax, and distributions made to the beneficiary for “qualified disability expenses” are likewise tax-free. Qualified disability expenses are defined broadly to include education, housing, transportation, employment training, assistive technology, health, wellness, financial management, and legal expenses (some of which are not already covered by Medicaid and OASDI benefits). Any other distributions, however, are subject to a 10-percent penalty and count as resources for purposes of the beneficiary’s Medicaid exemption.

There is no income tax deduction for contributions to the account, and any such contributions from third parties are treated as completed gifts of present interests to the beneficiary. Assets inside of an ABLE account do not count as “resources” of the beneficiary for purposes of qualifying for federal assistance. If, however, the account balance ever exceeds \$100,000, the beneficiary will be denied eligibility for SSI benefits. Furthermore, any assets inside of the account upon the beneficiary’s death are subject to Medicaid payback rules.

The 2017 Act contained three temporary modifications to ABLE accounts, all of which were to expire at the end of 2025. The OB3 Act extends all three modifications permanently. The revenue loss from making these rules permanent is expected to be just \$25 million, according to the Joint Committee on Taxation.

Contribution Limits. First, §529A(b)(2)(B) provides that once an amount of cash equal to the federal gift tax annual exclusion amount has been contributed to an ABLE account, the account's designated beneficiary generally may contribute an additional amount up to such beneficiary's compensation for the year or, if less, the federal poverty line for a one-person household. This increase in the annual contribution limit is now permanent.

Saver's Credit. Second, the amount of any such additional contribution made by the designated beneficiary is eligible for the so-called "saver's credit" under §25B. This too is now permanent. (Interestingly, the OB3 Act provides for two additional changes to the saver's credit that take effect in 2027: (1) *only* the additional contributions made by designated beneficiaries to ABLE accounts will be eligible for the credit, as all other qualified retirement contributions will no longer be eligible; and (2) the maximum amount of the credit increases from \$2,000 to \$2,100.)

Rollovers Between §529 Plans and ABLE Accounts. Finally, the OB3 Act permanently allows amounts from a qualified tuition plan to be rolled over to an ABLE account without penalty, so long as the ABLE account is owned either by the qualified tuition plan's designated beneficiary or the beneficiary's spouse, descendant, sibling, ancestor, stepparent, niece, nephew, aunt, uncle, first cousin, or in-law. Any amounts rolled over from a qualified tuition plan count toward the overall limit on amounts that can be contributed annually to an ABLE account. As was the case from 2018 through 2025, any rolled-over amount in excess of the contribution limit will be treated as ordinary income to the distributee.

15. Limit on Deduction for Personal State and Local Taxes

Prior to 2018, a taxpayer could deduct state and local property tax as well as either state and local income or sales taxes (as well as foreign real property taxes) without limitation. For example, if a taxpayer in 2017 paid local real property tax of \$5,000 in connection with the taxpayer's personal residence, state income tax of \$10,000, and state sales tax of \$13,000 on personal costs, the taxpayer could deduct a total of \$18,000 (the \$5,000 in real property tax and the sales tax of \$13,000, because that amount is larger than the \$10,000 of state income tax).

But the 2017 Act famously limited the total deduction a taxpayer could claim for state and local taxes unrelated to the taxpayer's trade or business or other profit-seeking activity to just \$10,000, and the deduction for foreign real property taxes on property unrelated to a business or investment activity was repealed entirely. In the example above, then, if the same taxes were paid in 2024, the total deduction would be limited to \$10,000. If, on the other hand, the real property taxes were paid in connection with investment property, the total deduction for 2024 would be \$15,000 (\$10,000 in state income or sales tax plus the \$5,000 in real property taxes because the real property taxes are incurred in connection with a profit-seeking activity).

The \$10,000 limit on personal state and local taxes was reduced to \$5,000 in the case of a married individual filing a separate return. All of these changes were slated to sunset at the end of 2025. Had the sunset occurred, taxpayers in 2026 would again have been able to deduct personal state and local taxes (and foreign real property taxes) without limit.

But the OB3 Act retained a cap on the deduction for personal state and local taxes, now restricting the amount of the deduction to the “applicable limitation amount.” The applicable limitation amount, defined in new §164(b)(7), starts as a specific dollar amount:

<u>Taxable Year Beginning in</u>	<u>Applicable Limitation Amount</u>
2025	\$40,000
2026	\$40,400
2027	\$40,804
2028	\$41,212
2029	\$41,624
2030 or later	\$10,000

But if a taxpayer’s “modified adjusted gross income” (generally, a taxpayer’s adjusted gross income increased by the amount of any excluded foreign earned income) for 2025 through 2029 exceeds the “threshold amount,” the applicable limitation amount is reduced by 30 percent of the excess, though in no case can the applicable limitation amount dip below \$10,000. Like the applicable limitation amount, the threshold amount changes from year to year:

<u>Taxable Year Beginning in</u>	<u>Threshold Amount</u>
2025	\$500,000
2026	\$505,000
2027	\$510,050
2028	\$515,151
2029	\$520,302

For example, an unmarried taxpayer with a modified adjusted gross income of \$510,000 in 2025 can deduct up to \$37,000 in personal state and local taxes paid in 2025:

Modified AGI	\$510,000	
Less Threshold Amount	<u>(500,000)</u>	
Excess	\$10,000	
X 30%	<u>x 0.30</u>	
Reduction to Limitation Amount		\$3,000
Applicable Limitation Amount for 2025		\$40,000
Less Reduction to Limitation Amount (above)		<u>(\$3,000)</u>
Maximum Personal SALT Deduction		\$37,000

The applicable limitation amount and the threshold amount for married couples filing jointly is the same as for unmarried taxpayers and heads of households. This was true of the original \$10,000 limitation imposed by the 2017 Act. And, as was the case under the 2017 Act, the amounts are cut in half for any married taxpayer who files separately. Thus, if the taxpayer in the above example is married but filing separately, the taxpayer can deduct up to \$5,000 in personal state and local taxes paid in 2025:

Modified AGI	\$510,000	
Less Threshold Amount	<u>(250,000)</u>	
Excess	\$260,000	
X 30%	<u>x 0.30</u>	
Reduction to Limitation Amount		\$78,000
Applicable Limitation Amount for 2025		\$40,000
Less Reduction to Limitation Amount (above)		<u>(\$78,000)</u>
Maximum Personal SALT Deduction (minimum)		\$5,000

The continued limitation of the deduction for personal state and local taxes, while with a more generous cap, is expected to raise over \$946 billion in revenue over the next 10 years, according to the Joint Committee on Taxation.

16. Discharge of Student Loan Debt

The 2017 Act introduced §108(f)(5), which generally excluded from gross income the cancellation of a student loan on account of the student's death or total disability where such cancellation occurred after 2017 and before 2026. The American Rescue Plan Act of 2021 made the exclusion applicable to all federal student loan forgiveness occurring from 2021 through 2025, regardless of the reason. The OB3 Act returns to the exclusion to its original scope (applicable only in cases of death or total disability) and makes it permanent.

Because the exclusion is now permanent, it is expected to result in a 10-year revenue loss of \$386 million, according to the Joint Committee on Taxation. That figure would have been substantially higher if Congress had decided to make permanent the exclusion for all forms of student loan forgiveness.

17. Deduction for Qualified Tips

Starting in 2025, individuals can deduct up to \$25,000 in "qualified tips" received during the year. This deduction, set forth in new §224, is available through 2028. Like the temporary senior deduction and the qualified business income deduction, the deduction for qualified tips is allowed both to taxpayers who itemize and those who take the standard deduction, but the deduction is taken into account after the computation of adjusted gross income. (In other

words, it is a “below the line” deduction available to all individual taxpayers.) No deduction for qualified tips is allowed for married individuals who file separate returns.

Qualified Tips. Section 224(d)(1) generally defines “qualified tips” as “cash tips received by an individual in an occupation which customarily and regularly received tips on or before December 31, 2024, as provided by the Secretary.” (The OB3 Act requires Treasury to publish within 90 days of the date of enactment of the OB3 Act a list of occupations with customarily and regularly received tips on or before December 31, 2024.) While this gives Treasury some discretion, §224(d)(2) provides that tips received by someone engaged in (or employed by) a specified service business are not qualified tips. Section 224(d)(2) further requires that qualified tips must be “paid voluntarily without any consequence in the event of nonpayment” in an amount “determined by the payor” and must not be the subject of negotiation. Section 224(d)(3) clarifies that “cash tips” includes tips paid in cash, tips charged to a debit or credit card, and tips received under “any tip-sharing arrangement.”

Phaseout of Deduction. Under §224(b)(2), the amount of the qualified tips deduction otherwise allowable under §224(a) is reduced by \$100 for every \$1,000 by which the taxpayer’s “modified adjusted gross income” (again, generally, adjusted gross income increased by the amount of excluded foreign earned income) exceeds \$150,000 (or \$300,000, in the case of joint return filers). Thus, for example, if an individual who receives \$50,000 in qualified tips in 2025 has a modified adjusted gross income of \$200,000, the amount of the individual’s §224(a) deduction for 2025 is \$20,000: the \$25,000 maximum deduction minus \$5,000 (\$50,000 excess modified adjusted gross income, divided by \$1,000, multiplied by \$100).

Tips Received by Non-employees. Where a self-employed individual receives tips, §224(c) provides that the §224(a) deduction will only apply to the extent that the gross income from the individual’s business for the taxable year (including any qualified tips) exceeds the total deductions allocable to the business. Suppose, for example, that an individual entrepreneur in 2025 has \$100,000 of gross income from the individual’s business activity, \$20,000 of which is in the form of qualified tips. Further suppose the individual has \$85,000 of deductible expenses in connection with the business (not including the §224 deduction) in 2025. Under §224(c), the individual can only deduct \$15,000 in qualified tips, the amount by which the business income exceeds the other deductions allocable to the business.

Not Quite “No Tax on Tips.” The OB3 Act section introducing new §224 calls it “No Tax on Tips,” but that’s not accurate. For one thing, a below-the-line deduction is not the same as an exclusion or even an above-the-line deduction. The deduction does not reduce an individual’s adjusted gross income, only the individual’s taxable income. For another, the deduction is limited to the first \$25,000 in tips received. Oh, and the deduction only covers cash tips (not tips in kind) and does not exempt any amount of tips from payroll or self-employment taxes. A more accurate title would be “Limited Deduction for Some Cash Tips,” though obviously that has substantially less political appeal.

Delivering (to a limited extent) on this campaign promise will, according to the Joint Committee on Taxation, cost over \$31.6 billion over 10 years. Given the prevalence of tipping in many service-based industries, this number initially seems modest. But then one must remember that many (most?) tips are not included in gross income already. Cash slipped to a valet, a skycap, or a bellhop rarely finds its way to a federal income tax return.

18. Deduction for Qualified Overtime Compensation

Starting in 2025, individuals can deduct up to \$12,500 in “qualified overtime compensation” received during the year. This deduction, set forth in new §225, is available through 2028. Like the deduction for qualified tips, the deduction for qualified overtime compensation is allowed both to taxpayers who itemize and those who take the standard deduction, but the deduction is taken into account after the computation of adjusted gross income. The maximum amount deductible grows to \$25,000 in the case of married couples that file joint returns, but married individuals who file separately do not qualify for any deduction.

Qualified Overtime Compensation. Section 225(c) defines “qualified overtime compensation” with reference to section 7 of the Fair Labor Standards Act of 1938. In essence, any compensation that is in excess of the regular rate at which an individual is employed that is required to be paid under federal law counts as qualified overtime compensation.

Phaseout of Deduction. Section 225(b)(2) contains a phaseout provision that copies the one applicable to qualified tips. Under this rule, the amount of the qualified overtime compensation deduction otherwise allowable under §225(a) is reduced by \$100 for every \$1,000 by which the taxpayer’s modified adjusted gross income exceeds \$150,000 (or \$300,000, in the case of joint return filers). To use a familiar example, if an unmarried individual who receives \$50,000 in qualified overtime compensation in 2025 has a modified adjusted gross income of \$200,000, the amount of the individual’s §225(a) deduction for 2025 is \$7,500: the \$12,500 maximum deduction minus \$5,000 (\$50,000 excess modified adjusted gross income, divided by \$1,000, multiplied by \$100).

Not Quite “No Tax on Overtime,” Either. “No tax on overtime” suggests a complete exclusion of overtime from gross income. A below-the-line deduction will not be as beneficial to individual taxpayers as an exclusion from gross income would have been. Still, the revenue loss from delivering on this promise is significant. Even though the maximum amount of the deduction for qualified overtime compensation is half the maximum amount of the deduction for qualified tips, the estimated revenue loss is considerably higher: over \$89.5 billion, according to the Joint Committee on Taxation. To assist employees in determining the amount of the §225(a) deduction, the OB3 Act requires employers to list the total amount of qualified overtime compensation received by an employee on the employee’s Form W-2 for any given taxable year.

19. Deduction for Interest Paid on Qualified Passenger Vehicle Loans

Section 163(h)(1) generally disallows any deduction for “personal interest” paid or accrued during a taxable year. Section 163(h)(2) defines “personal interest” as any interest that would otherwise be deductible, with just six exceptions (including, notably, business interest, qualified residence interest, and student loan interest). The OB3 Act introduces a seventh exception, allowing a deduction of up to \$10,000 in “qualified passenger vehicle loan interest,” available for taxable years beginning in 2025 through 2028. The details of the new exception are set forth in what is a modified §163(h)(4).

Qualified Passenger Vehicle Loan Interest. New §163(h)(4)(B) generally defines “qualified passenger vehicle loan interest” as any interest paid or accrued on debt incurred after 2024 used for the purchase of an “applicable passenger vehicle” for personal use, provided the debt is secured by a first lien on that vehicle. There is no deduction for interest paid on loans to finance fleet sales, loans for the purchase of a commercial vehicle, any lease financing, or loans to finance the purchase of a vehicle to be used for scrap or parts. In addition, under §163(h)(4)(E)(iii), no deduction is allowed for interest paid on a debt owed to a related party.

Applicable Passenger Vehicle. Section 163(h)(4)(D) defines an “applicable passenger vehicle” as any vehicle that meets these seven requirements: (1) final assembly occurred within the United States; (2) the original use of the vehicle commences with the taxpayer; (3) the vehicle is manufactured primarily for use on public streets, roads, and highways; (4) it has at least two wheels; (5) it is a car, minivan, van, SUV, pickup truck, or motorcycle; (6) it is classified as a motor vehicle for purposes of title II of the Clean Air Act; and (7) it has a gross vehicle weight of less than 14,000 pounds.

Phaseout of Deduction. Under §163(h)(4)(C)(ii), the amount of the deduction is reduced by \$200 for every \$1,000 (or portion thereof) by which a taxpayer’s modified adjusted gross income exceeds \$100,000 (or, in the case of a married couple filing jointly, \$200,000). Here too an example may be helpful. Assume an individual borrows \$50,000 in 2025 to purchase an applicable passenger vehicle and the loan is secured by the vehicle. The individual pays \$4,000 interest on the loan in 2025, and the individual’s modified adjusted gross income for 2025 is \$115,000. The individual can take a §163(h)(4) deduction of \$1,000: a \$4,000 deduction minus \$3,000 (\$15,000 excess modified adjusted gross income, divided by \$1,000, multiplied by \$200).

Deduction Available to Non-Itemizers Too. While most other forms of deductible personal interest are classified as itemized deductions under §67, the new deduction for car loan interest is also available to those who take the standard deduction, though it only serves to reduce taxable income and not adjusted gross income. While the deduction is only scheduled to last for 4 years, the Joint Committee on Taxation estimates the revenue loss from the new deduction at over \$30.6 billion.

20. Trump Accounts

Dubbed “MAGA accounts” (“MAGA” standing for “Money Accounts for Growth and Advancement”) in the original House of Representatives bill, the OB3 Act provides for the 2026 debut of so-called “Trump accounts” in new §530A. In simplest terms, Trump accounts function as individual retirement accounts (IRAs) created for children under the age of 18. A child can only be the beneficiary of a single Trump account. The new accounts are expected to cost over \$15.2 billion in foregone revenue, according to the Joint Committee on Taxation.

Eligible Individuals. A Trump account can only be created for the exclusive benefit of an “eligible individual,” defined in §530A(b)(2) as one who: (1) will not have reached age 18 by the close of the calendar year in which the account is created, and (2) has been issued a social security number. An election to treat an account as a Trump account must be made, either by Treasury or by someone else.

Contributions. Trump accounts can be funded starting July 4, 2026. Contributions, which are not deductible, can be made in any calendar year before the year in which the beneficiary reaches age 18. For 2026 and 2027, the total amount that can be contributed to a Trump account is, generally, \$5,000. Starting in 2028, the contribution limit is adjusted for inflation. Unlike other IRAs, contributions to Trump accounts for any calendar year must be made during the calendar year. In other words, there is no ability to designate a contribution made early in 2027 as a contribution for 2026.

Under new §128, up to \$2,500 in contributions by an employer to a Trump account for the benefit of an employee or an employee’s dependent are not included in the employee’s gross income. The \$2,500 limit adjusts for inflation starting in 2028.

The OB3 Act also provides for a “contribution pilot program” under which the federal government will indirectly fund the first \$1,000 placed into a Trump account for a child born in 2025, 2026, 2027, or 2028. Rather than fund a new Trump account directly, new §6434 treats the first \$1,000 placed into a Trump account by an individual as a refundable payment of income tax. Thus, the government’s \$1,000 contribution comes in the form of a \$1,000 credit against the federal income tax liability of the contributing individual. The \$1,000 indirect contribution does not count against the \$5,000 contribution limit in play for 2026 or 2027 (or the inflation-adjusted limits for 2028 and later). The OB3 Act sets aside \$410 billion to remain available through 2034 to carry out this pilot program.

Rollovers. The funds from a Trump account can be rolled over into a new Trump account for the same beneficiary, but because a child can only be the beneficiary of a single Trump account, all funds from the old account must roll over into the new account. Qualified rollovers are not treated as contributions and do not give rise to federal income tax consequences.

Investments. Until the start of the calendar year in which the beneficiary reaches age 18, Trump account funds can only be held in “eligible investments,” a term defined in §530A(b)(3) as, generally, a mutual fund or exchange traded fund that tracks the S&P 500 or any other index comprised of equity investments in “primarily United States companies,” provided the index is not industry- or sector-specific. Further, the fund must not charge annual fees and expenses in excess of 0.1 percent of the fund’s balance.

Distributions. Generally, no distributions are allowed until the start of the calendar year in which the beneficiary reaches age 18. Once the beneficiary turns 18, a Trump account is treated like an ordinary IRA. This means, for instance, that withdrawals will be treated as ordinary income to the beneficiary, and withdrawals taken before the beneficiary reaches age 59.5 may incur a 10-percent penalty. Certain early withdrawals, however, like those for a first-time home purchase, for qualified educational expenses, or for certain medical expenses, are not subject to the early withdrawal penalty even though they remain taxable as ordinary income.

ABLE Account Rollovers. A Trump account can also distribute funds to an ABLE account established for the benefit of the Trump account beneficiary without tax consequence, provided the rollover happens during the calendar year in which the beneficiary reaches age 17.

Account Beneficiary’s Death. If the beneficiary of a Trump account dies before reaching age 18, the account ceases to be a Trump account and taxable amounts in the account are included on the beneficiary’s final federal income tax return. If someone other than the beneficiary’s estate acquires the beneficiary’s interest in the Trump account upon the beneficiary’s death, the taxable amounts are included in that person’s gross income for the taxable year which includes the beneficiary’s date of death.

21. Adoption Credit

Section 23 offers a credit for “qualified adoption expenses” paid or incurred by individual taxpayers. The credit is generally claimed in the year in which the adoption is finalized. See §23(a)(2)(A). Traditionally, the credit was nonrefundable, meaning that if the credit amount exceeded a taxpayer’s total liability for tax, the credit would reduce the taxpayer’s liability to zero but the excess credit would not be refunded to the taxpayer. Instead, the excess credit would carry over and be added to other credit amounts claimed under §23 for up to five succeeding taxable years. See §23(c). But under the OB3 Act, up to \$5,000 of the credit is refundable, starting in 2025. To the extent the taxpayer still has unused credit, the normal carryover rule will apply. This refundable feature is expected to cost the fisc over \$2.3 billion in lost revenues over 10 years, according to the Joint Committee on Taxation.

22. Child and Dependent Care Credit

Section 21 offers a credit equal to a stated percentage of a taxpayer's "employment-related expenses" in providing the principal place of abode for certain dependents and incapacitated spouses. Under current law, the amount of the credit varies from 20 percent to 35 percent of such expenses. (The higher one's adjusted gross income gets, the lower the applicable percentage, although the applicable percentage never gets lower than 20 percent.) Specifically, §21(a)(2) provides that the credit decreases by 1 percent for each \$2,000 or fraction thereof increase in adjusted gross income above \$15,000. In any case, under §21(c), the total amount of the credit cannot exceed \$3,000 (\$6,000 if the taxpayer has two or more dependents for the year). Furthermore, because the credit is designed to assist those taxpayers who need to hire caretakers while away at work, §21(d) provides that the amount of the credit generally cannot exceed the taxpayer's earned income for the year.

Starting in 2026, however, the credit is enhanced. The OB3 Act increases the credit to anywhere from 35 percent to 50 percent of employment-related expenses. The reduction under §21(a)(2) for taxpayers with adjusted gross incomes over \$15,000 still applies, but as of 2026 there is another limit: for every \$2,000 (or fraction thereof) by which a taxpayer's adjusted gross income exceeds \$75,000 (\$150,000 for joint return filers), the credit is further reduced by 1 percent, but in no event less than 20 percent total. According to the Joint Committee on Taxation, this increase in percentage of creditable expenses is expected to cost over \$9.2 billion in revenue over the next 10 years.

23. Provisions Related to School Choice Programs

School choice programs get a boost starting in 2027, when new §§25F and 139K take effect. Section 25F creates a dollar-for-dollar nonrefundable credit of up to \$1,700 for cash contributions to "scholarship granting organizations" that grant elementary and secondary education scholarships to students living in households with an income not more than 300 percent of the median gross income in the local area. The amount of the §25F credit will be reduced by any amount allowed to the taxpayer as a credit on any state income tax return. Further, any credit allowed under §25F cannot be claimed as a charitable contribution under §170. Although the credit is nonrefundable, the statute contains a carryover mechanism so that any unused credit from one year can carry over to the next taxable year.

The benefits are not limited exclusively to donors. New §139K excludes from gross income any amounts provided to the taxpayer or to the taxpayer's dependent pursuant to a grant from a scholarship granting organization. There is no dollar limitation or expiration date associated with the exclusion.

The combined credit for donors and exclusion for recipients is expected to cost over \$25.9 billion in foregone revenue over the next 10 years, according to the Joint Committee on Taxation.

24. Exclusion for Employer Payment of Student Loans

Section 127 generally allows an employee to exclude from gross income up to \$5,250 of “educational assistance” furnished by an employer. Section 127(c)(1)(B) provides that payments made by an employer on an employee’s qualified education loan are treated as excludable “educational assistance,” but that rule was scheduled to sunset at the end of 2025. The OB3 Act makes the rule permanent. It also contains a mechanism for adjusting the \$5,250 exclusion cap for inflation starting in 2027. These measures are expected to sacrifice over \$11.2 billion in federal revenues over the next 10 years.

25. Section 529 Plan Withdrawals for Elementary and Secondary Schooling

Distributions from “qualified tuition programs” (also known as “§529 plans”) are not included in gross income if used to pay for “qualified higher education expenses.” The 2017 Act expanded the definition of “qualified higher education expenses” to include tuition expenses at “an elementary or secondary public, private, or religious school.” The OB3 Act clarifies that this expanded definition includes tuition, curricular materials, books, instructional materials, online educational materials, standardized test fees, dual enrollment fees, educational therapy fees, and even costs for tutoring by unrelated persons.

The 2017 Act provided that the maximum amount that may be distributed tax-free for elementary and secondary school tuition or for homeschooling expenses is \$10,000 per child (not \$10,000 per account); distributions in excess of that amount are taxable under the normal rules of §529. The OB3 Act increases this limitation of \$20,000 per child starting in 2026. The projected revenue cost of these measures is \$997 million over 10 years.

26. Excise Tax on Certain Private Colleges and Universities.

Although this particular change does not directly affect individuals, it affects college education and is thus included here. The 2017 Act imposed on certain private colleges and universities an excise tax equal to 1.4 percent of the school’s net investment income. The excise tax only applies to tax-exempt private schools with: (1) at least 500 tuition-paying full-time equivalent students (more than half of whom are located in the United States); and (2) aggregate endowments of at least \$500,000 per student.

Starting in 2026, the tax rates change. The tax remains at 1.4 percent of a school’s net investment income where the aggregate endowments are at least \$500,000 per student but not more than \$750,000 per student. The rate is 4 percent for institutions with aggregate

endowments of more than \$750,000 per student but not more than \$2 million per student, and the rate balloons to 8 percent for institutions with aggregate endowments of more than \$2 million per student. The OB3 Act also changes the threshold number of students for the excise tax to apply: starting in 2026, the tax only applies to private colleges and universities with at least 3,000 tuition-paying full-time equivalent students (more than half of whom are located in the United States).

The increase in the excise tax rates is expected to raise \$761 million in new revenue over the next 10 years. As adjusted by the OB3 Act, few private colleges and universities will face liability for tax, according to [one ranking](#):

<u>Endowment Per Student</u>	<u>Number of Colleges/Universities</u>	<u>New Tax Rate</u>
More than \$2 million	5	8.0%
More than \$750,000	29	7.0%
More than \$500,000	13	1.4%

C. Provisions Affecting Small Businesses and Their Owners

1. Section 179 Expensing

Prior to 2018, a taxpayer (other than an estate or trust) generally could elect to expense the first \$500,000 of so-called “§179 property” placed in service during the taxable year, but that amount was reduced by the amount by which all such property placed in service during the year exceeded \$2 million. Both of those numbers, however, were adjusted for post-2015 inflation. “Section 179” property, generally, is depreciable tangible personal property (or certain computer software) acquired by purchase for use in the active conduct of a trade or business.

The 2017 Act increased the annual cap from \$500,000 to \$1 million and increased the phaseout threshold from \$2 million to \$2.5 million. Both numbers adjusted for post-2018 inflation. In 2024, for example, the dollar limit on the §179 election was \$1,220,000 and the phaseout threshold was \$3,050,000.

The OB3 Act resets both figures, effective for taxable years beginning in 2025. For 2025, the dollar limit is \$2.5 million and the phaseout threshold is \$4 million. These numbers will still be adjusted inflation going forward. The Joint Committee on Taxation estimates that the bump in the §179 election amount will cost over \$24.8 billion in foregone revenue over the next 10 years.

2. Expensing of Depreciable Property

Prior law allowed a bonus depreciation deduction equal to 50 percent of the adjusted basis of “qualified property” (generally, new property with a recovery period of not more than

20 years and certain improvements made to other property) in the year the property was placed in service. For this purpose, the property's adjusted basis is determined after the elective application of §179 but before the application of the regular depreciation rules described in §168(a).

The 2017 Act generally increased the bonus depreciation deduction for qualified property, as shown in the following table:

<u>Year(s)</u>	<u>Applicable Percentage of Adjusted Basis</u>
2018 – 2022	100%
2023	80%
2024	60%
2025	40%
2026	20%
2027 and later	0%

The OB3 Act allows a permanent bonus depreciation deduction equal to 100 percent of the adjusted basis of qualified property, effective for property acquired after January 19, 2025. This means taxpayers can simply elect to expense (i.e., deduct) the entire cost of qualified property acquired after January 19, 2025, all in the year of acquisition. The depreciation rules under §§167 and 168 will only come into play for taxpayers who affirmatively elect out of the application of bonus depreciation under §168(k) and for taxpayers holding depreciable property to which §168(k) does not apply. Revival of 100-percent expensing comes with a hefty price tag: over \$362.6 billion over 10 years, according to the Joint Committee on Taxation.

3. Expensing of Qualified Production Property

The OB3 Act adds §168(n), which allows a deduction equal to 100 percent of the adjusted basis of “qualified production property” (“QPP”) to electing taxpayers. Effectively the provision allows for immediate expensing of costs of constructing manufacturing facilities rather than depreciating such construction costs over 39 years.

Section 168(n)(2)(A) defines QPP as any nonresidential real property that meets the following five requirements: (1) it is used by the taxpayer as an integral part of a “qualified production activity” (defined in §168(n)(2)(D) and (F) as the manufacturing, production, or refining of tangible personal property other than food or beverage in a restaurant); (2) it is placed in service in the United States or in a possession of the United States; (3) the original use of the property commences with the taxpayer; (4) construction of the property begins after January 19, 2025, and before 2029; and (5) the property is placed in service before 2031. Under §168(n)(2)(C), QPP does not include property used for “offices, administrative spaces, lodging, parking, sales activities, research activities, software development or engineering activities, or

other functions unrelated to the manufacturing, production, or refining of tangible personal property.”

If the property ceases to be used as QPP at any time during the 10-year period after it is placed in service, the property will be deemed to have been disposed of at an amount equal to its recomputed basis as computed under §1245, effectively requiring the taxpayer to recognize ordinary income equal to the amount expensed under §168(n).

The Joint Committee on Taxation predicts the new §168(n) expensing election will reduce revenues by over \$141.3 billion over 10 years.

4. Qualified Small Business Stock

As originally enacted, §1202(a)(1) generally excludes half of the gain from the sale or exchange of qualified small business stock held for more than 5 years. Under §1(h), the other half of such gain is subject to a preferential tax rate of 28 percent. In effect, then, the entirety of such gain is taxed at a rate of 14 percent (half of the gain is taxed at 28 percent, half of the gain is not taxed at all).

Over the last 16 years, however, Congress has tinkered with the exclusion amount, at every turn making the exclusion more favorable. In the American Recovery and Reinvestment Act of 2009, the exclusion increased to 75 percent of the gain from the sale or exchange of qualified small business stock acquired after February 17, 2009, and before January 1, 2011. (Where the special 75 percent exclusion applies, the effective rate of tax on the entire gain is only 7 percent.) The Creating Small Business Jobs Act of 2010 then went one step further: qualified small business stock acquired from September 28, 2010, through December 31, 2010, was eligible for a 100-percent exclusion. The Tax Relief and Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended the 100-percent exclusion for stock acquired through 2012, and the American Taxpayer Relief Act of 2012 further extended the 100-percent exclusion to stock acquired in 2013. It was extended again through 2014 by the Tax Increase Prevention Act of 2014. Finally, the Consolidated Appropriations Act of 2016 made the 100-percent exclusion permanent for stock acquired after September 27, 2010.

The OB3 Act again modifies the exclusion amount, effective for qualified small business stock acquired on or after July 4, 2025. Under a new phased increase exclusion, a taxpayer need only hold §1202 stock for 3 years in order to qualify for a partial exclusion. The exclusion percentage grows to 75 percent where the stock is held for 4 years, and the 100-percent exclusion still applies where the holding period reaches at least 5 years. The following table sets for the applicable exclusion amount based on when qualified small business stock was acquired:

For qualified small business stock acquired:	The amount of gain excluded under §1202 is:
On or before February 17, 2009	50% if held 5+ years
After February 17, 2009, but before September 28, 2010	75% if held 5+ years
After September 27, 2010, but before July 4, 2025	100% if held 5+ years
On or after July 4, 2025	50% if held 3 years 75% if held 4 years 100% if held 5+ years

As before, only C corporation stock can claim this benefit. Specifically, “qualified small business stock” is any stock in a domestic C corporation originally issued after August 10, 1993, but only if such stock was acquired by the shareholder either as compensation for services provided to the corporation or in exchange for money or other non-stock property, and only if the corporation is a qualified small business. Section 1202(d)(1) used to define a “qualified small business” as one with aggregate gross assets of \$50 million or less at all times after August 10, 1993, and before the date of issuance. The OB3 Act adjusts the cap on aggregate gross assets to \$75 million or less (adjusted for inflation as of 2027), effective for stock issued after July 4, 2025.

Section 1202(b)(1) traditionally limited the total amount of gain to which the exclusion could apply to \$10 million per issuer (or, if more, 10 times the total adjusted basis of all qualified small business stock of the corporation sold by the taxpayer during the taxable year). The OB3 Act increases this limit to \$15 million per issuer, effective for stock issued by the corporation and acquired by the taxpayer after July 4, 2025. The \$15 million limit is to be adjusted for inflation starting in 2027.

Combined, the modifications to §1202 are expected to cost over \$17.1 billion in revenue over the next 10 years.

5. Research and Experimental Expenditures

Section 174 allows taxpayers to amortize the cost of research or experimental expenditures paid or incurred in connection with a trade or business ratably over a 5-year period beginning with the midpoint of the taxable year in which such amounts are paid or incurred. The amortization period for expenditures attributable to “foreign research” (research conducted outside the United States, Puerto Rico, or United States possessions) is 15 years.

While software development costs are expressly within the scope of this rule, costs to acquire or improve land and exploration costs in connection with any deposit of oil, gas, ore, or other mineral are not eligible for amortization.

The OB3 Act essentially replaces this amortization rule with the enactment of new §174A, effective in 2025. The new rule allows an immediate deduction for any domestic research or experimental expenditures paid or incurred during a taxable year. Alternatively, a taxpayer may elect to amortize such costs ratably over a 60-month period. The new rule has the same scope as §174, meaning it does not apply to costs to acquire or improve land, nor to exploration costs in connection with any deposit of oil, gas, ore, or other mineral. Like §174, §174A treats amounts paid or incurred in connection with software development as research or experimental expenditures.

Certain small businesses are eligible for a retroactive application of the new regime to include expenditures from 2022, 2023, and 2024. In addition, a taxpayer may elect to deduct unamortized domestic research or experimental expenditures from 2022, 2023, and 2024 in 2025 (or, at the taxpayer's option, ratably over 2025 and 2026).

Going forward, §174 applies only to foreign research and experimental expenditures, still with a 15-year amortization period. Further, the research credit under §41 is revised to limit its scope to domestic research expenditures. The full expensing of domestic research and experimental expenditures is expected to cost over \$141.4 billion in foregone revenue over the next 10 years, according to the Joint Committee on Taxation.

6. Limit on Deduction for Business Interest

Since 2018, the deduction for "business interest" in the case of a taxpayer with average annual gross receipts of \$25 million or more over the past 3 years has been 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 to the next taxable year. In the case of partnerships, the limit is applied at the entity level, and each partner will have a share of the entity's adjusted taxable income.

Section 163(j)(5) defines "business interest" as any interest paid or accrued on debt properly allocable to a trade or business. The term does not include "investment interest," which has its own cap under §163(d). Section 163(j)(6) defines "business interest income" as the amount of interest includible in the taxpayer's gross income for the year that is properly allocable to a trade or business of the taxpayer. Here too, investment interest income expressly does not count as business interest income.

Section 163(j)(8) defines adjusted taxable income as the taxpayer's taxable income computed without regard to six items: (1) items not properly allocable to a trade or business; (2) business interest; (3) business interest income; (4) any net operating loss deduction; (5) any deduction for qualified business income under new §199A; and (6) deductions for depreciation, amortization, or depletion. Originally, the sixth item (depreciation, amortization, and depletion

deductions) only applied for the years 2018 through 2021. Under the OB3 Act, however, this item is reincluded and applies to taxable years beginning after 2024.

Section 163(j)(9) generally defines floor plan financing interest as interest paid on debt used to finance the acquisition of motor vehicles (defined to include both boats and farm equipment) held for sale or lease and which is secured by such vehicles. The OB3 Act now makes clear that “any trailer or camper which is designed to provide temporary living quarters for recreational, camping, or seasonal use and is designed to be towed by, or affixed to, a motor vehicle” also counts as a “motor vehicle.”

These tweaks may sound minor, but the Joint Committee on Taxation projects that the modifications will cost over \$60.5 billion in foregone revenue over the next 10 years.

7. Business Meals on Fishing Boats and at Fish Processing Facilities

The 2017 Act introduced §274(o), a provision that takes effect in 2026. That rule disallows a deduction by any employer for any the costs of operating an eating facility on the employer’s business premises, as well as the cost of any meal furnished on the employer’s business premises that is excluded from an employee’s gross income under §119.

The OB3 Act carves out certain exceptions from this rule, including exceptions for food and beverage costs required by federal law to be provided to crew members of a commercial vessel or provided on an offshore oil or gas platform or offshore drilling rig. It also creates an exception for food and beverage provided on a fishing vessel or at a fish processing facility that is “located in the United States north of 50 degrees north latitude” and not within a metropolitan statistical area. In effect, then, employers providing eating facilities or meals to employees of fishing vessels and certain fish processing facilities will be able to deduct the cost of furnishing meals in 2026 and beyond.

The Joint Committee on Taxation projects that this narrow exception will cost \$948 million in foregone revenue over 10 years. It would seem to be of particular benefit to Alaskans, where fishing and fish processing is a major industry (not to mention the only state north of 50 degrees north latitude). Perhaps Alaska Senator Lisa Murkowski—a Republican holdout in the fight to pass the OB3 Act—can explain why the final legislation contains this provision.

8. Employer-Provided Child Care Credit

Current law allows an employer to deduct 25 percent of “qualified child care expenditures” paid or incurred during the taxable year, with a maximum credit of \$150,000. The OB3 Act provides that, starting in 2026, the amount of the credit will increase to 40 percent of qualified child care expenditures, with a maximum credit amount of \$500,000 (adjusted for inflation after 2026). Moreover, the amount of the credit for an “eligible small business” is 50

percent of qualified child care expenditures, with a maximum credit amount of \$600,000 (also adjusted for inflation after 2026). An eligible small business is one that has average annual gross receipts of less than \$25 million for the past five taxable years.

Qualified child care expenses are costs to purchase, build, rehabilitate, or expand property used or to be used as a child care facility and not as the principal residence of any employee. It includes costs to operate the facility, including staff training. It also includes costs paid to an existing child care facility to provide child care services to the employer's employees.

9. Opportunity Zones

The 2017 Act introduced §§1400Z-1 and 1400Z-2, special rules for gains invested in specially designated low-income communities known as "opportunity zones." Under the 2017 Act, a taxpayer who, within six months of realizing a gain from the sale or exchange of any property to an unrelated person, invested such gain in a qualified opportunity fund (a fund that would then invest in development or business projects in designated opportunity zones) would receive three key federal income tax benefits. First, the gain from the sale would be deferred until 2026 (or, if earlier, the date on which the taxpayer sold or exchanged the investment in the qualified opportunity fund). Second, the deferred gain would be reduced by 10 percent if the taxpayer remained invested in the qualified opportunity fund for at least 5 years (15 percent if the taxpayer remained invested in the fund for at least 10 years). Finally, if the taxpayer remained invested in the qualified opportunity fund for at least 10 years, any gain from the sale or disposition of the taxpayer's investment in the fund would be excluded from gross income.

Opportunity zones were popular in 2018 and 2019, as taxpayers could maximize the period of deferral from their original gains. As 2026 neared, however, opportunity zones became less attractive to investors. Hoping to make opportunity zone investments attractive once again, the OB3 Act not only makes opportunity zones permanent but also provides for enhanced incentives to attract investors. First, gains invested in qualified opportunity funds starting in 2027 qualify for 5-year deferral in all cases, no matter when the investment occurs. Second, while the deferred gain will still be reduced by 10 percent if the taxpayer remains invested in the qualified opportunity fund for at least 5 years, the gain will be reduced by 30 percent in the case of a "qualified rural opportunity fund" (generally, a fund that devotes at least 90 percent of its assets to investments in opportunity zones in rural areas).

Because the rules do not take effect until 2027, there should be few new investments in opportunity zones in 2025 or 2026. The extended and expanded opportunity zone regime is expected to cost over \$40.9 billion over 10 years.

10. Qualified Farmland Property

Under new §1062, a taxpayer may elect to pay the “applicable net tax liability” attributable to any gain from the sale or exchange of “qualified farmland property” occurring after July 4, 2025, in four equal annual installments starting with the due date for the tax return for the year in which the sale or exchange occurs. The “applicable net tax liability” is the excess of the taxpayer’s tax liability for the taxable year over what the tax liability would have been without regard to any gain recognized from the sale or exchange of qualified farmland property.

New §1062(d)(2) defines qualified farmland property as: (1) real property located in the United States, (2) that the taxpayer uses or leases for farming purposes during substantially all of the 10-year period ending on the date of the sale or exchange, and (3) which is subject to some legally enforceable restriction that prohibits the use of the property for anything other than a farm for at least 10 years after date of the sale or exchange. “Farm” and “farming purposes” have the same meanings here as they do for purposes of the special use valuation rules for federal wealth transfer tax purposes in §2032A, including animal farms, orchards, ranches, greenhouses, and other operations.

Payments are accelerated if the taxpayer dies or makes a late installment payment. In the case of corporations, payments are accelerated if the corporation liquidates or makes a late installment payment. The installment payment of taxes attributable to gains from qualified farmland property is projected to cost over \$7.2 billion in foregone revenue over 10 years.

11. Excess Business Losses of Individuals, Partnerships, and S Corporations

Introduced in the 2017 Act, §461(l) disallows a noncorporate taxpayer’s “excess business loss” for the taxable year and treats the disallowed loss 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). Both of these dollar amounts are adjusted for inflation. In 2025, the threshold amount is \$313,000 (\$626,000 for joint filers).

Originally, §461(l) was set to expire at the end of 2025. But legislation in 2020, 2021, and 2022 kept extending the sunset date. Prior to the OB3 Act, §461(l) would have expired at the end of 2028. The OB3 Act makes the disallowance permanent. This is expected to raise over \$18.4 billion in revenue over the next 10 years.

12. Disguised Payments for Services Provided by a Partner to a Partnership

Section 707(a)(2)(A) gives the IRS the power to recharacterize certain distributions from a partnership to a partner who performs services for the partnership as transaction between

the partnership and one who is not a partner as determined “under regulations prescribed by the Secretary.” The IRS has earmarked a regulation for this purpose, but Regulation 1.707-2 has been sitting dormant (or “reserved”) for decades. The lack of regulations has led some to question whether the rule is really effective. If a Code provision provides for a rule to be issued “under regulations prescribed by the Secretary” but the IRS does not issue any regulations, does the Code provision still have effect?

The OB3 Act removes any doubt, changing “Under regulations prescribed by the Secretary” to “Except as provided by the Secretary.” This ensures that §707(a)(2)(A) applies no matter whether the IRS ever issues any regulations.

The OB3 Act makes clear too that the change should not be constructed “to create any inference with respect to the proper treatment under section 707(a) of the Internal Revenue Code of 1986 with respect to payments from a partnership to a partner for services performed, or property transferred, on or before the date of the enactment of this Act.” Though seemingly of minor import, this clarification is expected to generate over \$12.4 billion in added revenues over the next 10 years.

II. DISTRIBUTION OF QTIP TO SURVIVING SPOUSE DOES NOT TRIGGER DEEMED GIFT OF REMAINDER INTEREST, BUT COULD TRIGGER GIFT BY REMAINDER BENEFICIARIES (*McDougall v. Commissioner*, 163 T.C. No. 5, September 17, 2024), NOT TO MENTION INCOME TAX CONSEQUENCES (*Private Letter Ruling 202509010*, February 28, 2025)

In a unanimous opinion, the Tax Court confirmed that a surviving spouse did not make a gift under §2519 upon the termination of a marital trust holding “qualified terminable interest property” (“QTIP”) because the surviving spouse received all of the trust assets upon termination. It also held that the surviving spouse’s subsequent installment sale of the assets formerly held in the marital trusts likewise did not trigger a deemed gift under §2519. But the court went on to hold that the terminating distribution to the surviving spouse was a gift by the remainder beneficiaries of their vested remainder interests in the trust.

A. A Brief Primer on QTIP Elections and the Deemed Gift Rule in §2519

Both the gift tax and the estate tax offer an unlimited marital deduction for transfers of property to a spouse or surviving spouse, respectively. See §§2523(a) and 2056(a). To qualify for the deduction, generally, the spouse must receive complete ownership of the transferred property. Where the spouse receives only a life estate or some other terminable interest in property, the marital deduction is generally unavailable. See §§2523(b) and 2056(b)(1). There are exceptions to this “terminable interest rule,” and the one at play in this case is the exception for QTIP. See §§2523(f)(1) and 2056(b)(7)(A).

QTIP refers to property passing from the donor spouse (1) in which the donee spouse has a “qualifying income interest” for life; and (2) to which an election has been made to treat

the property as QTIP. §§2523(f)(2); 2056(b)(7)(B)(i). Although the spouse has only a partial interest in QTIP that will expire at some point, whether due to lapse of time or the occurrence of some event or contingency (often, the spouse's death), Congress is willing to give the donor spouse or the estate of the donor spouse a marital deduction for the full value of the QTIP. This is because the donee spouse will be treated as the absolute owner of the QTIP, so the remaining value of the QTIP will be subject to estate tax upon the death of the donee spouse. §2044. In this way, the QTIP election defers the imposition of wealth transfer tax until the time the QTIP leaves the control of the couple.

As previously mentioned, the recipient spouse must have a “qualifying income interest” for life in the transferred property in order for it to qualify as QTIP. This requires, generally, that the spouse receive all of the income from the property payable at least annually and that the property may not be appointed to anyone other than the spouse during the duration of the spouse's ownership. §2056(b)(7)(B)(ii). See also §2523(f)(3). Most often, QTIP is parked in a trust for the benefit of the recipient spouse. Upon the spouse's death, the property passes to the beneficiaries selected by the transferor spouse.

If the recipient spouse disposes of all or part of the qualifying income interest, the spouse is deemed to have transferred all interests in the QTIP other than the qualifying income interest. §2519. So if, for instance, the recipient spouse gifts the qualifying income interest to anyone else, the recipient spouse gifts not only the qualifying income interest but all of the other interests in the QTIP as well. If the recipient spouse sells the qualifying income interest, there is likewise a deemed transfer of all of the other interests in the QTIP, resulting in a deemed gift in addition to whatever income tax consequences attach to the sale. The purpose of the rule is straightforward—since the recipient spouse can no longer be deemed to have full ownership of the QTIP, it is appropriate to treat the transfer of the qualifying income interest as the moment the underlying property has left the control of the couple.

B. *Estate of Anenberg*

Earlier in 2024, the Tax Court in *Estate of Anenberg v. Commissioner*, 162 T.C. No. 9 (2024), dealt with a married couple, Alvin and Sally, that made their fortune through ownership of gas stations throughout Los Angeles and in other California locations. The couple established a revocable living trust in 1987, to which they contributed all of their assets, including the closely-held stock. When Alvin died in 2008, his half of the trust assets passed to two sub-trusts earmarked as “marital trusts.” Both marital trusts gave Sally a qualified income interest for life, and both marital trusts provided that only Sally could receive distributions of principal as needed for her support. The marital trusts further provided that, upon Sally's death, the remainder would pass to various other trusts created for the benefit of Alvin's two children from a prior marriage, Steven and Neil. Acting in his capacity as executor of Alvin's estate, Steven elected to treat the assets of both marital trusts as QTIP so that Alvin's estate could claim an estate tax marital deduction for the value of the assets passing to the marital trusts.

In 2011, Steven, acting as trustee of the marital trusts, petitioned a state court to terminate the marital trusts, claiming that he anticipated receiving consent to the termination from all of the current, vested, and contingent beneficiaries. The court issued its order approving the termination of the marital trusts early in 2012. At that time, the value of the assets in the marital trusts was \$25.45 million and the value of Sally's income interest totaled about \$2.6 million.

Later that year, Sally gifted about \$1.6 million worth of the closely-held stock to the trusts established for Steven and Neil. The next month, she sold almost all of the remaining closely-held stock to various trusts for Alvin's kids and grandkids in exchange for nine-year installment notes with a face value equal to the value of the transferred stock. All notes bore annual interest equal to the applicable federal rate at that time (0.84 percent). On a timely-filed federal gift tax return for 2012, Sally reported the gifts of the stock made to the trusts for Steven and Neil. She also disclosed the sale transactions but took the position that those transfers were not gifts because the promissory notes were full and adequate consideration for the transferred shares.

Sally died in 2016. In 2020, the IRS determined that Sally made a taxable gift of \$22.85 million in 2012 under §2519. This amount represents the difference between the value of the marital trust assets distributed to Sally and the value of her income interests in the marital trusts. When that determination generated a gift tax deficiency of more than \$9 million and an accuracy-related penalty of over \$1.8 million, the estate timely petitioned the Tax Court for a redetermination.

The IRS based its determination on the theory that Sally made a deemed gift under §2519 in 2012, either upon termination of the marital trusts or upon Sally's subsequent installment sales of the closely-held stock. But in a unanimous (13-0) decision, the Tax Court held that Sally made no deemed gift at either point.

There was no deemed gift upon termination of the marital trusts, said the court, because even if the terminations were "dispositions" within the meaning of §2519, they were not "gifts:"

[A]fter the transaction, Sally has full ownership of the ... shares. As a result of the Superior Court's order, she received free and clear the underlying property that section 2056(b)(7) deemed her to have received from Alvin to start with and with respect to which (we assume) section 2519(a) deemed her to have transferred remainder interests upon the termination of the Marital Trusts.

In other words, Sally was already the deemed owner of the assets of the marital trusts for estate and gift tax purposes, so when she received those assets outright following termination of the marital trusts, she was no poorer after the transaction. There was, thus, no transfer by gift to someone other than Sally.

Likewise, the court concluded, Sally did not make a deemed gift under §2519 when she sold the stock in exchange for the promissory notes. By the time of the sale transactions, Sally no longer held a qualifying income interest in the marital trust assets—she had absolute ownership of those assets. If she had no qualifying income interest, §2519, which requires a disposition of a qualifying income interest in order to effect a deemed gift, logically could not apply. As the court put it:

When the Superior Court terminated the Marital Trusts, the property interest Sally received was outright ownership of the ... shares, not an income interest. And because the Marital Trusts terminated, the property interest Sally received was unencumbered by any restrictions that were placed on it while it was in the Trusts, including restrictions that would have limited distributions to individuals other than Sally. For these reasons, Sally no longer held a qualifying income interest for life as defined by section 2056(b)(7)(B)(ii). Consequently, her sale of the ... shares for promissory notes could not trigger section 2519.

In a footnote, the court stated that “We express no view on whether the other beneficiaries of the Marital Trust could be treated as making a gift to Sally for gift tax purposes” when they consented to the termination of the marital trusts and, thus, to Sally’s absolute ownership of the trust assets. If this was not pursuant to a pre-arranged understanding that the sale transactions would later follow, the beneficiaries had no assurance they would continue to have a beneficial interest in the trust assets. At the very least, that bears the indicia of a gift transfer. Had the court been presented with that question, it is hardly certain the result would still be favorable to Steven, Neil, and the other heirs.

Indeed, in *Chief Counsel Advice 202118008* (May 7, 2021), the IRS concluded that the commutation of a QTIP trust—where the trust is terminated, the spouse receives an amount of assets equal to the present value of the qualifying income interest, and the remainder beneficiaries receive assets equal to the value of their remainder interests—resulted in taxable gifts by the surviving spouse and the remainder beneficiaries. It is somewhat surprising, then, that the IRS did not claim that Steven and Neil had made gifts of their remainder interests to Sally when they consented to the termination of the marital trusts.

The IRS would not be fooled twice.

C. *McDougall*

Clotilde McDougall died in 2011 with a gross estate of nearly \$60 million, survived by her husband, Bruce, and her two adult children, Linda and Peter. She left the bulk of her estate in trust for the benefit of Bruce and the kids. The trust required the trustee to pay annual income to Bruce, together with any principal needed for his health, maintenance and support. At Bruce’s death, the kids will take whatever is left in trust in shares determined by Bruce through exercise of a testamentary limited power of appointment. In his capacity as Clotilde’s executor,

Bruce made a QTIP election with respect to the property passing to the trust, enabling her estate to claim a marital deduction for the value of that property.

Whoever invested the trust assets earned a good fee: by 2016, the value of the trust assets had more than doubled. At that time, Bruce and the kids entered into a nonjudicial agreement pursuant to which the trust would terminate and the assets would be distributed outright and free of trust to Bruce. On the same day he received the trust assets, Bruce sold them to trusts established for the benefit of Linda, Peter, and their descendants in exchange for promissory notes.

On their federal gift tax returns, the parties took a unique position. They claimed that the termination of the QTIP trust resulted in a deemed gift by Bruce of the remainder interest in the trust under IRC §2519, but because Bruce received all of the trust assets, Linda and Peter made offsetting gifts of their remainder interests to Bruce. Because each party “gave what they got,” they claimed, no taxable gifts resulted. The IRS disagreed, issuing deficiency notices to Bruce, Linda, and Peter.

As the Tax Court observed, this case is eerily like *Anenberg*. Sticking to that decision, the court held that, just as Sally Anenberg made no gifts to her kids when she received all of the assets from her husband’s QTIP trust and then sold those assets to trusts for her children, Bruce made no gifts when he received the assets from Clotilde’s QTIP trust and then sold them to trusts for his Linda and Peter. But in this case, unlike *Anenberg*, the IRS also claimed that the remainder beneficiaries made gifts back to the surviving spouse. And on this point, the IRS prevailed. As the court explains:

Linda and Peter plainly made gratuitous transfers. Before the implementation of the Nonjudicial Agreement, they held valuable rights, i.e., the remainder interests in the QTIP. After the implementation of that agreement, which required their consent, Linda and Peter had given up those valuable rights by agreeing that all of the Residuary Trust assets would be transferred to Bruce. And they received nothing in return. By giving up something for nothing, Linda and Peter engaged in quintessential gratuitous transfers and are therefore subject to gift tax under sections 2501 and 2511.

While the “QTIP fiction” of IRC §2519 applies “for the limited purpose of determining [a surviving spouse’s] transfer tax liability when marital assets leave the marital unit,” it does not apply for purposes of allowing remainder beneficiaries “to escape transfer tax on their own transactions.”

The court also rejected the contention that Bruce and the kids made offsetting reciprocal gifts. Because Bruce did not make an actual or deemed gift through the termination of the trust

and the subsequent sale of the trust assets, there is nothing to offset the “very real gifts from Linda and Peter to Bruce.”

As noted, the decision was unanimous. Still, Judge Halpern contributed a concurring opinion in which he offers “an alternative analysis” that he dubs “a sounder basis for the Court’s conclusions.” He takes the position that when the trust terminates and Bruce receives all of the assets, he does not make a “disposition” of his qualifying income interest. Because he owns the assets, he still has the income interest from those assets. Thus, in his view, IRC §2519 has no application here. This leads to the same result, but in a way that avoids employment of a legal fiction. As he explains:

If section 2519(a) did not apply, we would have no occasion to impose asymmetrical treatment on a single exchange, treating Linda's and Peter's constructive transfers to Bruce as, simultaneously, (1) adequate and full consideration to him for a deemed transfer by him to Linda and Peter, and (2) wholly gratuitous, and thus taxable gifts by them to him. If Bruce made no deemed transfer under section 2519(a) to Linda and Peter, then, as the majority concludes, he made no taxable gifts to them, and their “very real” transfers to him stand alone as taxable gifts.

The court did not decide the value of gifts Linda and Peter made to Bruce, as it was ruling on cross-motions for summary judgment. Future proceedings will have to determine the value of their gifts. For now, it’s safe to say the gifts are large.

McDougall answers the question left open in *Anenberg* as to whether the termination of a QTIP trust through a nonjudicial settlement agreement represents a gift by the remainder beneficiaries. Still, at least one other question remains: suppose a court had ordered termination of the trust over the objection of Linda and Peter, or that the trustee decanted the trust in a manner such that Bruce had easier access to the trust’s assets. If Linda and Peter do not consent to the effective termination or limitation of their remainder interests, are they still making a gift? Assuming a gift requires the free and voluntary act of the transferor, there is an argument that, in such cases, the remainder beneficiaries are not making gift transfers. But the validity of that argument is an issue for another day.

D. *Private Letter Ruling 202509010*

And then there are the federal *income* tax issues related to the early termination of a trust. In *Private Letter Ruling 202509010*, the IRS considered the income, gift, and generation-skipping transfer (GST) tax consequences stemming from the court-approved termination of a trust. The trust, created before 1985, provided for the payment of an annual annuity to the grantor’s grandchild for that grandchild’s life. At the grandchild’s death, the annuity amount would be divided among the grandchild’s issue *per stirpes*. The trust would terminate upon the

last to die of ten listed individuals (including the grandchild), at which point the corpus would be paid to the grandchild's issue *per stirpes*.

The trustee, the grandchild, all of the current remainder beneficiaries, and a special representative appointed to represent minor and unborn beneficiaries have all agreed to terminate the trust pending a favorable ruling from the IRS. If the termination occurs, each beneficiary would receive an amount equal to the actuarial value of the beneficiary's interest in the trust. A court with jurisdiction over the trust has approved of the proposed early termination.

The IRS ruled that the early termination of the trust would not cause the trust to lose its GST tax-exempt status because the termination:

will neither cause a beneficial interest to be shifted to a beneficiary who occupies a generation lower than the beneficiaries who held the interests prior to the termination, nor extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original Trust, as long as the actuarial values of the trust accurately represent the actuarial value of each beneficiary's interest.

The IRS further ruled that the termination will not be treated as a gift by any beneficiary because each will receive an amount that matches the actuarial value of that beneficiary's interest.

But the IRS also ruled that for federal income tax purposes, the termination will be treated as a sale of the grandchild's life interest to the grandchild's children *and* as a sale by the issue who would take at the trust's natural termination of their rights to receive a potential distribution on termination to the grandchild's children. Furthermore, because every beneficiary has a zero basis in their interest, the entire amount received by each beneficiary in the transaction constitutes a long-term capital gain.

As always, keep in mind that a private ruling is binding only as to the taxpayer that requested it; it may not be cited as precedent before the Tax Court, and readers may not rely on it as it is not otherwise binding on the IRS. The IRS can, and often does, change its mind on any given issue examined in a private ruling. Still, professionals can gain insight into the IRS's current stance on relevant and interesting issues by reviewing a private ruling.

Note too that this ruling has been met with skepticism by some commentators. They wonder how a beneficiary who receives an amount equal to the value of his or her actuarial interest could be seen as selling to exchanging anything with any of the other beneficiaries. They claim that the commutation of a trust should not be seen as an exchange of beneficial interests. Indeed, in the gift tax context the IRS says as much when it concludes, "assuming the

actuarial values accurately represent each beneficiary's interest, we conclude that *no transfer of property will be deemed to occur* as a result of the termination and the Proposed Distribution." (Emphasis added.) Despite the concern with the reasoning, practitioners might well be concerned that the ruling signals a potential litigation position the IRS may take in other cases. For a thorough and helpful guide to the tax aspects of trust termination, see Boyle, Zaritsky, and Wallace, *The Uniform Basis Rules and Terminating Interests in Trusts Early*, 55 Real Prop. Tr. & Est. L. J. 1 (2020).

III. BOTCHED PORTABILITY ELECTION RESULTS IN ADDITIONAL ESTATE TAX FOR SURVIVING SPOUSE'S ESTATE (*Estate of Rowland v. Commissioner*, T.C. Memo. 2025-76, July 15, 2025)

The Tax Court has held that a decedent's estate could not make use of his deceased spouse's unused exclusion because the spouse's executor failed to comply with the requirements for a valid portability election. The executor thought it was sufficient simply to list the assets of the estate and not include their values, even though some of the assets were set to pass to individuals other than the surviving spouse. The case is a reminder that while estates otherwise not required to file estate tax returns may take advantage of a "simplified" method for making a portability election, they must in some cases still provide the values of assets included in the gross estate.

Introduced in the 2010 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act, a decedent's "applicable exclusion amount" for federal wealth transfer tax purposes is the sum of a "basic exclusion amount" and, in the case of a surviving spouse, a "deceased spousal unused exclusion amount," what regulations call a "DSUE amount." See IRC §2010(c)(2). Conceptually, the DSUE amount represents the remaining (unused) basic exclusion amount of the first spouse to die. Thus, if the executor of the deceased spouse complies with certain requirements, a surviving spouse can "port over" and use (for estate and gift tax purposes) the deceased spouse's unused exclusion. One of the requirements for a valid portability election, found in IRC §2010(c)(5)(A), is that the deceased spouse's executor must timely file an estate tax return.

Generally, estate tax returns are required only where the decedent's gross estate exceeds the basic exclusion amount. Yet IRC §2010(c)(5) insists that a decedent's executor must file an estate tax return in order to allow the surviving spouse to port over (and claim) any unused exclusion. This can be cumbersome, especially where a deceased spouse with a modest estate simply devises the entire estate to the surviving spouse. If forced to file a full and complete estate tax return, the executor would have to value all of the estate's assets and complete numerous schedules.

To alleviate some of the burden, Treas. Reg. §20.2010-2(a)(7)(ii) provides that where the estate is not required to file an estate tax return, the estate need not report the value of property qualifying for either the marital deduction or the charitable deduction; instead, the

estate tax return must provide “only the description, ownership, and/or beneficiary of such property, along with all other information necessary to establish the right of the estate to the deduction.” Assets passing to other beneficiaries, however, need to be separately stated and valued.

In this case, Fay Rowland died on April 8, 2016, survived by her husband, Billy. Fay’s revocable living trust and pour-over will provided for several bequests to her children, her grandchildren, her friends, a college, a charitable family foundation, and, of course, Billy. Fay’s executor obtained an extension for the filing of a federal estate tax return, postponing the due date for the return from January 9, 2017, to July 8, 2017.

Alas, Fay’s executor did not file an estate tax return until December 29, 2017. Normally that would disqualify Billy from claiming any DSUE amount, but in *Revenue Procedure 2017-34*, 2017-26 I.R.B. 1282, the IRS provided a safe harbor under which an estate tax return would be considered timely if filed before “the second annual anniversary of the decedent’s date of death.” *Id.* at 1284. Because the estate tax return for Fay’s estate was filed within two years of her death, it would seem Billy would be entitled to “port” Fay’s unused exclusion.

But even where the estate tax return is treated as timely filed, it must still comply with the other requirements for a valid portability election. And this is where Fay’s executor fell short. While the return listed various assets, it did not include the values for any of them. Instead, the return simply lists \$3 million as the “estimated gross estate” and \$1.5 million as the “estimated total allowable deductions.” The Tax Court (Judge Urda) agreed with the IRS that this shortcut rendered the portability election defective:

Fay’s Return makes no attempt to identify and distinguish marital and charitable deduction property and instead incorrectly applies the relaxed treatment across the board. Specifically, it reports (on Part 5 — Recapitulation) a value of “\$0” for each category of property listed on the various schedules and a total value of \$3 million on the entry for “Estimated value of assets subject to the special rule of Reg. section 20.20210-2T(a)(7)(ii).” The relevant instruction confirms that such treatment is reserved only for “the estimated value of the *assets subject to the special rule*,” i.e., marital and charitable deduction property. (Emphasis added.) As Fay’s Estate plainly contains property that did not pass to Mr. Rowland or charity, Fay’s Return failed to satisfy the applicable regulation (and instructions) as to the nonmarital and charitable deduction property. It thus was not complete and properly prepared.

When Billy died in January, 2018, his executor (the same person who was executor for Fay’s estate, by the way) timely filed an estate tax return that claimed a DSUE amount of just over \$3.7 million from Fay’s estate. But because the portability election was invalid, Billy had only a basic exclusion amount and no DSUE amount. That meant Billy’s estate owed more in federal estate tax.

Billy's estate argued that the portability election should be deemed valid because Fay's estate substantially complied with the election requirements. The Tax Court recognized that it has not before considered whether the doctrine of substantial compliance applies when making a portability election. But the court concluded that even if the doctrine did apply, Fay's executor did not substantially comply with the requirements of the portability regulations.

Generally, the doctrine of substantial compliance is designed to avoid hardship in cases where a taxpayer does all that is reasonably possible, but nonetheless fails to comply with the specific requirements of a provision. See, e.g., *Samueli v. Commissioner*, 132 T.C. 336, 345 (2009).

We are unconvinced that Fay's Return can be seen as doing all that was reasonably possible to comply with Treasury Regulation §20.2010-2(a)(7). This regulation requires a return making a DSUE election to satisfy the requirements of the Form 706 instructions. Treas. Reg. §20.2010-2(a)(7)(i). These instructions, in turn, direct an estate to list items of property by schedule and provide a fair market value of each item of property according to methodology provided in the instructions. * * *

Fay's Return falls well short of providing the requisite information. Although Fay's Return lists various items of property by schedule, it does not include the fair market value at the date of death of any such item. In computing the DSUE amount, Fay's Return instead estimates the gross value of Fay's Estate as \$3 million and includes the amounts of specific bequests to various individuals. Fay's Return thus provides a fraction of the detailed item-by-item value reporting required to support the claimed gross estate and DSUE amount.

Billy's estate then argued that the IRS should be precluded from disallowing the portability election under the doctrine of equitable estoppel. That too was rejected by the court:

Billy's Estate fails to establish the necessary prerequisites for estoppel. The record, which includes the IRS examining officer's activity notes and affidavits from the representatives of Billy's Estate, contains no hint of affirmative misconduct by the IRS examining officer. The record shows that the assigned examining officer identified the potential DSUE issue on June 30, 2021. Both the notes and the affidavits tell the same story: The examining officer requested limited information from the representatives of the Billy's Estate while analyzing various aspects of the issue over the next few months. On November 15, 2021, the examining officer informed the representatives that he had concluded that Fay's Return had made an improper DSUE election. We cannot conclude that the examining officer committed affirmative misconduct by not giving the representatives updates and opportunities to respond in medias res.

Thus, Fay's estate failed to make a valid portability election, meaning that Billy's estate did not have a DSUE amount that could be used to reduce liability for federal estate tax. The court granted the IRS's motion for summary judgment on these matters.

Note that in *Revenue Procedure 2022-32*, 2022-30 I.R.B. 101, the IRS replaced *Revenue Procedure 2017-34* with a new regime applicable to estates not required to file an estate tax return under IRC §6018(a). Under the current regime, estate tax returns filed before the fifth anniversary of a decedent's date of death will be treated as timely for purposes of the portability election, subject to certain requirements.

IV. VALUE OF QUALIFIED TERMINABLE INTEREST PROPERTY IS NOT REDUCED BY AMOUNTS DISTRIBUTABLE TO SURVIVING SPOUSE'S ESTATE (*Estate of Kalikow v. Commissioner*, No. 23-7957 (2d Cir. March 4, 2025))

The Second Circuit Court of Appeals has affirmed the Tax Court's determination that a decedent's gross estate included the value of assets held in a trust created under the will of the decedent's spouse for which the spouse's executors had made a qualified terminable interest property ("QTIP") election under IRC §2056(b)(7), without diminution for the amount that the trustees must pay to the decedent's estate in settlement of the estate's claim for undistributed income. It thus sustained a \$32.7 million estate tax deficiency. The appellate court also confirmed that the settlement amount could be not deducted under IRC §2053(b) as an administration expense.

A. Facts of the Case

When Pearl Kalikow's husband, Sidney, died in 1990, his will devised the residue of his estate to a trust for the benefit of Pearl. The will provided that upon Pearl's death, the trust would terminate, with the remainder passing in equal shares to two separate trusts, one for each of Sidney and Pearl's two children and their issue. The executors of Sidney's estate properly elected to treat this trust as a QTIP trust under IRC §2056(b)(7), thus enabling his estate to claim an estate tax marital deduction for the value of the assets passing to the trust.

The QTIP trust initially consisted of interests in ten New York City apartment buildings. Shortly after formation, the trustees transferred these interests to a family limited partnership in exchange for a 98.5-percent limited partner interest. At Pearl's death in 2006, the trust owned the limited partner interest and \$835,000 in liquid assets. These assets are subject to estate tax at Pearl's death as a condition to allowing Sidney's estate a marital deduction for the assets passing to the QTIP trust. Specifically, IRC §2044 requires inclusion in a surviving spouse's gross estate of the date-of-death value of the assets of a QTIP trust in which the surviving spouse held the right to annual income distributions. An estate tax return reported the value of the partnership interest at about \$42.5 million, but the IRS determined that the value of the interest was nearly \$105.7 million, resulting in a deficiency. By the time the dispute reached the

Tax Court, however, the parties had stipulated that the value of the partnership interest was about \$54.5 million.

While that would appear to be the end of the matter, there is more to the story. When one of Pearl's grandchildren petitioned the trustees for an accounting, the co-trustees filed competing accounts. One of the reports showed Pearl did not receive some \$16.9 million in income to which she was entitled. Under a QTIP trust, remember, a surviving spouse must receive all of the trust's net income at least annually. The report from the other co-trustee, on the other hand, concluded that Pearl had received nearly \$3.3 million *too much* from the trust.

The \$20 million difference led to litigation that lasted a decade. In 2019, a settlement was reached under which the trust would pay \$9.2 million to Pearl's estate. Of this amount, about \$6.5 million represented undistributed income that should have been paid to Pearl while she was alive. Pearl's will left her entire estate to a foundation she created, so the undistributed income payable under the settlement agreement would ultimately pass to charity. The balance of the settlement agreement represented legal fees and trustee commissions.

B. Tax Court Decision

The estate tax return filed by Pearl's estate reduced the amount of the QTIP trust includible in her gross estate by the \$6.5 million settlement payable to her estate. But the Tax Court rejected this position, noting that the parties had already stipulated to the value of the partnership interest. *Estate of Kalikow v. Commissioner*, T.C. Memo. 2023-21. The settlement agreement imposes liability for the settlement payment jointly on the QTIP trust and the two trusts that will receive the remainder of the QTIP trust. Importantly, the partnership itself is not liable for any portion of the payment. "Consequently," said the court, "there is no basis to conclude that this liability would affect the date-of-death fair market value of the [partnership interest], i.e., the liability would not affect the price of this partnership interest as determined between a hypothetical willing buyer and seller as of the date of the decedent's death." The court rejected the estate's argument that the decision has the effect of imposing estate tax on \$6.5 million that will ultimately pass to charity. "Inclusion of the [QTIP] trust assets in decedent's gross estate will give rise to neither double taxation nor any estate tax on any charitable bequest but rather will merely give effect to the provisions of section 2044(a)."

The estate then argued that if the \$6.5 million is not subtracted from the value of the QTIP trust assets, then that amount should be deductible as an administrative expense under IRC §2053(b). While the IRS conceded that the portion of the settlement allocable to trustee commissions was deductible, it claimed no other portion of the settlement payment was deductible. Here too, the Tax Court sided with the IRS. The settlement agreement created a claim *in favor of* the decedent's estate. The deduction under IRC §2053(b), on the other hand, relates to claims *against* the estate. Thus the settlement payment is an asset of the estate, not a liability of the estate.

C. Second Circuit Affirms

In a summary order, which may be cited although it does not have “precedential effect,” the Second Circuit affirmed both of the Tax Court’s conclusions. The Second Circuit observed that “a liability that belongs to the Trust but does not affect the value of the underlying assets would not alter the value of the gross estate.” Here, the settlement liability did not affect the assets of the trust, for, as the appellate court noted, “[a] hypothetical purchaser of the largest asset in the [QTIP] Trust—the [family limited] partnership [interest]—would not accede to the liability and therefore would not regard the liability as affecting the price of the asset.” The court found it telling that the estate and the co-trustees “knew of the undistributed income claim at the time they stipulated to” the \$54.5 million value of the partnership interest, and that the settlement agreement itself stated that the payment could be made from “readily available funds” from the trust without having to liquidate any of the properties held by the partnership. “Thus,” ruled the court, “there is no basis upon which to diminish the value of the assets included in the gross estate by the amount of the undistributed income claim.”

As for the claimed deduction under IRC §2053(b), the Second Circuit agreed with the Tax Court that the liability belonged to the trust and not to the estate. Because IRC §2053(b) only offers a deduction for claims against the estate, it would be improper to permit a deduction for the trust’s liability payable to the estate. The court also rejected the estate’s claim of double taxation, noting that the settlement payment, as part of Pearl’s residuary estate, will be paid to a charitable foundation, giving the estate a charitable contribution deduction for the amount of the settlement payment.

D. Observation

The court observed that the Tax Court “appropriately declined” to decide whether the QTIP trust would be entitled to a deduction on its own federal income tax return for the settlement payment. On this point it is important to note that the settlement was paid in 2019. Even where costs incurred in defense of a claim related to the administration of a trust are deductible under normal rules, those costs are “miscellaneous itemized deductions.” As a result, the deduction would be suspended (effectively, disallowed) under IRC §67(g). Section 67(e), which effectively exempts certain expenses of estates and trusts from this rule, see Reg. §1.67-4, would not apply because settlement payments are not unique to estates and trusts.

V. LESSER OF TWO BEQUESTS ENTITLED TO MARITAL DEDUCTION BECAUSE TERMINABLE INTEREST RULE DOES NOT APPLY (*Estate of Griffin v. Commissioner*, T.C. Memo. 2025-47, May 19, 2025)

The Tax Court has held that a \$2 million bequest to an irrevocable trust for the benefit of the decedent’s spouse did not qualify for the marital deduction because the bequest was a

terminable interest and the estate failed to elect to treat the bequest as “qualified terminable interest property” (“QTIP”). The court did, however, find that the estate could claim a marital deduction for a second bequest to the same trust because the language used in the bequest served to create a separate and distinct trust, one that did not contain a prohibited terminable interest. The case is a helpful reminder of the terminable interest rule and its nuances.

While IRC §2056(a) generally allows an estate tax deduction for property passing to a surviving spouse, IRC §2056(b) disallows a deduction where the spouse receives only a “terminable interest” in property. A terminable interest is one held by a spouse that will end upon the lapse of time, upon the occurrence of an event or contingency, or upon the failure of an event or contingency to occur. IRC §2056(b)(1). If someone else will possess or enjoy the property after the termination of the spouse’s interest, the property generally does not qualify for the marital deduction.

The purpose of this “terminable interest rule” is to deny a marital deduction for transfers between spouses where the transfer has been structured to avoid estate tax at the death of the surviving spouse. Where property passes to a spouse’s estate after the spouse’s death, however, the terminable interest rule does not apply and a full marital deduction is allowed. A marital deduction is also allowed in the case of QTIP, but, among other requirements, property is QTIP only where the decedent’s estate elects to treat the property as QTIP on the federal estate tax return.

The decedent, Martin Griffin, created a revocable living trust in 2012. In 2018, he created the “MCC Irrevocable Trust” (the “MCC Trust”), an irrevocable trust for the benefit of his wife, Maria Creel. The MCC Trust gave Maria a power to withdraw contributions made to the trust as directed by the donor. Any funds remaining in the MCC Trust as of Maria’s death would be distributed to those of her descendants that she chose through the exercise of a limited power of appointment. If she did not exercise the power, the assets would pass to her then-living descendants.

On the same day he created the MCC Trust, Martin amended his revocable living trust to provide for two bequests to be made at his death. The first was a \$2 million bequest to the MCC Trust, to be administered as follows:

the Trustee of the [MCC Trust] shall pay to Maria C. Creel a monthly distribution, as determined by Maria and Trustee to be a reasonable amount, not to exceed \$9,000.00 (such \$9,000.00 to be adjusted, from the initial funding date, by a factor for the Consumer Price Index, as reasonably determined by the Trustee, in his sole discretion).

The second bequest was in the amount of \$300,000, also payable to the MCC Trust. This bequest was to be used:

as a living expense reserve for Maria [C.] Creel, to be distributed to her in the amount of \$60,000.00 per year (\$5,000.00 monthly) (plus earnings on such amount as determined by Trustee), for up to 60 months from the time of the initial funding of this Bequest. Any undistributed amounts of this Bequest upon Maria C. Creel's death shall be paid to her estate.

Following Martin's death in 2019, his estate filed a federal estate tax return. The return did not list any property as QTIP; instead, it claimed a regular marital deduction for a total bequest to Maria of \$2.3 million. When the IRS disallowed the deduction and determined a deficiency in excess of \$1 million, the estate sought a redetermination from the Tax Court.

The Tax Court (Judge Nega) granted summary judgment to the IRS. As to the \$2 million bequest, the estate conceded that it was a terminable interest and that it did not make a QTIP election on the federal estate tax return. But the estate insisted that the bequest "might still be QTIP" because the IRS did not raise any issue with respect to the lack of a QTIP election during audit. The court called this argument "a nonstarter." It's pretty simple, really: "Since no QTIP election was made with respect to the \$2 million bequest, that bequest is not QTIP."

As to the \$300,000 bequest, the estate argued that it was not a terminable interest under applicable state (Kentucky) law. That bequest, recall, provides that any undistributed amounts remaining at Maria's death will be payable to her estate. The estate argued that that this disposition is valid under Kentucky law, but the IRS argued it was not because it contradicted the terms of the irrevocable MCC Trust. Because the MCC Trust required that all amounts still in trust at Maria's death pass as provided under the limited power of appointment, the attempt to have the remainder of this bequest pass instead to Maria's estate is invalid.

The Tax Court determined that the remainder of the \$300,000 bequest will pass to Maria's estate (and thus not be a terminable interest) only if the bequest served to create a separate trust from the MCC Trust. And sure enough, said the court, this bequest created a separate trust:

On the basis of the use of the phrase "living expense reserve" and the specification of distinct distribution provisions that clearly conflict with the existing provisions of the irrevocable MCC Trust agreement, we find that decedent intended to create a [separate] trust with the \$300,000 bequest and intended for that trust to be administered by the same person administering the MCC Trust. Bolstering this conclusion is the fact that the \$300,000 bequest contemplates how any remaining amount will be distributed upon Ms. Creel's death, whereas the \$2 million bequest contains no comparable provision. Further, the \$2 million bequest does not use the phrase "living expense reserve" — indicating a distinction between these two bequests. Decedent intended for the \$2 million bequest to be transferred to the MCC Trust and governed by the provisions of that trust. But he intended for the \$300,000 bequest to be a part of

a legally distinct trust administered by the same trustee overseeing the MCC Trust.

The court went on to hold that because this bequest created a separate trust that was not a terminable interest, the bequest qualified for the marital deduction. It thus granted the estate's summary judgment motion as to this bequest.

VI. DEATHBED PARTNERSHIP FAILS, SO ASSETS INCLUDED IN GROSS ESTATE (*Estate of Fields v. Commissioner*, T.C. Memo. 2024-90, September 26, 2024)

The Tax Court has held that assets transferred shortly before the decedent's death to a family limited partnership by the decedent's agent under a durable power of attorney are includible in the decedent's gross estate, denying valuation discounts claimed by the estate and, thus, increasing the amount of federal estate tax due.

The decedent, Anne Milner Fields, inherited an oil business from her husband in the 1960s. Under her leadership, the oil business did ... well. (Oil? Well? Get it?) According to the court, "She took a particular interest in her great nephew, Bryan Milner, educating him, mentoring him, and designating him as the successor to her wealth." She appointed Milner as the agent of a broad durable power of attorney, which proved an important component of some last-minute estate planning implemented about one month before her death.

Following a bad fall in May, 2016, the decedent's health began its downward spiral. That same month, Milner, on the advice of counsel, formed a family limited partnership, designating an LLC that he owned as the general partner and the decedent as limited partner. Milner transferred \$1,000 to the partnership on behalf of the general partner. Then, acting as the decedent's agent under the power of attorney, Milner transferred to the partnership some \$17 million in assets belonging to the decedent. Following the transfers, then, Milner's LLC was the 0.0059% general partner and the decedent was the 99.9941% limited partner. By the time the decedent's largest single asset was transferred to the partnership, the decedent had been diagnosed with end-stage Alzheimer's. Ten days after the last transfer, the decedent died.

Milner hired an expert to appraise the value of the decedent's limited partner interest. Applying a 15% minority interest discount and a 25% discount for lack of marketability, the appraiser set the value of the limited partner interest at about \$10.8 million. Milner, as the decedent's executor, reported this value on the decedent's federal estate tax return.

The IRS determined that the partnership should be disregarded and that the value of the assets contributed to the partnership on behalf of the decedent should be included in the decedent's gross estate. In the alternative, should a court determine that the partnership entity is to be respected, the IRS determined that the value of the decedent's partnership interest was \$15.388 million. The IRS also determined a negligence penalty should apply on these facts.

A. Inclusion of the Partnership Assets Under §2036(a)

Where a decedent transferred property during life but retained certain rights or interests in the property that were not relinquished before death, §2036(a) requires the property to be included in the decedent's gross estate for federal estate tax purposes. The parties stipulated that the decedent, through the actions of Milner acting as her agent, transferred assets to the partnership. They disagreed as to whether the decedent retained any rights or interests in the transferred property and as to whether the exception for "a bona fide sale for adequate and full consideration" applied.

The Tax Court agreed with the IRS that the decedent both retained possession or enjoyment of the transferred property (which causes inclusion under §2036(a)(1)) and retained the right to designate who shall possess or enjoy the transferred property (which causes inclusion under §2036(a)(2)).

Applying §2036(a)(1), the court observed that, following the transfers, the decedent was left with only \$2.15 million of assets outside the partnership, yet her will provided for bequests totaling \$1.45 million when a "substantial estate tax liability was foreseeable." That proved "an implicit agreement between Mr. Milner and [the decedent] that he, as manager of [the] general partner, would make distributions from the partnership to satisfy her expenses, debts, and bequests if and when necessary." Noting that "Virtually nothing beyond formal title changed in decedent's relationship to [her] assets," the court concluded, "The use of a significant portion of partnership assets to discharge obligations of a decedent's estate is evidence of a retained interest in the assets transferred to the partnership."

Applying §2036(a)(2), the court pointed to a provision in the partnership agreement giving the decedent the power, exercisable with Milner, to liquidate the partnership, sell its assets, and distribute the cash proceeds to the partners in accordance with their capital accounts. This power, said the court, gave the decedent the right "to at any time acquire outright all income from the transferred assets and then designate its disposition," giving her the power to control beneficial enjoyment of the assets. "We emphasize," the court concluded, "that here there was essentially no pooling of assets in the partnership, which accordingly functioned not as a joint investment vehicle but rather only as a vehicle to reduce estate tax."

B. The Bona Fide Sale Exception Does Not Apply

By its terms, §2036(a) does not apply to a transfer otherwise within its scope where the transfer is a "bona fide sale for an adequate and full consideration in money or money's worth." Precedent indicates that a transfer is a "bona fide sale" where it is "objectively likely to serve a substantial nontax purpose." *Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005). Any nontax reason must be "a significant factor that motivated the partnership's creation. A significant

purpose must be an actual motivation, not a theoretical justification.” *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005). The court also noted that “we may consider the decedent’s age and health at the time of the transfer” in determining the bona fides of a sale or exchange.

The decedent’s estate asserted four significant and legitimate nontax purposes for the partnership arrangement, but the Tax Court rejected them all. The estate first claimed the partnership would protect the decedent from financial elder abuse, citing events where the decedent had been preyed upon by manipulative caregivers. But the court noted that those instances occurred years before the formation of the partnership and that there was no evidence showing any likelihood that these events would be ongoing, especially given the decedent’s health condition at the time of formation.

The estate then claimed the partnership facilitated “succession management of assets,” effectively giving Milner the chance to name a successor to manage the partnership, a power he lacked under the power of attorney. But the court found no evidence to support this claim. Instead, the court found evidence that the only reason for formation of the partnership was to enhance applicable valuation discounts for estate tax purposes.

The third nontax purpose claimed by the estate was that the partnership “resolved the problem of third parties, such as banks, refusing to honor the general [power of attorney].” That might have had some legs were it not for the fact that the entity was formed only after the decedent’s health began its rapid decline, meaning that no one expected the power of attorney to last for much longer.

Finally, the estate argued that the partnership allowed for “consolidated and streamlined management of assets.” The court found the only evidence to support this was Milner’s own testimony, which had little probative value given a slew of other, unfavorable facts: all the transfers happened as the decedent’s health was in “precipitous decline;” the assets transferred “were of a disparate character, promised no obvious synergies with each other, and came almost exclusively from” the decedent; none of the assets transferred were business interests requiring active management; and the decedent “was not herself involved in any of the partnership planning or management.”

Thus, the transfers to the partnership were not “bona fide sales,” and because the decedent retained rights to (and control over) possession and enjoyment of the assets, the assets themselves are includible in her gross estate.

C. Valuation of the Amount Included in the Gross Estate and Application of the Penalty

Rather than simply hold that the decedent’s estate includes the date-of-death value of the assets Milner transferred to the partnership on her behalf, the court insisted on following

the cumbersome formula approach from *Estate of Moore v. Commissioner*. T.C. Memo. 2020-40. Under that formula:

$$V_{\text{included}} = C_d + FMV_d - C_t$$

V_{included} is the value that must be included in the gross estate. C_d is the date-of-death value of the consideration received by the decedent from the transfers that remains in her estate under IRC §2033. FMV_d is the fair market value of the property transferred to the partnership that is included in the gross estate under IRC §2036 as of the date of death. Finally, C_t is the value of the consideration, if any, received by the decedent as the time of the transfer, which must be subtracted under IRC §2043(a).

The court reasoned that because C_d and C_t are only 27 days apart, and because there is no evidence that the value of the assets changed over this time period, the two components cancel each other out, leaving only the date-of-death value of the assets as the amount included in the decedent's estate.

Why, oh why, must the Tax Court insist on using this formula in cases involving "deathbed formations" of a family partnership or LLC? The whole point of disregarding the partnership is to include the value of the assets held by the partnership instead of the value of the partnership interest. Unless a court finds actual consideration paid upon transfer, the formula offers little help and abundant complexity.

That brings us to the issue of valuation. At trial, the parties disputed only the valuation of one asset: some 89,000 shares of stock in North Dallas Bank & Trust. The estate's expert applied a 10% blockage discount to shares representing about 3.5% of the company's total stock, but the Tax Court noted there was no evidence or explanation given by the expert supporting the application of this discount. The court instead accepted the valuation of the IRS's expert, which valued the stock with a net asset value of \$5.43 million at just over \$5.1 million thanks to the application of a more modest 5.7% blockage discount supported by analysis from 32 comparable transactions. That meant the total amount included in the decedent's estate came to just over \$17 million, nearly \$6.2 million more than the amount shown on the estate tax return.

The IRS asserted a 20% negligence penalty in this case, which the estate resisted by claiming there was "reasonable cause" for its reporting position on the estate tax return. But the Tax Court found that "a reduction of approximately \$6.2 million in the Estate's reportable assets thanks to the seemingly inconsequential interposition of a limited partner interest between [the decedent] and her assets on the eve of her death would strike a reasonable person in Mr. Milner's position as very possibly too good to be true." Finding also that there was no evidence that Milner reasonably relied on professional tax advice, the court upheld the application of the negligence penalty.

D. Final Thoughts

Once upon a time, valuation cases involving transfers to family limited partnerships and LLCs were commonplace. Over time, planners have learned to avoid the common traps that apply to this technique, leaving fewer cases on court dockets. At the same time, the surge in the basic exclusion amount since 2017 has made it so only the largest estates find family limited partnerships and LLCs helpful in reducing the amount subject to estate tax. Generally, advisors for those largest estates are quite savvy in designing and implementing these plans, minimizing exposure to deficiency determinations.

VII. GIFT LOAN IS NOT A GIFT WHERE ADEQUATE INTEREST IS STATED AND PAID (*Estate of Galli v. Commissioner*, No. 7003-20, U.S. Tax Court, March 5, 2025)

The Tax Court has held that a loan arrangement between parent and child did not result in a taxable gift by the parent because the child agreed to pay (and in fact did pay) interest at a rate equal to the applicable federal rate (AFR) in effect in the month the loan was made.

In February, 2013, Barbara Galli, then age 79, transferred \$2.3 million to her son, Stephen. They both signed a promissory note under which the balance would be repaid in no more than nine years with interest at a rate 1.01 percent, the mid-term AFR for February, 2013. Barbara did not file a federal gift tax return reporting this transaction.

After Stephen made three annual payments of interest, Barbara died in 2016. Pursuant to her estate plan, the note was distributed to Stephen, effectively resulting in the note's cancellation. Barbara's estate tax return included in the gross estate an amount equal to the unpaid portion of the loan. But the IRS determined that the transaction was a gift. In support of its conclusion, the notice of deficiency noted the following additional facts:

The loan was unsecured and the note lacked provisions necessary to create a legally enforceable right to repayment reasonably comparable to the loans made between unrelated persons in the commercial marketplace. It has not been shown that the borrower had the ability or intent to repay the loan. It has not been shown that the decedent had the intent to create a legally enforceable loan, or that she expected repayment. ... For estate tax purposes, the estate valued the note at \$1,624,000. The difference between the amount lent and the fair market value of the note then determined by the IRS is \$869,000.

Stephen challenged the IRS's determination, arguing that the deficiency notice in essence treats the transfer not as a gift in its entirety but rather as a "gift loan." That is important, because under IRC §§7872(c)(1)(A), (d)(2), (e)(1), and (f)(3), a "gift loan" is not a taxable gift for gift tax purposes as long as interest on the loan is payable at a rate at least equal to the AFR as of the day on which the loan was made. Thus it would not matter that Barbara did

not report the transaction on a gift tax return, and the estate should not be tagged on the estate tax return with having a previously unreported gift on which no gift tax was paid.

The Tax Court (Judge Holmes) agreed. While it found the IRS's position not entirely clear, the court determined that the IRS is contending that the loan was a partial gift, not that the entire transaction was some kind of sham or disguised gift. Stephen had proof that the transaction was a loan: the note, Barbara's income tax returns including the interest paid, and bank statements proving the amounts were paid. The IRS, meanwhile, had only a theory based on the fact Barbara never filed a gift tax return. So if the IRS's position is that the transaction was a gift loan and not a gift in its entirety, Stephen is exactly right that under IRC §7872 there is no taxable gift for gift tax purposes in this case because Stephen was charged (and paid) AFR interest. The court thus granted the estate's motion for summary judgment.

Judge Holmes was right to grant the motion, as the proof of the loan and interest payments was clear. The IRS's description of the transaction in the deficiency notice reads as if it was pasted from another deficiency. It claims there was no evidence Barbara ever expected repayment, yet Stephen made all required payments on a timely basis. Had Stephen and Barbara been sloppy in following the formalities, the result may have changed. But here, the IRS just looks bad.

VIII. SECOND CIRCUIT UPHOLDS VALIDITY OF SALT WORKAROUND REGULATIONS (*New Jersey v. IRS*, 2d. Cir., August 13, 2025)

The Second Circuit Court of Appeals has upheld the validity of Reg. §1.170A-1(h)(3), a rule that reduces an otherwise allowable charitable contribution deduction "by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer." Three states and one city challenged the validity of this regulation, which had been promulgated in response to their efforts to find a workaround for the \$10,000 cap on the deduction for personal state and local taxes. They argued the regulation was promulgated in violation of the Administrative Procedure Act because it was arbitrary and capricious, but the Second Circuit rejected the claim.

A. Background

The 2017 Tax Cuts and Jobs Act imposed a limitation on the federal income tax deduction for personal state and local taxes of \$10,000 (\$5,000 in the case of a married individual filing a separate return). The rule took effect for taxable years beginning after December 31, 2017. It was set to expire in 2026, but as explained above, the 2025 One Big Beautiful Bill Act extended the limitation, though at higher amounts for the years 2026 through 2029 (\$40,000 limit in 2026, increasing by one percent each year through 2029, then reverting to \$10,000 for 2030 and thereafter).

Some states responded to the deduction cap by creating programs under which taxpayers could effectively treat state and local tax payments as charitable contributions that would be deductible in full for federal income tax purposes. By August, 2018, legislatures in four states (Connecticut, New Jersey, New York, and Oregon) had passed laws under which taxpayers making donations to state-administered charitable funds would receive state income or property tax credits. New York's law, for example, allowed taxpayers to contribute to "charitable gift trust funds" and receive a tax credit equal to 85 percent of the donation. New Jersey's statute allowed localities to create charitable funds to which contributing taxpayers may claim a New Jersey property tax credit equal to 90 percent of the contribution. Other states, including California, Illinois, and Rhode Island, considered similar legislation.

In response to these actions, the IRS in *Notice 2018-54*, 2018-24 I.R.B. 750, announced forthcoming proposed regulations:

addressing the federal income tax treatment of transfers to funds controlled by state and local governments (or other state-specified transferees) that the transferor can treat in whole or in part as satisfying state and local tax obligations. The proposed regulations will make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers. The proposed regulations will assist taxpayers in understanding the relationship between the federal charitable contribution deduction and the new statutory limitation on the deduction for state and local tax payments.

The proposed regulations were issued on August 27, 2018, and those regulations were finalized on June 11, 2019, in T.D. 9864. The regulations do not specifically target the legislation enacted in response to the \$10,000 cap on the deduction for state and local taxes; instead, the regulations broaden the scope to consider the proper tax treatment of all arrangements under which states give tax credits for donations made to certain charities. There are over 110 such credits available in a majority of states.

The final regulations, set forth at Reg. §1.170A-1(h)(3), generally provide that a taxpayer who transfers cash or property to a charity must reduce the amount of the IRC §170 charitable contribution deduction by the amount of any state or local tax credit the taxpayer receives or expects to receive. An example from the final regulations illustrates the rule:

A, an individual, makes a payment of \$1,000 to X, an entity described in section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70 percent of the amount of A's payment to X. Under paragraph (h)(3)(i) of this section, A's charitable contribution deduction is reduced by \$700 ($0.70 \times \$1,000$). This reduction occurs regardless of whether A is able to claim the state tax credit in that year. Thus, A's charitable contribution deduction for the \$1,000 payment to X may not exceed \$300.

Regulation §1.170A-1(h)(3)(vii), Example 1.

This rule does not apply where a taxpayer receives a *deduction* (rather than a credit) for state and local tax purposes for charitable contributions unless the amount of the deduction exceeds the value of the contribution. The rule also does not apply to tax credits in an amount not in excess of 15 percent of the value of the contribution because, as the preamble to the final regulations explains, the tax savings in such a case is not enough that a taxpayer would make the donation just to avoid application of the \$10,000 cap on the deduction for state and local taxes.

The regulation caused a significant decline in contributions. As the Second Circuit explained:

After New York enacted its tax credit program in April 2018, but before the IRS published the Proposed Rule in August of that year, New York's designated public fund received \$78.7 million from 487 contributions. After publication of the Proposed Rule, contributions to New York's public fund “sharply decreased,” totaling just \$25,416 from 17 contributions in 2019, the year the Final Rule became effective. * * * In 2018, the fund established by Scarsdale received over \$500,000 in contributions. Since the publication of the Proposed Rule, Scarsdale's fund has received no further contributions. Localities in New Jersey and Connecticut had not yet finalized their public funds at the time the Proposed Rule was announced and halted their plans after it was published.

That led states attorneys general in New Jersey, New York, and Connecticut, along with the Village of Scarsdale, New York, to bring this action the IRS, claiming the regulation is arbitrary and capricious, thus in violation of the Administrative Procedure Act. The decline in contributions was sufficient, ruled the court, to give the plaintiffs standing to challenge the validity of the regulation.

B. Regulation Valid

In March, 2024, a federal district court, giving deference to the IRS's interpretation of IRC §170 under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), granted summary judgment to the IRS, finding the regulation a reasonable interpretation of IRC §170. A few months later, of course, the Supreme Court overruled the practice of “*Chevron* deference” in *Loper Bright Enterprises v. Raimondo*, 603 U.S.369 (2024). Thus, on this appeal, the Second Circuit would have to determine whether the regulation is “the best readings of the statute [in order to] resolve the ambiguity.” 603 U.S. at 400.

The appellate court held that the “implicit *quid pro quo* principle” in IRC §170 permits the denial of a tax deduction where the taxpayer has received a corresponding tax credit from the recipient of a donation. It further held that the regulation is neither arbitrary nor capricious. It thus upheld the regulation's validity.

The *quid pro quo* principle confirms that a charitable gift only occurs to the extent the donor contributes more than the amount of any consideration received in exchange. As the court explained:

Our conclusion that Appellants' tax-credit programs constitute a *quid pro quo* is not based on the proposition that a taxpayer who contributes to a state fund does so to derive a tax benefit — though that is plainly most often the case — but on the outward, quantifiable features of the transaction. The state or locality receives a contribution that approximates the amount the taxpayer would otherwise have paid in taxes, which it then invests in public programs akin to those usually financed by tax revenues. Then, the same state or locality that was the recipient of the contribution extends a sizeable tax credit to the contributor, erasing the bulk of his state tax liability. The fundamental this-for-that contour of the arrangement is exactly the type of reciprocal exchange that has long been deemed disqualifying for the §170 deduction.

As for the claim that the regulation is arbitrary or capricious, the Second Circuit observed that:

An agency action survives arbitrary-and-capricious review so long as the agency “examine[d] the relevant data and articulate[d] a satisfactory explanation for its action including a rational connection between the facts found and the choice made.” *New York v. Raimondo*, 84 F.4th 102, 106-07 (2d Cir. 2023) (quoting *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)).

Among other things, the appellants argued that the IRS failed to consider how the regulation would disincentivize charitable contributions. But the court rejected this claim, observing:

that consideration was thoroughly ventilated [sic] by the IRS. The Final Rule continues to allow deductions for “the portion of a taxpayer's charitable contribution that is a gratuitous transfer,” and leaves state and local-level tax benefits untouched. * * * The Final Rule might make contributions to Appellants' funds less likely (because those contributions were presumably motivated by the prospect of a §170 deduction notwithstanding the simultaneous state tax credit), but that does not mean that charitable contributions generally will be deterred.

The court rejected other claims that the regulation was arbitrary and capricious. It thus affirmed the decision of the district court upholding the regulation.

IX. FINAL REGULATIONS (AT LONG LAST) IMPLEMENT BASIS REPORTING AND DUTY OF CONSISTENCY RULES (T.D. 9991, September 17, 2024)

The IRS has unveiled final regulations related to the so-called “duty of consistency,” a statutory requirement that a recipient’s basis in certain property acquired from a decedent must be consistent with the value of the property as finally determined for federal estate tax purposes, as well as the corollary duty to report information related to basis both to recipients and to the IRS. The final regulations, effective as of September 17, 2024, implement regulations first proposed in 2016.

A. Background

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 created two new income tax provisions as revenue raisers. First, IRC §6035(a)(1) requires executors of estates required to file a federal estate tax return to provide “a statement identifying the value of each interest in” property included in the decedent’s gross estate. The statement must be furnished to the IRS and to “each person acquiring any interest” in such property within 30 days of the date on which the estate tax return is filed or due (including extensions), whichever is earlier. Of relevance, IRC §6035(b) authorizes legislative regulations to enforce this “basis reporting” requirement, and it directs Treasury and the IRS to consider, among other things, the application of this requirement to cases where no estate tax return is required to be filed. A conforming amendment to IRC §6724(d)(1) makes the failure to furnish this statement subject to a \$250 penalty.

Second, IRC §1014(f) provides that the basis in property acquired from a decedent cannot exceed the final value that has been “determined” for federal estate tax purposes. Where there has not yet been a “determination” of the property’s value, the basis cannot exceed the amount provided in the IRC §6035 statement. Basis is “determined” for federal estate tax purposes where the value is shown on the federal estate tax return and the IRS does not contest it before expiration of the statute of limitations. If the IRS does timely contest the value and the executor relents, the basis of the property will be “determined” as the value set by the IRS. Of course, basis can also be “determined” by a court or through a settlement agreement between the IRS and the executor.

These rules, which effectively prohibit claiming property has a lower value for estate tax valuation purposes and a higher value for income tax basis purposes, are applicable to property “with respect to which an estate tax return is filed” after July 31, 2015, some two weeks after enactment. That gave Treasury little time to implement the new regime.

In *Notice 2015-57*, 2015-36 I.R.B. 24, the IRS indicated that for IRC §6035 statements required to be filed or furnished to a beneficiary before February 29, 2016, the due date would be postponed to February 29, 2016. This would give the IRS time to issue guidance implementing

the basis reporting and consistency rules and, ideally, a form. Indeed, the notice told executors and others required to furnish IRC §6035 statements not to do so “until the issuance of forms or further guidance by the Treasury.”

B. Form 8971

On January 29, 2016, Treasury released the final version of Form 8971, Information Regarding Beneficiaries Acquiring Property From a Decedent, together with instructions. The Form asks for general information about the decedent and executor, as well as the name, taxpayer identification number, and address of each beneficiary. The Form includes a Schedule A, the page to be furnished to each beneficiary of the estate. The schedule must provide a “description of property acquired from the decedent,” along with an indication of where the item is reported on the estate’s Form 706. The schedule must indicate whether the asset increased estate tax liability, the valuation date for the asset, and the “estate tax value (in U.S. dollars).” The Schedule A includes this notice to beneficiaries:

You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. Retain this schedule for tax reporting purposes. If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional.

Instructions accompanying the form indicate that if final distributions have not been made by the time the Form 8971 is due, “the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary’s distribution on that beneficiary’s Schedule A. (This means that the same property may be reflected on more than one Schedule A.) A supplemental Form 8971 and corresponding Schedule(s) A should be then filed once the distribution to each such beneficiary has been made.” As Steve Akers observed in a March, 2016 report:

This [will] cause real heartburn for some estates. Executors may be reluctant to provide full information about all estate assets to beneficiaries who are only entitled to receive a general bequest that may represent a fairly small portion of the estate. Furthermore, it will be burdensome. In effect, *each* beneficiary who has not already been funded by the 30 day due date will receive a report that may be about as long as the Form 706—including a list of all assets listed on the return that have not yet been sold or distributed and that could be distributed to the beneficiary.

Steve R. Akers, *Basis Consistency Temporary and Proposed Regulations* at 9 (Mar. 25, 2016).

In *Notice 2016-19*, 2016-9 I.R.B. 362, the IRS extended the first deadline for IRC §6035 statements (Forms 8971) from February 29, 2016, to March 31, 2016. Then, in *Notice 2016-27*, 2016-15 I.R.B. 576, the IRS again extended the deadline for Form 8971 filings to June 30, 2016.

C. Proposed (and Now Final) Regulations

On March 4, 2016, the IRS issued proposed regulations offering guidance on the application of IRC §§1014(f) and 6035. The proposed regulations offered a number of clarifications, the vast majority of which survived in the final regulations. First, the proposed regulations stated that while IRC §1014(f) caps the initial basis a beneficiary takes in property, **subsequent adjustments** to basis for improvements, depreciation, and the like will still be allowed. The final regulations retain this rule and further clarify that where the property is subject to recourse or nonrecourse debt, the beneficiary's initial basis will be the gross value of the property without any reduction for the amount of debt, regardless of whether the estate reports the net equity value of the property or separately reports the gross value of the property and claims an estate tax deduction for the amount of the outstanding debt. Reg. §1.1014-10(b)(3)(i).

Second, the proposed regulations provided that because IRC §1014(f) applies to property the inclusion of which in the decedent's gross estate actually increases the estate's liability for federal estate taxes, **property eligible for the marital and charitable deductions is exempted** from IRC §1014(f), as is any tangible personal property for which an appraisal is not already required under the estate tax regulations (the final regulations refer to this as "**household and personal effects**"). But all other property included in the gross estate is subject to IRC §1014(f) if any federal estate tax liability is incurred. The final regulations retain this rule, further clarifying that the exclusion does not apply to property qualifying for only a partial marital or charitable deduction. Reg. §1.1014-10(c)(2)(xi). This means, for example, that property passing to a charitable remainder trust or a charitable lead trust is still subject to the duty of consistency, as is property passing to a trust to which a only partial QTIP election has been made.

Third, the proposed regulations addressed property discovered after the filing of the Form 706 and property omitted from the Form 706 (herein, "**omitted property**"). If the omitted property is reported before the expiration of the statute of limitations on the assessment of estate tax, the regular rules for determining the final value of property would apply. But if the omitted property is reported after expiration of the statute of limitations, it would have a final value of zero. Likewise, if no estate tax return is ever filed, the final value of all property includible in the gross estate that is subject to IRC §1014(f) would be deemed to be zero.

To the surprise of no one, the IRS received a lot of comments on this "zero basis rule." The preamble to the final regulations notes that comments either challenged the IRS's authority to implement a zero basis rule or decried the zero basis rule as "onerous, unduly harsh, and

unfair.” While claiming it absolutely had authority to implement the zero basis rule, the IRS recognized that it affects only the recipients of omitted property, many of whom will have no knowledge of the omission or any involvement in the failure to report the property. Accordingly, the final regulations abandon the zero basis rule. Comforted by the fact that intentional omission of property will trigger criminal liability, the final regulations clarify that the basis consistency rule only applies to property included in the value of the decedent’s gross estate. Reg. §§1.1014-10(c)(1)(i); 1.1014-1(d)(4).

Fourth, the proposed regulations clarified that the IRC §6035 reporting requirement does not apply where an estate tax return is filed solely for purposes of making a **portability election** or a **generation-skipping transfer tax exemption allocation**. The final regulations retain this rule.

Fifth, the proposed regulations **exempted the following assets** from IRC §6035 reporting: cash (narrowed in the final regulations to only United States dollars but also broadened to include any cash equivalent payable in United States dollars, like life insurance proceeds), income in respect of a decedent (specifically including retirement plans, per the final regulations), items of tangible personal property for which an appraisal is not required under the estate tax regulations (again referred to in the final regulations as “household and personal effects”), and property that will not be distributed to a beneficiary because it has been sold or otherwise disposed of by the estate in a taxable transaction. The final regulations retain this rule, subject to the modifications described above.

Sixth, the proposed regulations made clear that **where an individual executor is also a beneficiary**, the executor must still furnish a Schedule A to Form 8971 to himself or herself. If the beneficiary is an estate, trust, or business entity, the notice is to be delivered to the entity and not its beneficiaries or owners. If the executor cannot locate a beneficiary in time, the Form 8971 is to explain the efforts taken to locate the beneficiary. The final regulations retain this rule, deleting a requirement from the proposed regulations that would require an executor to use “reasonable due diligence” to locate a missing beneficiary.

Finally, the proposed regulations provided that where the recipient of property reported on the Form 8971 **transfers** all or any portion of the property to a related party, the transferor must file a supplemental Form 8971 documenting the new ownership if the transferee’s basis is to be determined with reference to the transferor’s basis. Realizing this rule “is too heavy a burden to impose on individual beneficiaries who, as a practical matter, may have no way of knowing the existence of, or of how to comply with, this subsequent reporting requirement,” the final regulations narrow the rule to apply only to “trustees of beneficiary trusts making a distribution of property that was reported on a Statement furnished to those trustees, or of any other property the basis of which is determined, in whole or in part, by reference to the basis of this property.” Reg. §1.6035-1(h)(1).

D. Worth the Wait?

The preamble to the final regulations offers no explanation or apology for the eight-year gap between the issuance of the proposed regulations and the final regulations. Still, to the extent the final regulations eliminate the zero basis rule and the requirement that recipients report carryover basis transfers to third parties—rules that most generated the most objections from commentators—many practitioners will likely consider the final regulations worth the wait.

X. ORDINARY INCOME ALLOCATED TO LIMITED PARTNERS IN NAME ONLY IS SUBJECT TO SELF-EMPLOYMENT TAX (*Soroban Capital Partners LP v. Commissioner*, T.C. Memo. 2025-52, May 28, 2025)

The Tax Court has closed the loop on a self-employment tax case involving a Delaware limited partnership that operates as an investment firm. The partnership has one general partner (a limited liability company) and five limited partners, consisting of three individuals and two limited liability companies, each of which is wholly owned by one of the individuals. Thus, for federal income tax purposes, there are only three limited partners since the two LLCs are disregarded.

On its federal income tax return for 2016, the partnership reported about \$2 million in net earnings from self-employment, and its 2017 return reported about \$1.9 million in net earnings from self-employment. In both cases, while the reported amounts included the guaranteed payments made to the limited partners, the reported amounts did not reflect the limited partners' distributive shares of the partnership's ordinary income. In 2022, the IRS determined that the limited partners' distributive shares of the partnership's ordinary income should have been included, which brought the parties to the Tax Court.

A. Statutory Background

Under IRC §1401, individuals must pay a tax on “the net earnings derived from self-employment” during the year. The Code defines net earnings from self-employment as “the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member.” IRC §1402(a). Thus, an individual's distributive share of a partnership's ordinary business income is included as net earnings from self-employment.

But under IRC §1402(a)(13), net earnings from self-employment *does not include* “the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the

nature of remuneration for those services.” This is often referred to as the “limited partner exception.”

B. The Tax Court’s Prior Decision (“*Soroban I*”)

The partnership argued that because its three limited partners were, well, limited partners in a state law limited partnership, the limited partner exception applied without any further examination. But in *Soroban Capital Partners LP v. Commissioner*, 161 T.C. 310 (2023) (*Soroban I*), the Tax Court held that the exception from self-employment taxes for distributive shares allocable to “limited partners, as such” only applies to distributive shares allocable to those actually functioning as limited partners and not to the shares allocable to those acting as limited partners in name only. The *Soroban I* court also held that the determination of whether a partner is truly a limited partner or one acting in name only is a partnership-level determination over which the Tax Court has jurisdiction in a partnership-level proceeding.

The *Soroban I* court observed that the purpose of the exception was to prevent limited partners who merely invested in a partnership and did not actively participate in business operations from earning social security coverage on what was, effectively, investment income. It thus makes sense to construe the exception as applying only to the distributive shares of limited partners who are involved merely as investors and not as active participants in the partnership’s business. Invoking its decision in *Renkemeyer, Campbell & Weaver LLP v. Commissioner*, 136 T.C. 137 (2011), the *Soroban I* court again proclaimed that limited partners who performed services for a partnership in their capacities as partners should be liable for self-employment taxes. In *Renkemeyer*, the court used a “functional analysis test” to determine whether a limited partner was truly a “limited partner, as such” or one who performed services for the partnership in the way in which a self-employed person would act.

But the *Soroban I* court also noted that the *Renkemeyer* case involved law partners in a limited liability partnership, while this case involved an entity organized as a state law limited partnership. So the court had to determine whether the functional analysis test should also be applied to limited partners in a state law limited partnership. The court concluded in the affirmative, noting simply that:

If Congress had intended that limited partners be automatically excluded, it could have simply said “limited partner” [in IRC §1402(a)(13)]. By adding “as such,” Congress made clear that the limited partner exception applies only to a limited partner who is functioning as a limited partner.

161 T.C. No. 12 at 11. The partnership pointed to excerpts from the legislative history and other cases to support its argument that the exception applied to all limited partners regardless of their roles in the partnership, but the *Soroban I* court found those references either out of context or merely statements of general rules and not official interpretations of the limited partner exception.

C. Tax Court Confirms *Soroban I* (*Denham Capital*)

In *Denham Capital Management LP v. Commissioner*, T.C. Memo. 2024-114, the Tax Court stuck to its guns, holding that individual partners in an investment firm were not “limited partners, as such” for self-employment tax purposes because of their active involvement in the partnership's management. As a result, their distributive shares were subject to self-employment tax for the years at issue. In reaching this decision, the court affirmed its commitment to the rule announced in *Soroban I* that the exemption from self-employment tax for “limited partners, as such” does not apply to individuals who are limited partners in name only:

Petitioner contends that *Soroban* missed the mark because therein the Court did not consider a third element of the definition of partnership items — that the item must affect the entire partnership, not just the partners individually. The Court adheres to the doctrine of stare decisis and thus affords precedential weight to its prior reviewed and division opinions. ... We revisit our prior decisions only when presented with a special justification to do so. ... We see no special justification to revisit *Soroban*’s reasoning.

D. Applying the Test to the Limited Partners (“*Soroban II*”)

In *Soroban II*, the court (Judge Buch) applied the “functional analysis” test from *Renkemeyer*, under which a limited partner’s distributive share of partnership income is excluded from net earnings from self-employment where “the surrounding circumstances of the partner’s economic relationship with the partnership ... sufficiently indicate that it is generally one of passive investment.” This required the *Soroban II* court to consider the sources of the partnership’s income for the years at issue, the roles of the partners in generating that income, and the relationship between the distributive shares of the limited partners and any capital contributions they made to the partnership.

In this case, the partnership charged clients for managing investments, and the court found that the “time, skills, and judgment” of the limited partners “were essential to these services.” All of the limited partners controlled the investment process that generated over \$245 million in revenue over the taxable years at issue. Although the partnership also hired other people to carry out its business operations, it was clear from the record that the limited partners maintained control over the core functions of the entity’s business. Moreover, the limited partners devoted their full-time efforts during the years at issue to the active pursuit of the partnership’s investment-management business.

The court found it important that the partnership actively marketed the expertise of the limited partners. The court noted that the experience of one of the limited partners “was so crucial that if he became incapacitated, it would be a key-man event triggering rights notice to investors and the right to withdraw funds on short notice.” Finally, the court pointed to the

“insignificant” capital contributions of the limited partners as proof that their distributive shares were not returns on investment. As the court stated:

When the size of a partner’s investment is relatively small in comparison to the fees the partnership charges for services it provides, the small investment is not sufficient to classify the partner’s distributive share as a return on investment.

T.C. Memo. 2025-52 at 18. In this case, one of the limited partners contributed \$4 million, yet his distributive shares over the two years at issue came to \$80 million. It was even worse for the other two limited partners, for they made no capital contributions to the partnership at all.

The taxpayer tried to convince the court that it mattered that state law classified the limited partners as limited partners, but the *Soroban II* court rejected the invitation:

Labels are perhaps least relevant because they may be inconsistent with the economic reality of a partner’s relationship with the entity. A partner labeled a limited partner who works for the business full time, whose work is essential to generating the business’s income, who is held out to the public as essential to the business, and who contributes little or no capital, is not functioning as a limited partner regardless of the label placed on that partner.

T.C. Memo. 2025-52 at 20. Consequently, held the *Soroban II* court, the individual partners here are not “limited partners, as such” within IRC §1402(a)(13), so their distributive shares are net earnings from self-employment.

If the taxpayer appeals this case to the Second Circuit Court of Appeals, it would be the third circuit to address the application of IRC §1402(a)(13) to limited partners. As of this writing there are cases pending in the First Circuit and the Fifth Circuit. *Denham Capital* was appealed to the First Circuit, and the Tax Court’s Rule 251 decision in favor of the IRS in *Sirius Solutions LLLP v. Commissioner*, Docket No. 30118-21 (2023) was appealed to the Fifth Circuit.

XI. UNANIMOUS TAX COURT INVALIDATES REGULATION INTERPRETING DEADLINE FOR PARTNERSHIP ADJUSTMENT (*JM Assets, LP v. Commissioner*, 165 T.C. No. 1, July 2, 2025)

The Tax Court has held that a Regulation §301.6235-1(b)(2)(A) invalidly extended the period during which the IRS must complete a final partnership adjustment and that, therefore, the regulation is void. The case is noteworthy, as it is rare for any court to invalidate a regulation on substantive rather than procedural grounds. Moreover, it is especially rare for the Tax Court to invalidate a regulation in a unanimous reviewed opinion.

The case involves a Texas limited partnership that manages various parcels of real property. In 2018, the partnership disposed of some real property, reporting the transactions as installment sales on its federal income tax return for 2018. After examining the return, the IRS

on June 9, 2022, issued a notice of proposed adjustment under which the partnership would be required to recognize all of the gains from some of the installment sale transactions on the 2018 return. Under the proposed adjustment, the partnership would have about \$5.5 million more in net “\$1231 gain,” resulting in an underpayment of just over \$2 million.

On February 14, 2023, the partnership submitted a request for modification seeking to modify the tax rates that would apply as to two of its partners in connection with the proposed deficiency. The IRS approved that request on June 5, 2023. Then, on December 1, 2023, the IRS issued a final partnership adjustment formally determining the underpayment of just over \$2 million, together with penalties. The partnership argued the determination was void because the IRS waited too long to issue the final adjustment.

Generally, under IRC §6235(a)(3), once the IRS issues a proposed adjustment, it has at least 330 days to mail a final adjustment. But under IRC §6225(c), if the partnership timely seeks a modification to the adjustment, then the final adjustment can be mailed up to 270 days “after the date on which everything required to be submitted to the Secretary ... is so submitted.” Regulation §301.6235-1(b)(2) defines that date:

(2) Date on which everything is required to be submitted—(i) In general. For purposes of ... this section, the date on which everything required to be submitted to the IRS pursuant to section 6225(c) is so submitted is the earlier of—

(A) The date the period for requesting modification ends (including extensions) as described in §301.6225-2(c)(3)(i) and (ii); or

(B) The date the period for requesting modification expires as a result of a waiver of the prohibition on mailing a notice of final partnership adjustment (FPA) under §301.6231-1(b)(2). See §301.6225-2(c)(3)(iii).

Thus, if the partnership waives the period for requesting modification, then the waiver is treated as the submission of everything required to be submitted. But if there is no such waiver, everything is deemed submitted at the close of the 270-day period during which the partnership can request modification. That implies the 270-day period for a final adjustment does not start until the end of the 270-day period for requesting a modification.

So how does this play out here, you (didn’t) ask? The partnership argued that under the Code, the final adjustment must be made within 330 days after mailing the proposed adjustment or within 270 days after the partnership submitted everything required to request modification of a proposed underpayment, whichever is later. But the IRS, citing the regulation, argued that the 270-day period does not begin to run until the close of the period during which the partnership can request a modification. If the partnership is right, the final adjustment in this case came too late and is therefore of no effect. But if the IRS is right, the final adjustment is timely.

The Tax Court (Judge Buch, in an opinion joined by all of his colleagues) agreed with the partnership, finding the IRS's regulation in contravention of the statute:

As applied in this case, there is a direct conflict between the statute and the regulation on which the Commissioner relies. Section 6235(a)(2) provides the period for when the Commissioner can make an adjustment for a partnership in the event a modification request for the imputed underpayment is submitted to the Commissioner. The plain text of that statute states that date is "270 days . . . after the date" everything required for a complete modification request under section 6225(c) "is so submitted." I.R.C. §6235(a)(2). The regulation interprets that date to be 270 days after "[t]he date the period for requesting modification ends." Treas. Reg. §301.6235-1(b)(2)(i)(A). As is made evident in this case, those are different dates, and the regulation must give way to the statute.

The partnership in this case submitted everything in connection with its modification request on February 14, 2023, and the IRS did not ask for (or receive) any additional information after that date. That meant the final adjustment had to be mailed on or before November 13, 2023 (270 days later was technically November 11, 2023, but that was a Saturday.) Because the final adjustment here was mailed on December 1, 2023, it was untimely.

The IRS argued that a six-year limitations period under IRC §§6235(c)(2) and 6501(e)(1) applied because of a substantial omission of income, but the court found that the partnership had disclosed all information about the sale transactions on its original income tax return, so there was no substantial omission of income.

This decision is hardly surprising, especially in light of the Supreme Court's announcement in *Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244 (2024), that agency interpretations of statutes are no longer entitled to deference. Unquestionably, courts will invalidate guidance that conflicts with unambiguous language in the Code. Note too that the taxpayer benefitted from making complete and accurate disclosures on its original federal income tax return, as the IRS was unable to invoke an extended assessment period under IRC §6235(c)(2).

XII. DEVELOPMENTS IN REPORTING FOREIGN BANK ACCOUNTS

The Bank Secrecy Act of 1970 requires United States citizens and residents to file reports related to certain relationships with foreign financial institutions. Pursuant to the Act, Treasury issued regulations requiring an individual to file a Report of Foreign Bank and Financial Account (misleadingly known as an "FBAR") for any calendar year in which the individual has more than \$10,000 in a foreign bank account. Today, the required disclosure is made on Form 114 of the Financial Crimes Enforcement Network ("FinCEN Form 114"), but the original FBAR "acronym" persists.

The Act provides that failing to file an FBAR can lead to a penalty of \$10,000 per violation, which increases to \$100,000 per violation (or, if more, 50 percent of the value in the foreign account) where the failure to file an FBAR is willful. Taxpayers have been challenging these penalties in court with mixed results. Consider the following cases.

A. Penalties Survive the Decedent (*United States v. Hendler*, S.D. N.Y., September 17, 2024)

A federal district court held that a \$70,000 penalty for negligently failing to report the existence of foreign bank accounts over a seven-year period does not abate upon the death of the account holder. It thus granted the federal government's motion for summary judgment on the issue. The decision is consistent with that of other federal courts, all of which have found that because the penalty is "remedial" rather than "penal," liability for the penalty continues after death.

In this case, David Benishai, a United States citizen, had signatory authority over nine Israeli bank accounts. For the years at issue (2004 through 2010), he did not timely file FBARs. The IRS began an examination in late 2015, when Benishai finally filed FBARs for the years at issue. The examination did not conclude until 2021, but Benishai and his agents agreed in writing several times to extend the deadline by which the IRS had to assess penalties. The last extension agreement reflected a deadline of June 30, 2021. The IRS assessed initial penalties of \$250,000 against Benishai in April, 2021—before the stipulated deadline. The only wrinkle: Benishai died three months earlier, in January, 2021. In 2023, the IRS, in response to the Supreme Court's holding in *Bittner v. United States*, 598 U.S. 85, that the \$10,000 penalty for negligent failure to file FBARs applies on a per-report basis and not a per-account basis, reduced the penalty to \$70,000 (i.e., one \$10,000 penalty for each of the seven years).

On behalf of his estate, Benshai's spouse and daughter, Hanna Hendler and Danielle Benishai (hereafter "Hendler"), resisted the reduced penalty, arguing that penalties cannot be asserted against a decedent. Hendler claimed that because the IRS did not assert the penalty until after Benishai's death, it was too late. But the district court rejected this argument, noting that other courts have concluded that liability for an FBAR penalty accrues on the date the form is due, not on the date of assessment.

Hendler then argued that even if the penalty applied, it was extinguished at Benishai's death. The court observed that under federal common law, a penalty that is "penal" abates at death, but penalties that are "remedial" survive the decedent and are enforceable against the decedent's estate. Citing *Kahr v. Commissioner*, 414 F.2d 621 (2d Cir. 1969) as controlling precedent, the court concluded that because one purpose of the FBAR negligence penalty is to "protect the tax revenue and to reimburse the Government for the public funds which must be expended in the investigation and uncovering of taxpayer tax evasions activities," the penalty is

remedial and not penal. The court noted that this conclusion was in accord with cases from federal district courts in Florida. Indeed, it found no cases holding otherwise.

Hendler also argued that the statute of limitations for collecting on a penalty that accrued from 2004 through 2010 had long ago expired, but the court cited several cases confirming that agreements to extend the IRS's time for assessment are valid. The court went on to reject Hendler's constitutional arguments related to due process and the Excessive Fines Clause of the Eighth Amendment, favorably citing *United States v. Toth*, 33 F.4th 1 (1st Cir. 2022), for the proposition that the Excessive Fines Clause does not apply because the penalty is remedial and not penal.

B. Ninth Circuit Confirms That Recklessness is Willful for FBAR Penalty Purposes (*United States v. Hughes*, 9th Cir., August 21, 2024)

The Ninth Circuit Court of Appeals has joined other circuits in holding that recklessness in failing to file required foreign bank account reports (FBARs) constitutes "willfulness" in failing to file, triggering the application of a higher penalty. The taxpayer pushed the court to adopt a rule by which only the subjective intent not to file would constitute a willful failure to file, but the court declined the invitation.

In this case, the taxpayer, a United States citizen residing in San Francisco, owns a New Zealand winery and wine bar. She has signatory authority over the business accounts at a New Zealand bank, and the balance in those account was such that FBARs are required. But she did not file FBARs for 2010, 2011, 2012, or 2013. The IRS determined that the failure was willful, so it assessed a penalty of nearly \$679,000. The taxpayer paid the penalty and commenced a refund suit in federal district court.

The district court determined that the failure to file FBARs in 2010 and 2011 was merely negligent, as there was no evidence the taxpayer had notice of the requirement to file FBARs. But the court further determined that the failure to file in 2012 and 2013 was willful, as the evidence showed she checked a box on her 2012 federal income tax return indicating she was required to file. Although the Ninth Circuit had not then addressed whether a reckless failure to file rose to the level of a "willful" failure to file, the court found persuasive precedent from five other circuits so holding. For those keeping count, the five circuits are the Third, Fourth, Sixth, Eleventh, and Federal Circuits.

The Ninth Circuit upheld the district court's application of those cases, agreeing that equating recklessness with willfulness is consistent with the Supreme Court's decision in *Safeco Insurance Co. v. Burr*, 551 U.S. 47 (2007), where, for purposes of penalties under the Fair Credit Reporting Act, the Court held that reckless violations of a standard satisfy the "willfulness" condition for a civil penalty to apply. The court also observed that the Court has let stand the decisions of the other circuits equating recklessness with willfulness, refusing to grant review in

the three cases for which review was sought. Finally, the Ninth Circuit found the taxpayer offered “no persuasive reason to distinguish *Safeco* and buck the consensus of other Courts of Appeals.” It thus upheld the imposition of a willful penalty for both 2012 and 2013.

C. Eleventh Circuit Holds FBAR Penalties Can Violate Excessive Fines Clause, Creating Circuit Split (*United States v. Schwarzbaum*, 11th Cir., August 30, 2024)

The Eleventh Circuit Court of Appeals has held that the penalty for willful failure to file an FBAR is a “fine” and thus subject to the Excessive Fines Clause of the Eighth Amendment. The court went on to hold that three \$100,000 penalties imposed against the defendant were excessive, reducing a penalty of over \$12.55 million to just over \$12.25 million. The case is important because the result is contrary to that reached by the First Circuit on similar facts in *United States v. Toth*, 33 F.4th 1 (1st Cir. 2022), creating a split amount the circuits that could prompt Supreme Court review.

German-born Isac Schwarzbaum became a citizen of the United States in 2000. During the years at issue (2007, 2008, and 2009), he lived in Switzerland. During those years, he had dozens of bank accounts in Switzerland and Costa Rica. His accountant prepared an FBAR for 2007, but it only disclosed a single account. Schwarzbaum then filed his own returns for 2008 and 2009, including his own FBARs; one of the FBARs disclosed a single account, and the other disclosed just three accounts.

The IRS determined that Schwarzbaum’s failure to list all of the accounts was “reckless,” and, therefore, “willful,” triggering the application of the higher penalty. Under the Bank Secrecy Act, recall, the penalty for willful failure to file an FBAR is the greater of \$100,000 or half the balance of the bank account as of the date the FBAR was originally due. The IRS initially determined a penalty of \$35.4 million. Finding this amount too high, the IRS, on its own initiative, reduced the penalty to about \$13.7 million. When Schwarzbaum failed to pay the penalty, it instituted this proceeding in federal district court. The district court agreed that Schwarzbaum’s failure to file was willful, but concluded the IRS miscalculated the penalty amount, entering judgment that Schwarzbaum was liable for a penalty of just over \$12.9 million. In a prior ruling, the Eleventh Circuit held that the district court should have remanded the penalty determination back to the IRS instead of computing the penalty itself. *United States v. Schwarzbaum*, 24 F.4th 1355 (11th Cir. 2022). The lower court did as instructed, but Schwarzbaum is back again at the Eleventh Circuit, this time arguing the penalty violates the Excessive Fines Clause.

As any good criminal defense lawyer will tell you (from memory), the Eighth Amendment provides: “Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted.” In *Austin v. United States*, 509 U.S. 602 (1993), the Supreme Court held that the Excessive Fines Clause applies to civil penalties that constitute “punishment.” It further held that in order to fall outside the scope of the Excessive Fines

Clause, a penalty must “fairly be said solely to serve a remedial purpose.” Later, in *United States v. Bajakajian*, 524 U.S. 321 (1998), the Supreme Court clarified that the Excessive Fines Clause applies to any penalty that “is designed to punish the offender” and thus serves as “punishment even in part.”

Against this framework, the Eleventh Circuit determined that the purpose of the FBAR penalty on willful failure to file “is—at least in part—punishment,” and therefore subject to the Excessive Fines Clause. It rejected the IRS’s argument that the penalty is remedial because it remedies its investigation and enforcement expenses associated with FBAR violations:

The Government can impose a \$1,000,000 penalty on a \$2,000,000 account regardless of whether the Government spent a million dollars investigating the case or whether it spent nothing at all, or any number in between. ... A willful violation of the FBAR statute thus has a ceiling limited only by the size of the violator’s bank account, regardless of the corresponding tax liability or cost spent by the Government remediating the problem.

Further, observed the court, the willfulness penalty requires a culpable state of mind “equivalent to that of a criminal under the same statute,” underscoring the punishment aspect of the penalty. The court also tossed in excerpts from Treasury explanations of the 2004 legislation that toughened the penalty for willful violations indicating that the purpose of the tougher penalties was to improve compliance and deter violations of the reporting requirement. Penalties designed to deter behavior are punitive (or “penal”) in nature, the court reasoned, and thus subject to the Excessive Fines Clause.

The court acknowledged that its conclusion is contrary to that reached by the First Circuit in *Toth*, *supra*. The First Circuit determined that the penalty was remedial based on earlier Supreme Court precedent that the Eleventh Circuit says is “no longer applicable in the Excessive Fines context.” The Eleventh Circuit also pointed to Justice Gorsuch’s dissent from the denial of certiorari in *Toth*, in which he argues that the First Circuit’s analysis “is difficult to reconcile with our precedents” and that a penalty that “serves even ‘in part to punish’ is subject to analysis under the Excessive Fines Clause.”

The Eleventh Circuit then proceeded to determine whether the penalty was excessive. This required the court to examine not whether the total aggregate penalty amount was excessive but, rather, whether any of the 23 penalties imposed on each of the accounts for the years at issue was excessive. The court reasoned it had to perform a detailed, account-by-account analysis because the statute characterizes each willful failure to report an account as a separate violation.

In the end, the Eleventh Circuit determined that three of the \$100,000 penalties imposed were excessive. Those three penalties all related to a single account that never had a

relevant balance in excess of \$16,000. “A \$100,000 penalty for an account holding comparatively small amounts of currency strikes us as being ‘grossly disproportional to the gravity of the defendant’s offense.’” Accordingly, it reduced the total penalty by \$300,000.

Justice Gorsuch’s dissent from the denial of certiorari in *Toth* was a clear signal that, in his mind, the First Circuit was wrong. If his goal in dissenting was to invite another circuit to reach a different result, it seems the Eleventh Circuit was happy to oblige. Note too: it appears the Excessive Fines Clause applies only to the willfulness penalty. The \$10,000 penalty for negligent failure to file FBARs does not require a particular mental state, and to date every court that has considered the issue has found the negligence penalty “remedial” rather than “penal.”

D. District Court Agrees Penalties Survive Decedent But Collecting from Spouse or Beneficiary Violates the Eighth Amendment (*United States v. Leeds*, No. 1:22-CV-00379, D. Idaho, March 7, 2025)

A federal district court has held that while a decedent’s liability for penalties in connection with willfully failing to disclose foreign bank accounts survived the decedent’s death, the Excessive Fines Clause of the Eighth Amendment applies to willful penalties. This proved important, for while the penalties applied to the decedent did not violate the Eighth Amendment, the penalties *do* violate the Eighth Amendment “to the extent the Government seeks to recover the penalties against” the decedent’s spouse, who was also his executor. It thus granted the government’s summary judgment motion against the decedent’s estate but denied the motion to the extent the government sought to collect from the decedent’s spouse personally.

Richard and Patricia Leeds, United States citizens, were married in 1955. An expert in satellite communications, Richard worked for an international architectural engineering firm providing services under government contracts. Through his work, Richard met and interacted with top military and political figures in other countries. As Patricia tells it, he also worked for the CIA, though she did not learn of this until well after his retirement. While on a business trip to Saudi Arabia in 1984, Richard’s plane was hijacked and forced to land in Iran, where he was questioned extensively for several hours. The experience led Richard to set up two foreign bank accounts so he would have “readily available cash” to pay future ransoms if needed.

During the years at issue (2006 through 2012), Richard did not disclose these accounts to the IRS, even though he was required to do so by the Bank Secrecy Act. In each of the years, Richard’s tax preparer, a CPA, asked him whether he had any foreign bank accounts. Each year, Richard said he did not. By the end of 2011, the bank that maintained both accounts informed Richard that in order for the bank to comply with the Foreign Account Tax Compliance Act, all United States clients were no longer welcome and that he would need “to find a solution for his assets.” He then bought more than \$1.45 million in precious metals using account funds and then withdrew (and later sold) the remaining foreign currency.

In 2014, the bank urged Richard to participate in the Offshore Voluntary Disclosure Program (OVDP) to reduce his risk for prosecution and monetary penalties. He followed up with questions about how far back the bank would disclose information about his accounts and whether closed accounts would be reported, but took no further action. When the IRS started an investigation, Richard applied for participation in the OVDP but then opted out nearly two years later. That led the government to assess willful FBAR penalties against Richard totaling over \$1.5 million in 2020.

When Richard died in November, 2021, the government sought to collect over \$2 million in penalties, late fees, and interest from Patricia in her capacities as beneficiary of Richard's estate and as his personal representative. Once discovery was complete, the government moved for summary judgment against the estate, the motion giving rise to this decision.

The court first determined that Richard's failure to file FBARs for the years at issue was willful. Under *United States v. Hughes*, 113 F.4th 1158 (9th Cir. 2024), discussed *supra*, "willfulness can be shown by proof of objective recklessness as well as subjective intent." Under this test, the same as that employed by "every other Court of Appeals to have considered the question," the court found Richard's conduct was willful. He acted to conceal the existence of his accounts from the government by lying to his preparer about the existence of the accounts, using pseudonyms for the accounts that allowed him to sign using fake names, and having the bank hold his mail so that he could only collect it in person. "Based on the undisputed facts," said the court, "Richard should have known about the FBAR requirements and that there was a grave risk he was not complying with his filing requirements despite being positioned to easily discover his tax obligations." Accordingly, the court determined the government was entitled to "maximum penalties" in this case.

That raises the issue of the penalty amount. Patricia argued the penalty imposed by the government violated the Excessive Fines Clause of the Eighth Amendment. That again raises the conflicting cases of *Toth* and *Schwarzbaum*, *supra*. An appeal in this case would go to the Ninth Circuit, which has not taken a side in this debate. The court, thus free to go with what it found the better rule, decided that the Eleventh Circuit's analysis in *Schwarzbaum* was "more well-reasoned." It thus held that the FBAR penalty is a "fine" for purposes of the Eighth Amendment.

The court then had to determine whether the "fines" imposed by the government were "excessive." Under *United States v. Bajakajian*, 524 U.S. 321 (1998), a fine is excessive if is "grossly disproportional" to the gravity of the offense. In determining the "disproportionality" of an offense, a court is to consider the nature of the conduct, the resulting harm, and whether other penalties may be imposed. The burden of proof is on the party subject to the fine.

Applying this test, the court first determined that the FBAR penalties in this case are grossly disproportionate as applied to Patricia. The IRS countered that she misunderstands the

case because the government is not suing her personally but only in her capacity as executor of Richard's estate. But the court found that "the Government's allegations are less than clear how it intends to recover the FBAR penalties and that it does not intend to recover the FBAR assessments against Patricia personally." After all, the caption to the case names Patricia both as Richard's personal representative and in her personal capacity. So if there's a chance the government could go after assets in which Patricia has a personal interest, the court wants to be on record that any penalty applied to her would be excessive. "Patricia had no access to [the] Accounts and no knowledge about them until the IRS began its investigation into Richard after he had closed the Accounts."

While Patricia met the burden of showing that penalties applied against her would be excessive, she was unsuccessful in claiming that the fine applied to Richard's estate was excessive due to his willful failure to file FBAR reports. So Patricia then argued that Richard's liability for willful negligence died with him. But the court, citing a consistent string of opinions from other federal district courts, held that FBAR penalties are remedial for purposes of survival, meaning the FBAR penalties here survived Richard's death.

While it seems inconsistent to say an FBAR penalty is "a fine and not a remedy" for purposes of the Excessive Fines Clause but "a remedy and not a fine" for purposes of determining whether the penalty survives the offender, the court in footnote 9 reconciles these seemingly contradictory positions:

This conclusion [that FBAR penalties survive the decedent] is not inconsistent with the conclusion that the Excessive Fines Clause applies to the penalties because "the test in the Excessive Fines context remains whether the purpose of the penalty is solely compensatory." *United States v. Schwarzbaum*, 127 F.4th 259, 275 (11th Cir. 2025); see also *United States v. Green*, 457 F. Supp. 3d 1262, 1272 (S.D. Fla. 2020) ("[T]he FBAR penalty is the proverbial square peg in the round hole; it fits perfectly in neither of the round holes of the remedial-penal dichotomy. Rather, the FBAR penalty is primarily remedial with incidental penal effects.").

Whether the explanation is convincing is left to the reader. Of greater interest, if the government appeals this decision to the Ninth Circuit, we could see a third opinion in the debate over the applicability of the Excessive Fines Clause, setting the stage for possible resolution by the Supreme Court. Stay tuned.

XIII. CASES INVOLVING SUBSTANTIATION AND VALUATION OF CHARITABLE CONTRIBUTIONS

A. Appraisal of Bargain Sale of Furniture Factory Was Lazy, Boy (*Leo v. Commissioner*, T.C. Memo. 2025-9, January 29, 2025)

The Tax Court has determined that the 2013 bargain sale of 136 acres in Union County, Mississippi, containing a furniture factory resulted in a charitable contribution of just over \$4 million, not the \$12.425 million amount deducted on the taxpayer's return. The taxpayer argued that the appraisal obtained in connection with the bargain sale transaction should be binding in the computation of the deduction amount, but the court observed that it was not bound by the appraisal. Indeed, the report contained many inaccuracies, including a statement that the factory was in "average condition and well maintained." In fact, the property was in poor shape. Furthermore, and likely even more damning, there was evidence the appraiser had precommitted to value the property at an amount of at least \$15 million before conducting any inspection. As the court notes, "this precommitment impaired his objectivity in evaluating the condition of the ... property."

The taxpayer submitted an appraisal from another expert, but the court rejected that one too, finding the appraiser did not conduct a thorough independent investigation but simply relied on much of the information from the prior appraisal. The second appraisal used an income-based approach, but the court concluded that the assumed \$1.50 per square foot rental value was far in excess of the 48-cent and 45-cent per square foot rental rates in effect under prior lease agreements in effect shortly before the donation.

Instead, the court found the report of the IRS's expert to be more credible. The IRS's expert used a comparable-sales-based approach, then adjusting it for the relatively poor condition of the subject property. Importantly, the IRS's expert performed an inspection of the property, interviewed its former tenants, and accounted for the fact that much of the property was not suitable for rental in its then-present state. The court rewarded the extra legwork by adopting the IRS expert's report. Oh, and there was this: the property itself was later sold by the charity in May 2015—just 17 months after the bargain sale transaction—for a total of \$1.13 million. That suggests the IRS's determination of value is more credible than the valuation offered by the taxpayer.

Because the taxpayer's deduction was more than double the correct value, the court upheld the imposition of a 40-percent gross valuation misstatement penalty under §6662.

B. Forms 8283 are Not Qualified Appraisals, so Taxpayers Lose Charitable Deduction (*Cade v. Commissioner*, T.C. Memo. 2025-20, March 10, 2025)

The Tax Court has granted the IRS's motion for summary judgment as to whether a married couple had obtained a "qualified appraisal" of the items they allegedly donated to

charity. The taxpayers argued the appraisal summary they attached to an amended return was sufficient for this purpose, but the IRS and the Tax Court concluded otherwise. The case reminds us that an “appraisal summary” is not the same thing as a “qualified appraisal.”

William and Mary Cade, a married couple, originally filed a federal income tax return for 2019 showing a balance due of \$89,013. The taxpayers did not include any payment with the return. They then filed an amended return claiming to have made a charitable contribution in December, 2019, to their church of various “surplus items” they did not need in their real estate business, including over 2,200 jackets and over 1,200 short sleeve coveralls. (You know, because realtors need lots of jackets.) They also claimed to have donated some \$89,100 in cobblestones as well as over 9,600 pieces of commercial vinyl tile and ten four-gallon tubs of floor-tile adhesive. Completed Forms 8283, Noncash Charitable Contributions, were attached to the amended return. If allowed, the resulting federal income deduction from the donations would—wait for it—eliminate any liability for additional tax and even result in a modest refund. The IRS disallowed the deduction on the grounds that the donations were not adequately substantiated, leading the taxpayers to seek redetermination in Tax Court.

But the Tax Court largely held in favor of the IRS. It agreed with the IRS that the taxpayers had not obtained a contemporaneous written acknowledgment from the church, as required by IRC §170(f)(8). The taxpayers initially argued the Forms 8283 doubled as an acknowledgment from the church, but the court found that argument “does not hold water,” because the acknowledgement must include a statement as to whether the recipient provided any goods or services in consideration for the gift, and the Forms 8283 contained no statement to that effect. The taxpayers then claimed to have discovered a receipt from the church, “ostensibly dated” on the claimed donation date, but the court found the timing of this discovery “arouses suspicion.” The taxpayers “found” the receipt many months after the IRS kept requesting copies of it. “If petitioners or their return preparer had this document in their files, it seems odd that it was no provided sooner.”

On top of that, the receipt itself “has other questionable features,” including illegible signatures, no indication of the signatory’s name or title, and inconsistent addresses for the church. “Given that the documents were ostensibly executed on the same day, these seeming discrepancies require explanation.” Given the many factual questions about the authenticity of the receipt, the court denied the IRS’s motion for summary judgment to the extent it was based on the failure to secure a contemporaneous written acknowledgment.

The Tax Court also rejected the argument of the taxpayers that the Forms 8283 could constitute “qualified appraisals,” calling the argument “a non-starter.” While the Form 8283 qualifies as an “appraisal summary,” that is not the same as a “qualified appraisal.” The requirements for a qualified appraisal are set forth at Reg. §§1.170A-13(c)(3) and 1.170A-17(a), and the regulations make clear that an appraisal summary and a qualified appraisal are two different documents. The taxpayers then claimed that statements they obtained from three

experts more than three years after the donation could constitute qualified appraisals, but the court had none of it, finding the statements were too short to be complete and were prepared more than two years after the taxpayers filed their amended return. (The regulations provide that a donor must receive the qualified appraisal before the return is filed. See Reg. §§1.170A-13(c)(3)(iv)(B) and 1.170A-17(a)(4)(iii).)

The court went on to hold that even if the statements were considered to be timely appraisals, the three experts who supplied them were not “qualified appraisers,” as required by IRC §170(f)(11)(E)(ii). None of the three individuals regularly perform appraisals for money, and none had indicated successful completion of professional or college-level coursework in valuing the type of property appraised. So the court granted the IRS’s motion for summary judgment to the extent it disallows the deduction for lacking substantiation from a qualified appraisal by a qualified appraiser.

The court made no decision regarding whether the taxpayers had reasonable cause for failing to meet the substantial requirements, finding this defense “typically raises factual questions illsuited [sic] to summary adjudication.”

C. Lack of Qualified Appraisals Excused, But Donated Paintings Were Still Overvalued on Returns (*WT Art Partnership LP v. Commissioner*, T.C. Memo. 2025-30, April 9, 2025)

The Tax Court has held that a limited partnership could deduct the value of five ancient Chinese paintings donated to New York’s Metropolitan Museum of Art (“the Met”) over three taxable years even though the taxpayer did not obtain “qualified appraisals” for the works. The court excused the failure to comply with the substantiation requirements by applying the reasonable cause exception in IRC §170(f)(11)(A)(ii)(II). The court went on to value the most expensive donated work, finding the value to be much closer to the value determined by the IRS’s expert than the value determined by the taxpayer’s expert.

In 1997, Oscar Liu-Chen Tang, a successful entrepreneur and investor, acquired 12 ancient Chinese paintings through the taxpayer, a family partnership, for a total price of \$5 million. Later that year, Tang and his family executed a “deed of promised gift” in favor of the Met that covered 11 of the paintings. The deed provided that the taxpayer would retain ownership of the works for several years and that, during such time, the Met could exhibit the works. At some point, ownership of the paintings would pass to the Met.

Tang made good on the promise. Over the years 2010 – 2012, the taxpayer donated five of the paintings, reporting total charitable contribution deductions in those years in excess of \$73 million. Attached to the tax returns claiming these deductions were appraisals prepared by the second largest art auction house in China, China Guardian Auction Co. Ltd. Nonetheless, the

IRS disallowed the deductions, determining that China Guardian was not a “qualified appraiser.” In the alternative, the IRS claimed the taxpayer had overvalued the paintings.

The Tax Court held that China Guardian was not a qualified appraiser. This was an easy case. Section 170(f)(11)(E)(ii) defines a qualified appraiser as “an individual” with certain qualifications. China Guardian is an entity, not an individual. Further, there was no evidence that any of the individuals who signed the appraisals on behalf of China Guardian possessed the relevant education and experience required to be a qualified appraiser of ancient Chinese art. China Guardian is an auction house that, as a courtesy to clients, provides estimates of the values at which works might sell at auction. But those rather short estimates fall short of what the Code requires for a qualified appraisal.

Although the taxpayer did not substantiate its deductions with a “qualified appraisal,” the Tax Court held that the taxpayer’s failure to comply with the qualified appraisal requirement was due to reasonable cause, and therefore the taxpayer could still deduct the value of the paintings. The court was convinced that Tang in good faith believed that China Guardian was a reputable firm that could deliver a qualified appraisal. China Guardian was recommended to him by expert in Chinese art. Tang knew that another expert had furnished information about the works to China Guardian. Perhaps most tellingly, when the IRS challenged charitable contributions deductions Tang had claimed on prior returns, the IRS at no point challenged the appraisals submitted by Tang—appraisals that had been performed by China Guardian. Based on these facts, the court concluded that Tang (and, thus, by extension, the taxpayer) had reasonable cause to believe the appraisals prepared by China Guardian here would comply with the substantiation requirements. Because the reasonable cause exception applied, the failure to secure qualified appraisals here did not preclude a deduction.

The Tax Court then had to consider the value of the donated works. The parties had stipulated to the values of four of the works but could not reach agreement on the most valuable painting, *Palace Banquet*. The taxpayer’s expert claimed the painting was worth \$21 million, while the IRS’s expert determined it was worth \$10 million. Given the dearth of modern sales involving early Chinese art, both experts, unsurprisingly, looked to the same (few) comparable works that had been sold. The taxpayer’s expert placed great weight on the comparable work that fetched the highest selling price, but the Tax Court was not persuaded that the most expensive piece was the most comparable, concluding that the expert “set out to reach a very high value, so she worked exclusively off the highest price sale, despite indications that the sale price might be questionable.” Instead, the court found the analysis of the IRS’s expert to be more persuasive, especially given Tang’s testimony at trial that it “was a surprise” that *Palace Banquet* appraised as high as it did because he expected the value was “about \$11 million.” In the end, the court determined *Palace Banquet* was worth \$12 million.

The IRS insisted that the value of *Palace Garden* should be further reduced by a discount for lack of marketability attributable to a “deaccession restriction” that allegedly applied to the

Met. According to the court, a “deaccession” is when a museum removes a work from its collection and puts it up for sale. A “deaccession restriction,” then, would preclude the Met from selling the work. The Tax Court held that no marketability discount was appropriate here because there was no evidence proving that the Met agreed to or was bound by any such restriction. Although the Met had agreed to similar restrictions in connection with earlier donations from Tang, the deed of gift provided that Tang (through the taxpayer) was donating *all rights* in the work to the Met. That would include a right to sell the work. The court thus stuck to its conclusion that *Palace Garden* was worth \$12 million and no less.

The following table thus summarizes the values of the donated paintings as reported by the taxpayer and as finally determined for federal income tax purposes:

Painting	Basis	Value Reported on Tax Return	Value Agreed to by Parties (or Determined by the Court)
<i>Palace Banquet</i>	\$250,000	\$26,000,000	\$12,000,000
<i>Tiantai Mountains (40% interest)</i>	\$60,000	\$6,320,000	\$4,500,000
<i>Snow Covered Mountains</i>	\$100,000	\$11,000,000	\$9,500,000
<i>Lofty Virtue</i>	\$250,000	\$8,568,000	\$7,500,000
<i>Simple Retreat</i>	\$750,000	\$22,032,000	\$20,000,000
TOTAL	\$1,410,000	\$73,920,000	\$53,500,000

Finally, the Tax Court determined that because the reported value of *Palace Banquet* was more than double the correct value, a 40-percent gross valuation misstatement penalty under IRC §6662(h) applied. Gross valuation misstatements cannot be excused by reasonable cause, so the taxpayer owes a 40-percent penalty on \$14 million. The court refused to impose other penalties sought by the IRS in connection with the values of the other works, finding no negligence on the part of the taxpayer and no facts to suggest the taxpayer or Tang knew that the reported values were too good to be true.

XIV. CONSERVATION EASEMENT DEVELOPMENTS

While §170(f)(3)(A) generally disallows a charitable contribution deduction for the donation of “an interest in property which consists of less than the taxpayer’s entire interest in such property,” §170(f)(3)(B) allows a deduction for certain partial-interest transfers, including the donation of a “qualified conservation contribution.” The rules for qualified conservation contributions, found in §170(h), require a taxpayer to donate a “qualified real property interest” to a charity exclusively for conservation purposes. To be a “qualified real property interest,” the donated interest must include a perpetual restriction on the use which may be made of the real property. See §170(h)(2)(C).

Most qualified conservation contributions take the form of “conservation easements” in connection with large parcels of land. A conservation easement is, in essence, a covenant that typically restricts the use of the subject real property to its current use in perpetuity. The

amount of the deduction for the donation of a conservation easement is measured as the difference between the value of the land at its highest and best use and the value of the land now that its use is forever limited to its existing use. That difference in value is often quite large; in fact, in many cases the tax savings from the deduction proves to be more than the cost to acquire the subject property. As a result, taxpayers seeking large deductions have found conservation easements quite attractive.

At first, the IRS limited its policing of conservation easement transactions to question of valuation. Instead of disallowing deductions altogether, the IRS would question the appraisals used to determine the amount of the deduction, often concluding that the donation amounts were quite smaller than those claimed by taxpayers. But over the past several years, the IRS found an Achilles heel in several conservation easement deeds that, according to the IRS, caused the donations to flunk the perpetuity requirement explained above. The IRS's position was based on Regulation §1.170A-14(g)(6)(ii), known on the streets as the "proceeds regulation." In short, the proceeds regulation provides that upon a judicial extinguishment of a conservation easement that has become impossible to fulfill and subsequent sale of the property, the perpetuity requirement will be met only if the charity is entitled to a certain share of the sale proceeds. Early conservation easement deeds provided that the charity would receive a share of the *net* sale proceeds (after reimbursing the donor for the costs of any improvements made to the property after the easement's donation), but the IRS successfully argued the proceeds regulation required that the charity had to receive a share of the *gross* sale proceeds.

Until 2021, the IRS was overwhelmingly successful in attacking conservation easement deductions based on this argument. But then, in *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 2021), the Eleventh Circuit held that the proceeds regulation is invalid because the IRS did not comply with the Administrative Procedure Act in promulgating the regulation. If the regulation is invalid, then the IRS cannot disallow a conservation easement contribution deduction on the basis that it violates the regulation. In 2022, the Sixth Circuit concluded the regulation was valid. *Oakbrook Land Holdings, LLC v. Commissioner*, 28 F.4th 700 (6th Cir. 2022). Maddeningly, the Supreme Court refused to resolve the split among the circuit courts of appeal.

As the following developments show, conservation easement disputes continue to clog the courts and command the time and attention of the IRS.

A. Final Regulations Identify Syndicated Conservation Easements as Listed Transactions (T.D. 10007, October 8, 2024)

Treasury has finalized regulations proposed in December, 2022, that identify a "syndicated conservation easement transaction" as a "listed transaction" for purposes of §§6011, 6662A, and 6707A. The proposed regulations were issued in response to the Tax Court's decision in *Green Valley Investors, LLC v. Commissioner*, 159 T.C. No. 5 (2022), in which the court, in a 15-2 decision, held that the IRS's prior identification of syndicated conservation

easement transactions as listed transactions in *Notice 2017-10*, 2017-4 I.R.B. 544 (2016), violated the notice-and-comment procedures for legislative rules under the Administrative Procedure Act (“the APA”) and was therefore invalid. The final rule, Reg. §1.6011-9, should ensure that syndicated conservation easement transactions are subject to the rules of §§6011, 6662A, and 6707A. The final regulations are effective as of October 8, 2024.

1. Background on Reportable Transactions

Section 6011(a) generally provides that taxpayers must include information identified in regulations when they file their federal income tax returns. Pursuant to this rule, Reg. §1.6011-4(a) provides that where a taxpayer participates in a “reportable transaction,” the taxpayer must file a disclosure statement (currently Form 8886) with the taxpayer’s federal income tax return. A copy of the Form 8886 must also be sent to the IRS’s Office of Tax Shelter Analysis. Reportable transactions come in five forms: confidential transactions, transactions with contractual protection, loss transactions, transactions of interest, and, most importantly for immediate purposes, “listed transactions.” A listed transaction is one that is the same or substantially similar to one that the IRS determines to be a tax avoidance transaction “identified by notice, regulation, or other form of published guidance.” Reg. §1.6011-4(b)(2).

A number of Code provisions police the reporting of (and participation in) reportable transactions, with stiffer sanctions often applicable to those reportable transactions that are listed transactions. For example, §6707A imposes a penalty generally equal to 75 percent of the decrease in tax shown on the taxpayer’s return as a result of the reportable transaction for failing to disclose the transaction.

In addition, §6662A imposes another 20-percent accuracy-related penalty on any understatement attributable to a reportable transaction; if the taxpayer did not properly disclose the transaction, the penalty increases to 30 percent of the understatement. Furthermore, IRC §6111 and Reg. §301.6111-3(a) require that a “material advisor” with respect to a reportable transaction must file a disclosure statement (currently Form 8918) with the Office of Tax Shelter Analysis, with IRC §6707 imposing penalties on a material advisor that fails to file a timely disclosure or files an incomplete or false disclosure.

2. The Need for Regulations in Light of Adverse Case Law

The APA generally requires a federal agency to publish a notice about a proposed rule, allow for public comment, consider submitted comments, make appropriate revisions, and provide a concise general statement of the basis and purpose of the final rule adopted. These steps apply any time an agency promulgates a “legislative rule,” one that announces a new law or a change in the law. The notice-and-comment procedure is not required for an “interpretive rule,” one that identifies how the agency construes a statute.

Historically, the IRS identified listed transactions and other reportable transaction by publishing a notice in the Internal Revenue Bulletin. Notices traditionally did not undergo the notice-and-comment procedures required by the APA. This proved problematic when parties challenged the identification of reportable transactions and listed transactions by notice. In *Mann Construction, Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022), the Sixth Circuit Court of Appeals held that *Notice 2007-83*, 2007-45 I.R.B. 960, in which the IRS designated certain employee-benefit plans featuring cash-value life insurance policies as listed transactions, was void because the notice was a legislative rule that did not undergo notice and comment.

Federal district courts within the Sixth Circuit, citing *Mann Construction*, invalidated other notices on similar grounds. See, e.g., *CIC Services v. IRS*, 592 F.Supp.3d 677 (E.D. Tenn. 2022) (setting aside *Notice 2016-66*, 2016-47 IRB 745, which identified micro-captive insurance arrangements as listed transactions); *GBX Associates, LLC v. Commissioner*, 130 A.F.T.R. 2d 2022-6440 (N.D. Ohio 2022) (invalidating *Notice 2017-10*, which identified syndicated conservation easements as listed transactions, on similar grounds). Then, in *Green Valley Investors, supra*, the Tax Court likewise invalidated *Notice 2017-10*.

If the decisions in the foregoing cases are correct, every notice that identified reportable transactions is void, as none of the notices has undergone the APA's notice and comment procedures. That in turn means that none of the statutory penalties applicable to participation in reportable transactions (or the failure to fully and timely disclose them) would apply to any taxpayer. Faced with such high stakes, the IRS decided to issue proposed regulations in connection with syndicated conservation easement transactions. As Treasury stated in the preamble to the proposed regulations:

The Treasury Department and the IRS disagree with the Sixth Circuit's decision in *Mann Construction* and the Tax Court's decision in *Green Valley* and are continuing to defend the validity of *Notice 2017-10* and other notices identifying transactions as listed transactions in circuits other than the Sixth Circuit. At the same time, however, to eliminate any confusion and ensure consistent enforcement of the tax laws throughout the nation, the Treasury Department and the IRS are issuing these proposed regulations to identify certain syndicated conservation easement transactions as listed transactions for purposes of all relevant provisions of the Code and Treasury Regulations.

3. A Change in the Statute

Just 15 days after issuing the proposed regulations, Congress passed the SECURE 2.0 Act of 2022. Section 605 of the Act added §170(h)(7)(A), which provides that a contribution by a partnership is not treated as a qualified conservation contribution if the amount of the contribution exceeds 2.5 times the sum of each partner's relevant basis in the partnership. This

new rule applies to contributions made on or after December 30, 2022. Regulations implementing this new rule were finalized in June, 2024, as explained above.

With the addition of §170(h)(7)(A), Congress effectively killed syndicated conservation easement transactions, as there is now little benefit at best from engaging in them. Still, the IRS found it necessary to finalize the proposed regulations identifying syndicated conservation easement transactions as listed transactions. For one thing, §170(h)(7)(A) does not apply to transactions involving contributions before December 30, 2022. For another, §170(h)(7)(A) does not automatically disallow all contributions made via syndicated conservation easement transactions. And finally, the IRS is aware that, in some syndicated conservation easement transactions, the partnership substitutes the contribution of a fee simple interest in real property for contribution of a conservation easement.

4. Overview of the Final Regulations

The final regulations make only a few changes to the proposed regulations. Regulation §1.6011-9(a) provides that “Transactions that are the same as, or substantially similar to, a transaction described in paragraph (b) of this section are identified as listed transactions...” Regulation §1.6011-9(b) then states that:

The term "syndicated conservation easement transaction" means a transaction in which the following steps occur (regardless of the order in which they occur)—

- (1) A taxpayer **receives promotional materials** that offer investors in a **pass-through entity** the possibility of being allocated a charitable contribution deduction the amount of which equals or exceeds an amount that is **two and one-half times** the amount of the taxpayer's investment ... in the pass-through entity, as determined under paragraph (d) of this section (2.5 times rule);
- (2) The taxpayer **acquires an interest** directly, or indirectly through one or more tiers of pass-through entities, **in the pass-through entity that owns real property** (that is, becomes an investor in the entity);
- (3) The **pass-through entity** that owns the real property **contributes an easement** on such real property, which it treats as a conservation easement, to a qualified organization and allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the taxpayer; and
- (4) The **taxpayer claims a charitable contribution deduction** with respect to the contribution of the real property interest on the taxpayer's Federal income tax return.

(emphasis added). Of these elements, the “2.5 times rule” in Regulation §1.6011-9(b)(1) garnered the most attention from commenters. For purposes of the 2.5 times rule, “promotional materials” are any written or oral communications provided to investors, specifically including:

marketing materials, appraisals (including preliminary appraisals, draft appraisals, and the appraisal that is attached to the taxpayer's return), websites, transactional documents such as the deed of conveyance, private placement memoranda, tax opinions, operating agreements, subscription agreements, statements of the anticipated value of the conservation easement, and statements of the anticipated amount of the charitable contribution deduction.

Reg. §1.6011-9(c)(4). In addition, if the promotional materials suggest or imply a range of potential charitable deduction amounts, the highest suggested or implied deduction amount will be used to determine if the 2.5 times rule is met. Reg. §1.6011-9(d)(2). In fact, the proposed regulations presume the 2.5 times rule is met where:

[(1)] the pass-through entity donates a real property interest within three years following the taxpayer's investment in the pass-through entity, [(2)] the pass-through entity allocates a charitable contribution deduction to the taxpayer the amount of which equals or exceeds two and one-half times the amount of the taxpayer's investment, and [(3)] the taxpayer claims a charitable contribution deduction the amount of which equals or exceeds two and one-half times the amount of the taxpayer's investment.

Reg. §1.6011-9(d)(3). The preamble to the final regulations state that many commenters objected both to this rebuttable presumption and to the 2.5 times rule generally, arguing the threshold was arbitrary and that the proposed regulations offered no guidance for overcoming the presumption. The IRS declined to offer such guidance formally, but the preamble suggests that:

a taxpayer may be able to rebut the presumption by establishing that the partnership was not open to other investors (and thus the only promotional materials were documents needed to execute the transaction) or that similar properties in the same area had increased significantly in value in the period between the time the taxpayer invested in the partnership and the date the conservation easement was contributed.

Note that where promotional materials tout a pass-through deduction *equal to* 2.5 times the taxpayer's investment, the transaction is still a listed transaction even though the amount of the deduction would not be disallowed under §170(h)(7)(A) because the deduction does not

exceed 2.5 times the taxpayer's investment. The preamble to the final regulations states this is not an oversight.

Anticipating that investors could easily avoid the 2.5 times rule by contributing other investment assets to the pass-through entity in addition to the amounts used to purchase a share of the real property on which the conservation easement will be placed, the regulations contain an "anti-stuffing rule" under which only the investor's contribution attributable to the portion of the real property on which the easement is placed is considered in determining whether the 2.5 times rule is met. Reg. §1.6011-9(d)(4).

To illustrate the anti-stuffing rule, suppose an investor acquires a ten-percent interest in the LLC that owns both real estate (worth \$1 million) and marketable securities (also worth \$1 million) by paying \$200,000. In applying the 2.5 times rule, the investor's contribution is \$100,000 (that portion of the investment allocable to the land). Thus, a suggested deduction of \$250,000 or more would satisfy the 2.5 times rule.

These regulations had more bite before the enactment of §170(h)(7)(A). A syndicated conservation easement transaction is a good investment only where the investor will receive a pass-through deduction in an amount that at least 2.5 times the amount of investment. If an investor in the 37-percent tax bracket contributes \$100,000 to participate in a syndicated conservation easement transaction, a pass-through deduction of \$250,000 would save the investor \$92,500 of tax ($37\% \times \$250,000$). That's not a great return on investment. But now that a deduction larger than \$250,000 in this example would be *completely* disallowed by the statute, the transaction is an unattractive investment across the board.

B. IRS Concedes That Notice Targeting Syndicated Conservation Easement Transactions is Invalid (A.O.D. 2024-01, 2024-52 I.R.B. 1354, December 23, 2024) *Green Rock LLC v. IRS*, 11th Cir., June 4, 2024)

In 2024, the Eleventh Circuit Court of Appeals held that *Notice 2017-10*, 2017-4 I.R.B. 544 (December 23, 2016), in which the IRS announced that a "syndicated conservation easement transaction" is a "listed transaction" for purposes of §6707A (and, thus, for purposes of the penalty in §6662A), was invalid under the Administrative Procedure Act (the "APA"). *Green Rock LLC v. IRS*, 104 F.4th 220 (11th Cir. 2024). The court's ruling was consistent with decisions from the Tax Court, *Green Valley Investors, LLC v. Commissioner*, 159 T.C. 80 (2022), and the Northern District of Ohio, *GBX Associates LLC v. United States*, 1:22cv401 (N.D. Ohio 2022). Ultimately, in A.O.D. 2024-01, 2024-52 I.R.B. 1354 (December 23, 2024), the IRS Chief Counsel office announced that the IRS will no longer defend any guidance identifying "reportable transactions" after the enactment of the American Jobs Creation Act of 2004 (the "AJCA") unless such guidance underwent notice-and-comment rulemaking procedures set forth in the Administrative Procedure Act (the "APA").

1. Statutory Background

Section 6707A(a), introduced in 2004, imposes a penalty on any person who fails to provide required information with respect to a “reportable transaction” on a return. A reportable transaction is one identified in regulations “as having a potential for tax avoidance or evasion.” §6707A(c)(1). “Listed transactions” are a subset of reportable transactions which have been specifically identified by the IRS as tax avoidance transactions. §6707A(c)(2). The maximum penalty for listed transactions is significantly higher than the maximum penalty for other reportable transactions.

In addition, §6662A, also introduced in 2004, imposes an accuracy-related penalty on understatements with respect to “reportable transactions.” Specifically, a taxpayer must pay an additional tax equal to 20 percent of the taxpayer’s “reportable transaction understatement” for any taxable year. §6662A(a). Generally, the reportable transaction understatement is the product of the highest tax rate imposed by §1 (or §11, in the case of a C corporation) and the amount by which the amount of taxable income shown on the return is less than the amount of taxable income that should have been shown on the return. §6662A(b)(1)(A). Section 6662A defers to §6707A for the definitions of “listed transactions” and “reportable transactions.”

In effect, the statutes give the IRS the authority to identify reportable transactions and listed transactions. Over the years, the IRS has done so through notices rather than through proposed regulations. Recent case law finds that method of operation problematic under the APA. Among other things, the APA requires that, in order for an administrative agency’s rule to be valid, the rule must undergo a “notice-and-comment” procedure. This typically involves the agency publishing a proposed rule, soliciting public comments on the rule, considering those comments, and then publishing a final rule together with a preamble that explains how the comments received did (or did not) affect the wording of the final rule. IRS notices do not undergo this notice-and-comment procedure, and that has proven to be an Achilles heel for the IRS.

2. Notice 2017-10

As mentioned, *Notice 2017-10* declared that a “syndicated conservation easement transaction” is a listed transaction. Section 2 of the notice defines a syndicated conservation easement transaction as one the same as or substantially similar to the following:

An investor receives promotional materials that offer prospective investors in a pass-through entity the possibility of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment. The promotional materials may be oral or written. ... The investor purchases an interest, directly or indirectly (through one or more tiers of pass-through entities), in the pass-through entity that holds real property. The pass-through entity that holds the real property contributes a conservation easement encumbering the property to a tax-exempt entity and allocates,

directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the investor. Following that contribution, the investor reports on his or her federal income tax return a charitable contribution deduction with respect to the conservation easement.

The notice makes clear that taxpayers participating in a syndicated conservation easement transaction are required to disclose certain information about the transaction under Regulation §1.6011-4, and those who fail to do so will be subject to penalties under §6707A and to an extended statute of limitations under §6501(c)(10). The notice also provides that “the IRS may impose other penalties on persons involved in these transactions or substantially similar transactions, including the accuracy-related penalty under §6662 or §6662A, the §6694 penalty for understatements of a taxpayer's liability by a tax return preparer, and the §6695A penalty for certain valuation misstatements attributable to incorrect appraisals.”

3. Eleventh Circuit Puts the Nail in the Coffin

The notice was not first issued in proposed form, presenting the problem addressed by the Eleventh Circuit in *Green Rock*. Green Rock, an investment entity based in Birmingham, Alabama, is a material advisor to transactions that clearly fall within the ambit of *Notice 2017-10*. It complied with the reporting requirements of the notice at all times. In 2021, it filed this lawsuit to have the notice set aside. The Northern District of Alabama ruled in favor of Green Rock, and the Eleventh Circuit affirmed.

The court acknowledged that Congress can exempt an agency from compliance with the notice-and-comment procedure, but it must do so expressly. “No such express language appears in the statute before us.” While the statutes do provide that the IRS gets to define listed transactions and reportable transactions, they do not make any reference to the APA or to any procedural requirements at all.

The IRS argued that because the statutes ratified pre-existing regulations that specified identification of listed transactions by notice, Congress signaled its approval of the notice-listing process by implication. But the court rejected the argument, observing that while the statutes did copy-and-paste much from pre-existing regulations, it did not include the language about identification by notice. And “an indirect series of cross-references hardly suffices as the ‘express’ indication necessary to supplant the baseline procedures of the Administrative Procedure Act.”

Finally, the IRS asserted that an adverse ruling would mean that there are no listed transactions. But the court was not convinced this is necessarily the case:

According to the Service, it would be absurd for Congress to “invalidate sub silentio each and every one of the listed transactions already identified” in the 2004 Act, which provided penalties to strengthen the listing regime. But our holding does not necessarily compel such a result.

Other listed transactions were issued in a different regulatory context. As we have explained, the pre-2004 listed transactions—that is, 28 of the 34 existing listed transactions—were *not* backed by statutory penalties at the time of their issuance. And “penalties and criminal sanctions” are what render a listing notice a “legislative” rule subject to notice and comment to begin with. Indeed, the judges of the United States Tax Court have suggested that section 6707A might be read to ratify the *substance* of existing, pre-2004 listed transactions, without exempting the Service from *prospective* notice-and-comment procedures after statutory penalties were enacted. But to be clear, we do not purport to rule on the validity of any listed transaction not before us. Our decision is specific to Notice 2017-10. Because the notice was a legislative rule and Congress did not expressly exempt the Service from notice-and-comment rulemaking, Notice 2017-10 is not binding on Green Rock.

(Emphasis added, citations omitted.)

4. IRS Concedes the Issue

In *A.O.D. 2024-01*, Chief Counsel expressly disagreed with the results in these cases, but recognized both that the IRS has consistently lost on this point and that “the reasoning of this adverse precedent applies to all existing post-AJCA reportable transaction notices.” Thus, Chief Counsel announced a new policy:

The Service will follow the Sixth and Eleventh Circuit and the Tax Court decisions in all circuits and will no longer defend post-AJCA reportable transaction notices. The Service will not enforce the disclosure and reporting requirements set forth in those notices and will not assert penalties under sections 6662A, 6707, 6707A, and 6708 resulting from identification of reportable transactions pursuant to post-AJCA guidance that did not go through notice-and-comment rulemaking procedures.

Chief Counsel also announced that the IRS will concede or abate penalties asserted under the Code provisions listed above in pending cases “resulting from identification of reportable transactions pursuant to post-AJCA notices that did not go through notice-and-comment rulemaking procedures.” Chief Counsel also made clear that “[t]his AOD does not apply to pre-AJCA notices.”

5. Waning Impact

As part of the 2022 Consolidated Appropriations Act, Congress amended §170(h) so as to limit the deduction from a syndicated conservation easement transaction to 2.5 times the sum of each investor’s relevant basis in the investment entity. As a result of this rule, the classic

syndicated conservation easement transaction targeted by *Notice 2017-10* is dead. Going forward, then, the notice is of no concern. But the amendment to §170(h) is not retroactive, so the court's holding is still of interest to those who engaged in syndicated conservation easement transactions before December 2022 can take comfort in knowing that the statutory penalties for failing to report information required under *Notice 2017-10* do not apply.

C. Conservation Easement Deduction Was “Just” 178 Times Actual Value, But Negligence Penalty Still Applies (*J L Minerals, LLC v. Commissioner*, T.C. Memo. 2024-93, October 8, 2024)

The Tax Court has held that the donation of a conservation easement in nearly 65 acres of land in rural Georgia yielded a federal income tax deduction of \$93,690. But because the taxpayer claimed a deduction of \$16,745,000 for the donation, the court upheld the determination of a deficiency plus an accompanying accuracy-related penalty.

In December, 2015, two real estate professionals purchased 645 acres of land in rural Georgia for \$1.6 million through an LLC they formed for this purpose. That same day, they conveyed about 65 acres of that land to a separate LLC (the “Easement LLC”) they owned. Those 65 acres had previously been subject to a 10-year mineral lease that gave a mining company the right to find and extract kaolin, a mineral abundant in the area. The mining company never engaged in any activity on the land despite having this leasehold.

In January, 2016, a timber company bought a 98-percent interest in the Easement LLC. In December, 2017, the Easement LLC donated a conservation easement in the 65 acres to a qualified charitable organization. On its federal income tax return for 2017, the Easement LLC claimed a federal income tax charitable contribution deduction of \$16,475,000. The IRS disallowed the deduction in its entirety, and the resulting deficiency and imposition of penalties lead to this lawsuit.

The IRS argued that the Easement LLC lacked donative intent, thus disqualifying it from the deduction. But the Tax Court, citing *Mill Road 36 Henry, LLC v. Commissioner*, T.C. Memo. 2023-129, and other cases, rejected this argument, observing that “a donor motivated by guilt, or by the hope of being admired, or by the desire for a tax benefit, may still deduct his contribution.” Congress created the federal income tax deduction for charitable contributions in part to spur donations, so a taxpayer should not be punished for taking advantage of the incentive.

The IRS then claimed the donation was not made exclusively for conservation purposes, as required by §170(h)(4)(A). The court held that the deed in this case satisfies the requirement that the easement protect “a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem.” The land subject to the easement will not be developed even if all the parcels surrounding it are, one day, developed. That is sufficient to satisfy the statutory requirement,

said the court. Although the deed did reserve certain rights to the donor to engage in limited agriculture and forestry, it prohibited commercial forestry and imposed no-cut zones in areas covering about two-thirds of the subject land. The deed allowed the LLC to borrow pits for limited specific uses, but it prohibited any activity that would change the topography of the land except as consistent with IRS regulations.

The IRS also claimed the Easement LLC failed to secure a “qualified appraisal,” as required by §170(f)(11). Specifically, it alleged that the appraiser was not qualified because the LLC’s owners knew or should have known that the appraiser would falsely overstate the value. The court rejected this argument, finding from the evidence that the back-and-forth between the appraiser and the Easement LLC’s owners in this case was normal. The court held that a reasonable person with the knowledge of the Easement LLC’s owners would not expect the appraiser to overstate the value of the easement, and there was no evidence that the appraiser and the owners had a “meeting of the minds on a predetermined result.” Accordingly, said the court, the appraiser was qualified.

Having found a conservation easement deduction was proper, the court turned its focus to the amount of the deduction (i.e., the value of the easement). Here the Easement LLC did not fare well. The Easement LLC’s expert said the “highest and best use” of the subject property was as a kaolin mine, but the court rejected that claim. “To put it bluntly,” said the court, “multiple kaolin processors had taken a close look at the easement property and, in at least two cases ..., decided that it was not worth mining or even keeping it as part of a long-term reserve.”

The court also expressed “considerable skepticism” in the credibility of the Easement LLC’s expert:

[O]n at least eight occasions to our knowledge [the expert] concluded that a property in rural Georgia had an extremely large kaolin deposit (ranging between 3.6 and 6.4 million tons of kaolin), which was later used to support a very large charitable contribution deduction (between \$14.6 and \$22 million dollars (sic)). If [the expert] were correct, the entire kaolin industry failed to appreciate hundreds of millions of dollars of valuable kaolin right under its feet, despite decades of drilling and testing and buying and selling. Occa’s razor suggests a different result: [the expert] repeatedly overstated the amount of commercial-grade kaolin in its reports.

The court instead agreed with the IRS’s expert that the highest and best use of the subject property was its current use: “agricultural/residential/recreation use with knowledge that some mineral exists on the site.”

The court found it relevant that the timber company that bought a 98-percent interest in the Easement LLC paid a purchase price that translates to \$2,647 per acre. It also found the IRS

expert's evidence about comparable sales of nearby parcels to be probative. It ultimately concluded that the value of the land before the easement's conveyance was \$2,700 per acre, or \$174,690. It then applied the lowest value of the land after the easement's conveyance indicated by the IRS's expert. That value was \$81,000. Thus, the proper deduction amount was \$93,690.

Because the value claimed on the Easement LLC's tax return was more than 200 percent of the correct amount (heck, it was about 17,800 percent more than the correct amount!), the IRS determined that the Easement LLC was liable for the 40-percent gross misstatement penalty. The Easement LLC resisted this too, but the court held that the "deduction claimed in this case, however 'does not pass any reasonable smell test.' JL Minerals and its coterie of advisors took Congress's attempt to promote conservation and cynically used it as a cover to fleece the public fisc to the tune of nearly \$17 million in baseless deductions." It thus upheld the imposition of the penalty.

D. Conservation Easement Deduction Proved Not So Gneiss (*Jackson Crossroads, LLC v. Commissioner*, T.C. Memo. 2024-111, December 19, 2024)

The Tax Court has held that although two related limited liability companies were entitled to conservation easement deductions, the deduction amounts were far lower than what they claimed on their federal income tax returns, leading to the application of gross valuation misstatement penalties. While the taxpayers prevailed against IRS attacks on the bonafides of the deductions, they lost on the all-important issue of valuation.

Our story begins in 2015, when a couple of college pals who made it big in real estate formed an LLC that acquired title to two adjoining parcels of real property, both straddling Walton and Morgan Counties in Georgia, from unrelated sellers. This LLC paid a combined \$5.2 million for the two parcels, which totaled about 925 acres. In 2016, the LLC subdivided the 925 acres into four separate lots. It then assigned one parcel containing nearly 230 acres to one of the taxpayers in this case, a new subsidiary. A second parcel consisting of nearly 310 acres was assigned to a second new subsidiary LLC, the second taxpayer in this case. Thus, the taxpayers are subsidiaries of a master LLC owned by the two real estate moguls.

The taxpayers then, late in 2016, conveyed conservation easements in their parcels to the Oconee River Land Trust. The first taxpayer claimed a charitable contribution deduction of about \$23.1 million, while the other taxpayer claimed a charitable contribution deduction of about \$13.8 million. (For those struggling in math, the total deduction amount for the taxpayers—both subsidiaries of a master LLC with two owners, remember—is about \$36.9 million.) When the IRS disallowed both deductions, each LLC ran to Tax Court. The court consolidated the two matters into this one case.

1. Adequate Substantiation

Where a taxpayer claims a charitable contribution deduction greater than \$500,000, the taxpayer must attach a “qualified appraisal” of the contributed property. IRC §170(f)(11). Regulations set forth the elements of a qualified appraisal, and one of the elements is that the appraisal must be “prepared, signed, and dated by a qualified appraiser.” Reg. §1.170A-13(c)(3)(i)(B). A qualified appraiser, in turn, is one who meets certain requirements, mostly related to the appraiser’s credential and experience. The requirement at issue here, however, is the one set forth in the so-called “knowledge regulation,” Reg. §170A-13(c)(5)(ii). That regulation states in part that:

An individual is not a qualified appraiser with respect to a particular donation ... if the donor had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property.

That seems odd: an *appraiser* is not qualified if a reasonable *donor* would expect the appraiser would falsely overstate the value of the donated property. As the Tax Court observed, this has nothing to do with the appraiser’s credentials, but instead turns on whether the donor “held specific knowledge of facts that would cause it to expect [the appraiser’s] opinion of value to be falsely overstated.”

Based on the record, the Tax Court found no evidence that a reasonable donor in the taxpayer’s position would know any such facts. Though the real estate developers who formed the entities in this case did hire the appraiser for multiple projects, the court found that the relationship between the founders and the appraiser:

could also be read as a relatively normal back-and-forth between client and appraiser. The client first retains someone who has experience and skill with real property valuations and then gives samples of what the client has found appropriate in the past. The client trusts the appraiser to pick an acceptable method and believes that the income method makes sense given the uniqueness of the property. The appraiser, although responsive to feedback, explicitly aims to stay within the bounds of reasonableness.

The court went on to determine that the appraisals submitted by the taxpayers met all of the other requirements of a qualified appraisal.

2. Capital Assets or Inventory?

The IRS then argued that the subject lots were inventory in the hands of the taxpayers. If so, then the deductions of the taxpayers would be limited to their adjusted bases in the

properties under IRC §170(e)(1)(A). Given the master LLC paid only \$5.2 million for all 925 acres, this would significantly curtail the amount of the deduction.

But the Tax Court determined that the properties were capital assets to both taxpayers. As an appeal would be heard in the Eleventh Circuit, the court applied the test from *Sanders v. United States*, 740 F.2d 886 (11th Cir. 1984). Under that test, the question of whether a given asset is inventory:

involves three subsidiary inquiries: (1) whether the taxpayer was engaged in a trade or business; (2) whether the taxpayer held the property primarily for sale in that business; and (3) whether the sales thus contemplated were “ordinary” in the course of that business.

Here, the focus was on the second inquiry. The taxpayers argued they acquired the lots primarily for conservation purposes and not for sale to customers, while the IRS said that the properties were inventory because the founders frequently and continuously acquired land for the purpose of claiming conservation easement deductions.

The Tax Court decided that the focus should not be on the actions of the founders but on the actions of the LLCs. The LLCs showed the properties as “land” on their balance sheets (not as “inventory”). Further, none of the traditional indicia of inventory—like efforts to sell the property or the use of a business office to market it—were present here. Thus, said the court, the properties were capital assets.

3. Valuation of the Deduction

This brought the court to the valuation of the contributions. The value of a conservation easement is measured as the difference between the value of the property at its highest and best use and the value of the property following the restriction imposed by the easement. Here, the parties disagreed as to the highest and best use of the properties and as to the method that should be used to determine the value of that highest and best use.

The taxpayers claimed that the properties could be developed, one into a granitic gneiss mine and the other into an industrial warehousing or manufacturing site. The Tax Court concluded that while the first property could be used for mining, both the demand for the gneiss and the output capacity were overstated by the taxpayer, to the point that mining was not the highest and best use of the land. The court also concluded that there was no sustainable demand for the industrial site. It thus determined that the highest and best use of each property was its current use as agricultural, residential, and recreational land.

In valuing the properties, the taxpayer used an approach based on income and comparable sales. The court, however, found more probative the fact that all 925 acres had

been purchased the year before for just \$5.2 million, or \$5,600 per acre. The court then consulted evidence of comparable sales from three other experts, concluding that the “before value” for each property would be \$7,000 per acre, a total of about \$3.7 million. While the parties disagreed as to the “after value” of the lots, the court ultimately found the taxpayer’s average price per acre to be the better-reasoned conclusion. That resulted in a combined “after value” of about \$1 million. Accordingly, the proper deduction amount was about \$2.7 million.

4. Penalties

But the combined deductions claimed by the taxpayers came to about \$36.9 million. Because this amount exceeds twice the correct deduction amount (heck, it’s more than 13 times the correct amount!), the 40 percent “gross valuation misstatement” penalty of IRC §6662(h) applies. The taxpayers argued they had reasonable cause for the understatement, but the court observed that this exception does not apply to “gross” understatements. Thus, it sustained the 40-percent penalties imposed by the IRS.

5. Observation

The case is a helpful reminder that there is no “reasonable cause” exception to the gross valuation misstatement penalty. It also represents the recent reemergence of valuation as the core issue in conservation easements. For a few years, the IRS relied on regulations to disallow the deductions in full unless hyper-technical requirements were followed to the letter. But following decisions from the Tax Court and one federal circuit court of appeals invalidating those regulations, the IRS must once again wage war on the valuation front.

E. Façade Easement Deduction Fails for Want of Certification of Historic Structure Status (*Capitol Places II Owner, LLC v. Commissioner*, 164 T.C. No. 1, January 2, 2025)

The Tax Court has held that the donation of a building façade easement was not deductible because the taxpayer did not establish a “qualifying conservation purpose” for the contribution. The court thus granted summary judgment to the IRS, finding no genuine issue of material fact remaining to be decided.

In 2014, the taxpayer acquired ownership of the Manson Building, a three-story masonry building in Columbia, South Carolina, designed by a prominent local architect, James Urquhart. Built in the early 20th century, the building underwent a “fair share of alterations and remodeling,” including the addition of a stucco façade to the top two floors in the 1960s.

Back in 2000, the then-owner of the building applied with the National Park Service to get the building listed in the National Register of Historic Places. The NPS denied the

application, finding the building “has lost important character-defining features” and that much of the first-floor retail space had been altered.

In 2014, the Historic Columbia Foundation applied to get the “Columbia Commercial Historic District” listed in the National Register of Historic Places. The application listed 36 buildings within the district, including the Manson Building, as “contributing” to the area’s local significance. The application was approved, though in that process there was never a determination that the Manson Building itself was of historical significance to the district.

On December 17, 2014, the taxpayer granted a façade easement in the Manson Building to the Historic Columbia Foundation. On its short-year 2014 federal income tax return, the taxpayer claimed a charitable contribution deduction of \$23.9 million for the donation of the façade easement. The IRS disallowed the deduction, bringing the parties to the Tax Court.

1. A Little Ditty About Façade Easements

Section 170(f)(3)(A) generally prohibits a deduction for the charitable contribution of anything less than the donor’s entire interest in the donated property. Thus, for example, a taxpayer who owns all rights to a parcel of improved land may not deduct the value of an income interest donated to charity. There are a limited number of exceptions to this rule, the relevant one here being §170(f)(3)(B)(iii), which permits a deduction for a “qualified conservation contribution.” Under §170(h)(1)(C), only a contribution “exclusively for conservation purposes” can be a qualified conservation contribution.

Section 170(h)(4) then sets forth a number of qualifying conservation purposes, the relevant one here being “the preservation of an historically important land area or a certified historic structure.” §170(h)(4)(A)(iv). Section 170(h)(4)(C) explains that a “certified historic structure,” for this purpose, means either:

- (i) any building, structure, or land area which is listed in the National Register, or
- (ii) any building which is located in a registered historic district ... and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.

The Tax Court granted summary judgment to the IRS, finding first that the Manson Building was not listed in the National Register of Historic Places. The taxpayer argued it was sufficient that the Manson Building was within the Columbia Commercial Historic District, but the court rejected this argument. If it is enough that a building is within the boundaries of an area listed in the National Register, then the statute would not need to contain the second

method for qualifying as a certified historic structure. The court refused to read the first method in a way that renders the second method superfluous. As the court concludes:

[T]he text and context of section 170(h)(4)(C)(i) establishes that the phrase “listed in the National Register” refers to a building, structure, or land area individually listed in the National Register and not merely one located in a registered historic district.

Furthermore, observed the court, there was never a certification from the Department of the Interior that the Manson Building was of historic significance to the district. The taxpayer at no point even applied for this certification. The taxpayer claimed it was sufficient that the building was listed as “contributing” to the historical significance of the area in the district’s application for listing in the National Register, but even though a building “might conceivably qualify” for certification by reason of being a resource “contributing to” a registered historic district, certification is, nonetheless, still required.

The taxpayer then claimed that even if the Manson Building was not a certified historic structure, the façade easement protects “an historically important land area.” The court had little patience for this alternative argument, finding it suspicious that this other claimed purpose was not listed in the deed. Indeed (no pun intended, but what the heck), the easement deed specifically preserves a building and not a land area. As the court notes, “[a] single façade easement protecting a single building is insufficient.”

Because the taxpayer could not prove that the easement protected a qualifying conservation purpose, the court found that the taxpayer could not claim a charitable contribution deduction for the donated façade easement. But the failure of the deduction does not undo the easement: the taxpayer still owns the Manson Building and lacks any power to change the building’s façade without the consent of the Historic Columbia Foundation. While the taxpayer may not be as much as \$23.9 million poorer as a result of the donation, without question it now owns property worth less than its original value. The case underscores that taxpayers with visions of tax savings dancing in their heads should proceed carefully, as the transaction is not without genuine risk.

F. Conservation Easement Generated \$4.7 Million Deduction, Not the \$32.5 Million Claimed by the Taxpayer (*Seabrook Property, LLC v. Commissioner*, T.C. Memo. 2025-6, January 21, 2025)

The Tax Court has held that a syndicated conservation easement transaction resulted in a federal income tax deduction, but in an amount far less than the taxpayer claimed on its 2017 tax return. The easement covered roughly 620 acres in rural Liberty County, Georgia, land near the Florida-Georgia line that’s about a 45-minute drive from Savannah.

Some 250 acres of the property is marshland, but the remainder, while undeveloped, is prime for residential development. At least that's what the taxpayer's appraiser concluded, leading the taxpayer to claim a deduction of over \$32.5 million for the donation of the easement. The IRS agreed that residential development was possible, but at a much more modest level given the property's remote rural location and lack of nearby grocery stores, schools, restaurants, and hospitals.

But the IRS led with the argument that the taxpayer should get no deduction at all for lack of "donative intent." The argument goes that the LLC was only in it for the deduction, thus there was no "gift" to Southern Conservation Trust, Inc., the charitable recipient of the easement. The Tax Court rejected this argument, as it did in four cases from 2023 and 2024: *J L Minerals, LLC v. Commissioner*, T.C. Memo. 2024-93; *Buckelew Farm, LLC v. Commissioner*, T.C. Memo. 2024-52; *Mill Road 36 Henry, LLC v. Commissioner*, T.C. Memo. 2023-129; and *Oconee Landing Property, LLC v. Commissioner*, T.C. Memo. 2024-25. As the court (once again) reasoned, any "*quid pro quo*" in the form of a tax deduction is coming from Congress and not from the charity. In the court's view, it is enough that the taxpayer donated property to charity and received nothing back *from the charity*, or at least nothing more in value than what was given to the charity.

The IRS then argued that the appraisal attached to the 2017 tax return did not substantially comply with the requirements for a "qualified appraisal," as required by Reg. §1.170A-13(c). The IRS pointed to all kinds of nitpicky faults, none of which swayed the court into finding that the appraisal did not substantially comply with the requirements of the regulation. First, the IRS claimed the appraisal did not adequately describe the property, but the court found it contained enough information to alert the IRS as to the property to which the easement relates. Second, the IRS pointed out the appraisal did not state the date of donation, but the court felt it was enough that the donation date was specified on the Form 8283 and that the date of the appraisal was close to the donation date. Finally, the IRS griped that the appraisal made no mention of Georgia Forest Land Protection Act (FLPA) covenants related to the property, violation of which could result in a \$50,000 penalty. The court reasoned that because the penalty amounted to 0.14% of the appraised value of the land, the failure to mention or discuss the impact of the covenants on the appraised property value was of no import.

On the valuation of the property itself, though, the IRS prevailed. The court ultimately determined that the value of the easement was just over \$4.718 million, and because the amount of the claimed deduction (\$32.5 million, remember) was more than double that amount, the taxpayer was liable for a 40-percent gross valuation misstatement penalty under §6662. In reaching its conclusion, the court was more persuaded by evidence of comparable sales offered by the IRS's expert. Those sales reflected values ranging from \$7,000 to \$10,000 per acre. It found the taxpayer's expert less persuasive, faulting his report because it "ignores

real estate's oldest adage: 'Location, location, location.'" While the property may be pretty, it also pretty remote.

G. An Even Bigger Valuation Error (*Green Valley Investors, LLC v. Commissioner*, T.C. Memo. 2025-15, February 11, 2025)

The Tax Court has determined that the value of a conservation easement on about 140 acres in Chatham County, North Carolina, donated at the end of 2014 was roughly \$1.15 million. Alas, the taxpayer claimed a charitable contribution deduction of nearly \$22.6 million from the donation, so here too the taxpayer was liable for a gross valuation misstatement penalty under §6662.

This case was consolidated with three other cases involving related parties. In each case, the taxpayer, a limited liability company, purchased land and then donated a conservation easement to the Triangle Land Conservancy in either 2014 or 2015. If the taxpayer's name rings a bell, that may be because it and the other three taxpayers already appeared in Tax Court regarding these very donations. In the prior case, *Green Valley Investors, LLC v. Commissioner*, 159 T.C. 80 (2022), the IRS disallowed the deductions on the grounds that the donated easements violated the statutory requirement that they be given in perpetuity. And because the disallowed deductions resulted in understatements from syndicated conservation easement transactions, the IRS asserted §6662A penalties. The Tax Court held that these penalties could not apply because the IRS did not properly identify syndicated conservation easement transactions as "listed transactions" for purposes of this penalty. Importantly, though, that decision only rejected the application of the penalty applicable to listed transactions. It saved for another day the computation of the allowable deduction amount and whether other penalties might apply.

That day has now come. The taxpayer claimed that the subject property could be used as a crushed stone aggregate quarry. But the Tax Court held that while such an activity "is a physical and legal possibility," the actual development of the property for such a use is not financially feasible. Rather, said the court, the "highest and best use of the Green Valley property remains its current agricultural/residential/recreational use with knowledge of minerals on the site." From that lens, the size of the deduction was bound to be smaller.

Indeed it was. Considering that the taxpayer's predecessor in interest bought the land in 2011 for about \$3,700 per acre and that same year sold about 180 acres of it for about \$41,361 per acre, the taxpayer's claim that the easement was worth \$161,000 per acre seemed...a stretch. That led the court to its determination that the pre-easement value of the property was roughly \$1.4 million. Subtract the \$250,000 "after-easement" value stipulated by the parties, and you get the court's conclusion that the easement was worth about \$1.15 million. Because the deduction claimed by the taxpayer was nearly 20 times that amount, the 40-percent gross valuation misstatement applied. The court then applied a second, 20-percent accuracy-related

penalty under §6662 applicable to that portion of the taxpayer's underpayment not attributable to a gross valuation misstatement.

A little over two years earlier, Green Valley left the Tax Court with a victory under its belt. This time, the IRS emerged triumphant. While in the prior case the IRS hoped the Tax Court would disallow the deduction completely, this time the Tax Court disallowed the bulk of the claimed deduction, and the penalties in connection with the understatement will far exceed the tax savings from the deduction amount that was allowed.

H. Property Zoned for Agricultural Use Can't be Valued as a Limestone Mine for Charitable Contribution Purposes (*Ranch Springs, LLC v. Commissioner*, 164 T.C. No. 6, March 31, 2025)

In a unanimous reviewed opinion, the Tax Court has determined that the value of a conservation easement was \$335,500, an amount far below the \$25,814,000 deduction claimed on the taxpayer's federal income tax return. The large disparity resulted from the assumption in the taxpayer's appraisal that the highest and best use of the land would be for a limestone quarry. In fact, the property was zoned for light residential and agricultural use only, meaning use as a limestone quarry was not feasible. The court (Judge Lauber) also held that the taxpayer was liable for the 40-percent gross valuation misstatement penalty under IRC §6662.

The facts of the case are "painfully familiar" to the court. An LLC formed by a consortium of rich folks in December, 2016, purchased 110 acres of farmland in rural Shelby County, Alabama, for \$6,500 per acre (the total purchase price, accordingly, was \$715,000). The next year, the LLC granted a conservation easement on the entire property to Heritage Preservation Trust, a charitable organization. The easement prohibited commercial development of the land, but the LLC retained rights to use the property for agricultural, forestry, and recreational purposes.

At issue in the case is the value of the easement. This is determined by subtracting from the "highest and best use" of the property (the property's "before value") the value of the property at the use allowed by the perpetual conservation easement (the property's "after value"). An appraiser hired by the LLC valued the land at a "before value" of \$236,673 per acre (\$26,034,030 total). The appraiser "thus took the position that the land had appreciated by 3,641 percent in 12 months." Again, this was based on the assumption that the land could be used as a limestone quarry. After subtracting out the "after value" of \$220,030, the result is the deduction amount claimed by the taxpayer.

The IRS initially determined that the taxpayer should not get a charitable contribution deduction at all because the taxpayer failed to obtain a "qualified appraisal" from a "qualified appraiser." It stuck by this argument at trial, but the Tax Court found that appraiser was qualified and that the document produced met the requirements of a qualified appraisal.

But that does not end the matter. Having determined the taxpayer is entitled to a deduction, the focus shifts to the value of the conservation easement. The Tax Court held the “before value” was \$6,550 per acre, the amount suggested by the IRS’s expert and only a slight increase from the amount paid for the property by the taxpayer one year before the donation. According to the court, the transaction by which the taxpayer acquired the land was “at arm’s length between a willing seller and a willing buyer, both with knowledge of relevant facts and neither being under any compulsion to buy or sell.” Thus the original purchase price is “very strong evidence” of the value of the land before the donation, especially where the contribution is close in the time to the property’s acquisition.

More importantly, the court rejected the conclusion of the taxpayer’s appraiser that the highest and best use of the property was for limestone mining. The property was zoned for agricultural and light residential use, and the taxpayer failed to prove that rezoning to permit limestone mining was reasonably probable.

The court went on to observe that even if limestone mining was a permissible use, the taxpayer’s appraiser erroneously equated the value of the property in its then-current state as raw land with the net present value of a hypothetical quarry business conducted on the land. In determining the value of the easement, the appraiser used an estimated cashflow that could be derived from operating a quarry on the property for 35 years. “He opined, in other words, that the value of the raw land was equal to the assumed value of the hypothetical mining business.” As the court put it, “[n]o rational buyer with knowledge of relevant facts would pay, for one asset needed to operate a business, the entire future value of the business.”

At trial the taxpayer conceded that the “after value” of the land was \$385,000. The court thus concluded that because the “before value” of the land was \$720,500, the taxpayer was entitled to a deduction of \$335,500. That’s a mighty small consolation, however, because the court also upheld the IRS’s imposition of a 40-percent gross valuation misstatement penalty. The penalty applies once the value of property claimed on a tax return exceeds 200 percent of its correct value. Here, the value shown on the return was 7,694 percent of the correct value. In most circles, 7,694 percent is more than 200 percent, so the taxpayer was hit with the 40-percent penalty. Although the court did not compute the amount of the penalty, the numbers supplied in the case indicate that it is over \$10.19 million.

I. Eleventh Circuit Confirms: Deduction for Conservation Easement on Inventory Property is Limited to Basis (*Glade Creek Partners, LLC v. Commissioner*, 11th Cir., June 6, 2025)

The Eleventh Circuit Court of Appeals has affirmed the Tax Court’s decision that a limited liability company’s conservation easement deduction was limited to its basis in the real property subject to the easement because that property was inventory in the hands of the member that

contributed it to the LLC. The case has become an extended saga, bouncing repeatedly between the Tax Court and the Eleventh Circuit.

While the path of litigation has been long and twisted, the facts of the case are relatively straightforward. An investment entity acquired about 2,000 acres in Tennessee for just over \$9 million in 2006. That entity transferred the property to Hawks Bluff Investment Group, Inc., an S corporation, in 2010. In 2012, Hawks Bluff contributed the land to the taxpayer in exchange for a 98-percent interest in the taxpayer. Shortly thereafter, the taxpayer granted an easement on the land to Atlantic Coast Conservancy, Inc., and claimed a charitable contribution deduction of \$17.5 million on its 2012 income tax return.

The IRS initially disallowed the deduction on the grounds that the deed violated the so-called “proceeds regulation,” Reg. §1.170A-14(g)(6)(ii), because it provided that the charity would receive only a share of the net proceeds in the event of a judicial extinguishment and sale and not a share of the gross proceeds. The Tax Court agreed, consistent with what was then its precedent. *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2020-148. But in an unpublished opinion dated August 22, 2022, the Eleventh Circuit vacated the Tax Court’s decision, holding the proceeds regulation was invalid under *Hewitt v Commissioner*, 21 F.4th 1336 (11th Cir. 2021). (*Hewitt* held that the proceeds regulation was not promulgated in compliance with the Administrative Procedure Act, a position the Tax Court would later come to embrace in *Valley Park Ranch, LLC v. Commissioner*, 162 T.C. No. 6 (2024).) The Eleventh Circuit thus remanded the case back to the Tax Court for further determination as to the amount deductible.

But the Eleventh Circuit’s unpublished opinion also upheld the Tax Court’s determination that the value of the easement was just under \$8.9 million. One would think, then, that the Tax Court would have little left to determine on remand. Yet it was during the remand that the IRS argued, for the first time in the proceedings, that the taxpayer’s deduction should be limited to its basis in the property to which the easement relates because the property was inventory in the hands of Hawks Bluff, the contributing member. If the land was inventory, IRC §170(e)(1)(A) would effectively limit the deduction to basis, as it requires the amount of the deduction to be reduced by “the amount of gain which would not have been long-term capital gain ... if the property contributed had been sold by the taxpayer at its fair market value.” As for whether the land was inventory to the LLC, IRC §724(b) states that if a partner contributes inventory property to a partnership, any gain or loss recognized by the partnership upon a disposition of the property within five years is treated as ordinary income or loss.

The taxpayer argued that the easement was investment property in the hands Hawks Bluff, but the Tax Court in *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2023-82 (2023) (*Glade Creek II*), rejected this contention. The court noted that precedent in the Eleventh Circuit identifies seven factors to be considered in determining whether property is “held for sale to customers in the ordinary course of business” and, thus, inventory:

(1) the nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity, and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales.

While the *Glade Creek II* court acknowledged that most of the factors relate to sales and marketing activities (of which there were none), the court also noted that the factors do not have equal weight. Instead, said the court, significant weight should be given to the fact that Hawks Bluff took the position on its 2012 federal income tax return that it was in the business of selling real estate and that the subject property was inventory. Indeed, when Hawks Bluff then sold its interest in the taxpayer the day after contribution, it reported the resulting loss as an ordinary loss. The taxpayer argued that Hawks Bluff improperly reported the loss as an ordinary loss just to get better tax treatment for the loss, but the court faulted the taxpayer for presenting no evidence that Hawks Bluff or its predecessor ever held the land for investment purposes. With such evidence lacking, the position taken by Hawks Bluff on its 2012 federal income tax return gets significant weight.

The taxpayer argued that even a dealer in real property can hold land for investment, but the court observed that in such cases the burden of proof is on the taxpayer to prove that any given parcel was held for investment and not as inventory. Here again, said the *Glade Creek II* court, proof was lacking. "Hawks Bluff did not segregate the easement property ... in a manner sufficient to meet petitioner's burden to show that the easement property was investment property." Accordingly, the court held that the deduction would be limited to the taxpayer's basis in the underlying land. Based on evidence in the record, that would reduce the amount of the deduction to just over \$3.86 million.

But the taxpayer would not go down without yet another fight. On this latest trip to the Eleventh Circuit, the taxpayer based its appeal on three grounds, none of which proved successful.

The taxpayer's first claim was that the rule in IRC §170(e) does not apply to conservation easements. Instead, said the taxpayer, only IRC §170(h), the rules specific to conservation easements, apply to easements. The argument is silly, but it's also new to the appeal, and the Eleventh Circuit refused to consider on appeal an issue not raised before the Tax Court:

The IRS laid out this statutory framework in its pretrial memorandum, post-trial opening and answering briefs, and supplemental brief on remand. Glade could have raised its challenges ... at any of these points, but it failed to do so.

The taxpayer's second claim was that IRC §724(b) does not apply because it still owned the real property subject to the easement. The Eleventh Circuit rejected this argument for the same reason: it was too late for the taxpayer to raise an argument that should have been presented to the Tax Court.

The taxpayer's final claim was that the Tax Court's characterization of the real property subject to the easement as inventory was clear error. The taxpayer claimed the Tax Court over-relied on the 2012 tax return filed by Hawks Bluff because the return "does not reflect [the taxpayer's] intent." But the Eleventh Circuit found that irrelevant: it is the intent of the partner contributing the property to the partnership that triggers IRC §724(b), not the partnership's intent as to whether it will hold the property for sale to customers in the ordinary course of business. It was thus proper for the Tax Court to give weight to evidence showing Hawks Bluff's intent in holding the real property, for Hawks Bluff was the contributing partner.

As none of the taxpayer's arguments convinced the Eleventh Circuit, the court affirmed the decision of the *Glade Creek II* court in all respects. One hopes this will bring much-needed finality to the dispute.

J. Another Conservation Easement Deduction is Over-Valued, Leading to a Penalty (*Beaverdam Creek Holdings, LLC v. Commissioner*, T.C. Memo. 2025-53, June 2, 2025)

The Tax Court has held that although the taxpayer had attached a "qualified appraisal" in support of a claimed conservation easement deduction of nearly \$22 million, the value of the easement was merely \$193,250, resulting not only in a reduced deduction but also a gross valuation misstatement penalty under IRC §6662(h).

The case involved 85 acres of mostly-vacant land in Oglethorpe County, Georgia. The property was used as a granite quarry from the 1950s through 2012. In 2017, the property ended up owned by the taxpayer, a limited liability company formed by an investment entity and the granite company that originally owned the land. After admitting other members who paid \$25,000 per unit to invest, the taxpayer, on December 27, 2017, donated a conservation easement on the property to Foothills Land Conservancy. The taxpayer claimed a charitable contribution deduction of \$21,972,000 on its 2017 federal income tax return, that amount supposedly representing the fair market value of the easement. On the Form 8283, Noncash Charitable Contributions, attached to the 2017 return, the taxpayer computed the value of the easement as the difference between the property's \$22,100,000 value before the donation and the property's \$128,000 value after the donation. Also attached to the 2017 return was an appraisal, as required by the applicable substantiation rules. When the IRS disallowed the deduction in its entirety, this litigation ensued.

The IRS disallowed the deduction on the grounds that the appraisal attached to the taxpayer's 2017 tax return was not a "qualified appraisal" under IRC §170(f)(11). Specifically, the IRS concluded that the appraisal did not conform to generally accepted appraisal standards

(known in the trade informally as “USPAP,” short for the Uniform Standards of Professional Appraisal Practice) and that the report was not prepared by a “qualified appraiser.” But the Tax Court (Judge Goeke) held that while the appraisal does not fully comport with USPAP, it “is not so deficient that it fails to comply with generally accepted appraisal standards.” Further, the court determined that the appraisal was prepared by a qualified appraiser, for there was insufficient evidence that the taxpayer’s principals knew or reasonably should have known that the appraiser would falsely overstate the value of the donated property.

Having determined the taxpayer is entitled to a deduction, the court’s focus shifted to the amount of the deduction. The parties stipulated that the property was worth \$106,750 after the granting of the easement. So the value of the easement comes down to the value of the property before the easement was granted. This is determined with reference to the property’s “highest and best use.” The IRS argued that the best use of the property was for “limited agricultural, rural residential and recreation” uses. But the court agreed with the taxpayer that the highest and best use of the property was as a granite quarry, as demonstrated by its prior use and by valid forecasts that the property could feasibly re-open as a quarry.

The court disagreed, however, with the taxpayer’s contention that the value should be determined using the projected income stream that could result from resuming use of the property as a granite quarry:

In this case, the income method is not appropriate to value the easement property considering (1) no quarry business existed and all parties ... were aware that there was never an intent for Beaverdam to operate a quarry; (2) Beaverdam lacked industry knowledge and was unable to operate a quarry business without a hypothetical business partner; (3) the experienced [prior lessee] had failed to successfully quarry the property, and it had been abandoned since 2012; (4) sufficient sales data exists to establish a valuation that is based on actual transactions; and (5) other reasons discussed *infra*.

Instead, the court employed the comparable sales method, giving special weight to the fact that the original owner of the land sold the underlying land to the taxpayer for about \$225,000 in the same year as the property’s donation. On that basis, the court found that the value of the property before the easement was \$300,000. After subtracting the stipulated “after value” of the land, the resulting amount—the fair market value of the easement—was \$193,250.

The deduction claimed by the taxpayer was more than 110 times higher than the proper amount. Given that, under IRC §6662(h), there is a “gross valuation misstatement” where the value of property claimed on a tax return exceeds double the correct amount, the misstatement in this case was certainly gross. (Maybe “obscene” or “vulgar” would be more accurate?) As a result, the court upheld a 40-percent penalty.

The court did not address whether the taxpayer had reasonable cause for taking the reporting position as to the value of the easement because the Pension Protection Act of 2006,

Pub. L. No. 109-280, eliminated the reasonable cause exception for gross valuation misstatements that relate to charitable contributions. It is one thing to have a deduction slashed to a fraction of the originally claimed amount, but quite another to be forced to cough up a penalty equal to 40 percent of the misstatement on top of that. The high penalty should be a lesson to any taxpayer thinking about aggressive valuation positions with respect to charitable contributions.

**K. Appraiser Disqualified Because Donor Knew the Appraisal Would be Inflated
(*Rock Cliff Reserve, LLC v. Commissioner*, T.C. Memo. 2025-73, July 14, 2025)**

The Tax Court upheld the disallowance of charitable contribution deductions in their entirety because the appraisals attached to the taxpayers' federal income tax returns were not "qualified appraisals" under IRC §170(f)(11)(D). In addition, because the deductions were disallowed in full, the court determined the taxpayers were subject gross valuation misstatement penalties under IRC §6662(h).

This case was consolidated with three other cases involving transactions all arranged by the same party. In each case, the taxpayer, a limited liability company, purchased land in Walton County, Georgia, and then donated a conservation easement to the Atlantic Coast Conservancy on November 13, 2015. On their 2015 federal income tax returns, the LLCs claimed charitable contribution deductions totaling over \$60 million. The IRS reduced the total deduction amount to about \$64,000, leading the LLCs to petition the Tax Court for redetermination.

The Tax Court held that the LLCs should not get any deductions at all for their donations because the appraisals attached to their returns were not "qualified appraisals," as required by IRC §170(f)(11)(D). Among other things, a qualified appraisal has to be prepared by a "qualified appraiser." IRC §170(f)(11)(E)(ii). Both the Code and regulations set forth the various requirements for an appraiser to be qualified. Of relevance here, Reg. §1.170A-13(c)(5)(ii) states that an appraiser is not qualified "if the donor had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property." The regulation also states that an appraiser will be disqualified if "the donor and the appraiser make an agreement concerning the amount at which the property will be valued and the donor knows that such amount exceeds the fair market value of the property." Notice that the regulation does not look to the knowledge of the appraiser here. Instead, it asks whether the *donor* actually or constructively knows that the agreed amount exceeds the value of the underlying property.

Here, said the Tax Court (Judge Nega), there was evidence that the donor knew the appraiser was providing a false statement of the easement's value. To use the named taxpayer as an example, the LLC acquired the property for a little over \$1 million, yet it claimed the value of the easement on the property was worth over \$14.6 million. Further, there was evidence that the ringleader for each of the LLCs, Mr. Collins, was in cahoots with the appraiser, Mr. Foster, and that both parties knew the appraised value of the easement had to come in at a certain value in order to be attractive to investors. As the court observed:

Mr. Foster's final appraisal of the Rock Cliff Property was written long after Mr. Collins and Mr. Foster agreed on a value of approximately \$14.4 million for the conservation easement. Because Mr. Collins knew that the Rock Cliff Property was not worth \$14.4 million but rather was worth less than \$1.5 million, Mr. Collins “had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property.” Treas. Reg. §1.170A-13(c)(5)(ii). Consequently, Mr. Foster was not a qualified appraiser as to the donation of a conservation easement on the Rock Cliff Property.

For want of a qualified appraiser, then, there was no qualified appraisal. And because there was no qualified appraisal, the taxpayer was not entitled to a charitable contribution deduction.

The court then proceeded to determine the value of the donated easements. This was necessary because the value of the donated property is relevant in determining potential penalties that could apply. The parties agreed both that the highest and best use of the parcels at issue were as low-density residential subdivisions using private septic systems and that comparable sales were the best indicators of the values of the properties. But the parties offered very different sale transactions as comparable to the subject properties. The court found the comparables used by the IRS’s expert to be more probative, primarily because those properties were closer to the subject properties. Many of the comparables used by the taxpayer’s expert, on the other hand, were located in urban Fulton County, Georgia, much further from the site of the subject properties, and those properties had preexisting sewer systems. Finding the testimony and exhibits of the IRS’s expert to be more credible, the court determined the fair market value of each donation as follows:

LLC	Deduction Claimed	Property’s “Before” Value	Property’s “After” Value	Easement Value	Magnitude of Valuation Misstatement
Rock Cliff Reserve	\$14,665,625	\$1,145,833	\$185,000	\$960,833	1,523%
Jack’s Creek Reserve	\$19,005,000	\$2,031,862	\$125,000	\$1,906,862	996%
East Village Reserve	\$16,028,333	\$893,238	\$55,000	\$838,238	1,908%
Baker’s Farm Reserve	\$13,005,000	\$1,819,798	\$65,000	\$1,754,798	740%

In this case, the 40-percent gross valuation misstatement penalty under IRC §6662(h) applies where the amount of the claimed deduction exceeds 200 percent of the actual value of the donated property. As the table above shows, the claimed deductions here were all the result of gross valuation misstatements, so the court held the penalty applied to all of the LLCs.

Further, the court upheld the application of a second, 20-percent penalty based on either substantial understatement of income tax under IRC §6662(a) or negligence under IRC §6662(b). The taxpayers argued the reasonable cause defense would apply, but the court found that Mr. Collins failed to show ordinary care or prudence, citing this excerpt from his testimony on cross-examination:

Question: So for these four transactions at issue, did you receive any formal tax opinions?

Answer: I did not.

Question: Why not?

Answer: I have been told that tax opinions really weren't worth the paper they were written on.

The court upheld the 20-percent penalty based on substantial understatement of income tax or, in the alternative, negligence.

L. Penalties Were Properly Approved (*Sand Valley Holdings, LLC v. Commissioner*, T.C. Memo. 2025-74, July 14, 2025)

The Tax Court has granted the IRS's motion for partial summary judgment on the question of whether the IRS complied with requirements for securing timely supervisory approval of penalties in connection with a charitable contribution of a conservation easement. The taxpayer, a Georgia LLC, acquired land in Jefferson County, Georgia. In December of 2016, the taxpayer donated a conservation easement on the property to the Foothills Land Conservancy and claimed a \$35.38 million charitable contribution deduction on its federal income tax return. The IRS examined the return in 2020 and ultimately disallowed the deduction and imposed penalties.

In this matter, the taxpayer claimed the penalties should not apply because the IRS failed to follow proper procedures in imposing them. Specifically, IRC §6751(b)(1) requires that an initial determination of a penalty assessment must be "personally approved (in writing) by the immediate supervisor of the individual making such determination." Here, the revenue agent made the initial determination to assert penalties and that determination was approved in writing by a group manager, the revenue agent's immediate supervisor. This happened six months before the notice of final adjustment was sent to the taxpayer. On the basis of these facts, the Tax Court (Judge Lauber) concluded that the IRS complied with the requirements of IRC §6751(b)(1).

The court noted that the taxpayer "struggles in vain to gin up a dispute of material fact," but the court rejected all of the taxpayer's arguments. The taxpayer argued that the group

manager was really the person who made the initial determination to impose penalties, but the court dismissed it as “frivolous.” The taxpayer then argued that the initial determination was really made by someone in the Office of Chief Counsel because that person authorized the revenue agent to proceed without obtaining an appraisal. But the court determined that the authorization was based on the fact that an appraisal was not needed when the revenue agent concluded that the deduction should be disallowed entirely. The authorization, said the court, “was purely technical in nature, designed to ensure that the FPAA met all formal requirements.” Finally, the taxpayer claimed that the penalty had to be approved in writing by a director of field operations, a higher level official. This was, according to the court, “grasping at straws,” for the statute clearly states that written approval must come from a higher level official *or* the immediate supervisor of the person making the determination. As the court states, “Suffice it to say that the word ‘or’ permits approval by either type of official.”

The taxpayer then asked the court to defer on the partial summary judgment motion so that it could conduct further discovery and obtain all “documents electronically with metadata intact.” The court called this request an improper attempt to look behind statements and signatures appearing on the forms. “We will not condone fishing expeditions of this sort,” said the court. Having rejected all of the taxpayer’s arguments, the court granted the IRS’s motion for partial summary judgment.

M. Here We Go Again with the Overvaluations (*Veribest Vesta, LLC v. Commissioner*, Docket No. 9158-23, July 15, 2025)

The Tax Court, in a bench opinion by Judge Buch, has held that the taxpayer, a limited liability company, overvalued the donation of a conservation easement to such an extent that the taxpayer was liable for both a deficiency and a gross valuation misstatement penalty. The case involved a 55-acre parcel of land in Oglethorpe County, Georgia, on which an abandoned quarry was situated. One of the taxpayer’s members purchased the property for \$100,000 in 2016 and then contributed the property to the taxpayer. In 2018, the taxpayer donated a conservation easement on the property to Oconee River Land Trust.

The taxpayer’s 2018 federal income tax return claimed a charitable contribution deduction of \$20,310,000. This was based on a determination that the highest and best use of the property was as an operating quarry, and it determined a “before-easement” value using “optimistic projections of how much granite could successfully be mined” from the subject property. The Tax Court rejected the taxpayer’s computation of the “before” value, based on evidence both that contemporaneous sales of quarries in the surrounding region indicate a much more modest value and that the subject property itself sold just two years before the donation for a much lower price. Indeed, evidence showed that the subject property was worth less than the norm for the area, having been abandoned decades earlier because it was seen as not conducive to a successful mining operation.

The IRS contended the “before” value of the property was \$165,000. While the evidence suggested to the court that the “before” value could in fact be much lower, it accepted the IRS’s

conclusion as a concession as to the “before” value. Likewise, the court accepted the IRS’s determination that the “after-easement” value of the property was \$54,000 as another concession. This yielded a \$111,000 deduction. This made the claimed deduction of \$20,310,000 a gross valuation misstatement, so the 40-percent penalty applied.

Interestingly, the court also toyed with imposing sanctions and costs on the taxpayer under IRC §6673. That rule allows the Tax Court to impose a penalty of up to \$25,000 for maintaining a position that frivolous or groundless. And where a lawyer unreasonably and vexatiously multiplies the number of proceedings, the court can require the lawyer to pay excess costs, expenses, and attorney fees incurred because of that conduct. Here, said the court, “[a]rguing that a piece of property worth \$165,000 is worth in excess of \$20 million is patently frivolous.” Further, said the court, maintaining this argument caused inconvenience to several witnesses “so that petitioner could pursue an argument deemed by courts to be ‘not credible’ and ‘nonsense.’” Ultimately, the court did not impose sanctions here, but it concluded with this ominous statement:

We mention all this because this is one of eleven cases before this Court in which True North Resources is the partnership representative pursuing the litigation. And we provide this warning, that continuing to pursue similarly incredible, nonsensical, and, quite frankly, smelly arguments may result in sanctions on petitioner or its counsel.

XV. ON SALE NOW: ESTATE TAX CLOSING LETTERS! (T.D. 10031, May 20, 2025)

The IRS has issued interim final regulations reducing the user fee for estate tax closing letters from \$67 to \$56, effective for closing letter requests received as of May 21, 2025. The fee reduction was based on updated information as to the cost to Treasury in furnishing closing letters. On the same date, the IRS published the interim final regulations as proposed regulations, presumably in hopes that the interim final regulations can be made permanent following conclusion of the notice-and-comment procedures required by the Administrative Procedure Act

The preamble to the interim final regulations state that the IRS can charge a user fee for issuing an estate tax closing letter because it “constitutes the provision of a service and confers special benefits to authorized persons requesting such letters beyond those accruing to the general public.” User fees are determined based on internal costing standards determined in compliance with generally accepted accounting principles. In 2021, the IRS determined that the cost to the IRS to issue a closing letter was \$67, so it set the fee at that amount.

But now the numbers have changed. The IRS has now determined that receiving, reviewing, approving, composing, and sending estate tax closing letters currently requires 5,781 staff hours per year, based on an average of 8,894 annual requests consuming 0.65 staff hours per request. The IRS then converted the 5,781 staff hours into full-time equivalents, then

applied an average FTE salary of \$67,355 to determine the total compensation paid to handle closing letter requests. It then added an additional 62.5 percent of that amount to cover overhead (accounting, information technology, human resources, facilities, library and legal services, and more). That brings the total cost to the IRS to \$502,573. Divide that by the average of 8,894 annual requests and you get a cost of \$56 per request.

Finding it “unnecessary and contrary to the public interest for the IRS to continue to charge the current, higher user fee during the period provided for public comment on the proposal to reduce that fee,” the IRS found there was good cause to make the reduced \$56 fee effective immediately even though the new rule has not yet undergone notice-and-comment procedures. Accordingly, Reg. §300.12(b) now reads in its entirety as follows:

(b) Fee. The fee for issuing an estate tax closing letter is \$56.

This is the first set of final regulations promulgated in the second Trump Administration. In the last year of the Biden Administration, the IRS issued 44 Treasury Decisions containing final regulations. So far, in the first year of the second Trump Administration, the IRS is on track to issue ... three Treasury Decisions. The pacing suggests taxpayers should not expect an abundance of new guidance through 2028.

XVI. TAXPAYER SUCCEEDS IN VALUING GIFTED BUSINESS INTERESTS DESPITE FAILING AT LIFE IN GENERAL (*Pierce v. Commissioner*, T.C. Memo. 2025-29, April 7, 2025)

The Tax Court has determined the value of gifted interests in Mothers Lounge, LLC, a business treated as an S corporation for federal tax purposes. The case merits an extensive review of the facts. You know you’re in for an interesting read when the court begins its analysis with these words:

Backstabbing, infidelity, and blackmail – not the first words that come to mind in relation to a baby products company. However, these words aptly describe Mothers Lounge in the years leading up to June 4, 2014 (valuation date).

As the court (Judge Greaves) explains, Kaleb Pierce was an ambitious entrepreneur, and after he and his wife, Jeanette, produced a large family, Kaleb “looked to less savory businesses to make a quick buck.” These included brief stints in timesharing, house painting, and, with Jeanette, starting a business selling “Milk Bands,” bracelets designed to help nursing mothers remember which breast to use next when feeding their babies. They took this idea to trade shows, but sales were below expectations.

Kaleb and Jeanette watched with envy as another business at these trade shows, Hooter Hiders, did very well selling its nursing covers. When Kaleb determined that the patents owned by Hooter Hiders had expired, he decided to “create an identical nursing cover to knock off Hooter Hiders.” Kaleb also learned that while Hooter Hiders sold for about \$35 retail and \$15

wholesale, the cost to manufacture each cover was only \$1.30. He thus launched Udder Covers, renaming the existing business from Milk Bands to Mothers Lounge.

Kaleb's marketing gimmick appeared unusual: Udder Covers sold for the same price as Hooter Hiders, but he advertised promotional codes that allowed customers to buy the product for \$0 if they paid \$7.95 for shipping. The business would make money because the actual shipping charge was only \$1.57. Thus the total cost of each cover was \$2.87, turning each sale for \$0 into a profit of over \$5. By using materials of lower quality to make the knock off covers, Kaleb could grow the profit margin even further.

The plan worked. On the second day the Mothers Lounge website went live, it crashed from the large number of orders. Orders continued to roll in, but they soon led to complaints, as the packages were stamped with the actual shipping cost. When Mothers Lounge refused to pay refunds to disgruntled customers who wanted partial refunds, the customers took to the internet for revenge. "Within two weeks of the launch, more than 52,000 websites were calling Udder Covers a scam."

Undaunted, Kaleb and Jeanette decided to repeat the strategy of knocking off successful products pitched to first-time mothers by selling other inferior products for \$0 plus inflated shipping. They did so through several subsidiaries, thus giving customers the impression they were buying from different companies (so paying for shipping multiple times would make sense from the buyer's perspective). Through this model, the company sold knockoff baby slings, car seat covers, baby leggings, diaper covers, nursing pillows, reusable breast pads, and more.

Eventually, the couple ran out of products to knock off. Around the same time, Amazon entered the market, and soon web searches for products led customers there rather than to Mothers Lounge. And Amazon could afford to sell better products just as cheaply as Mothers Lounge because of its economies of scale.

The troubles continued when Mothers Lounge was the defendant in two lawsuits, one alleging trademark infringement and another brought by Hooter Hiders claiming both patent infringement and illegal marketing practices. If Mothers Lounge were to lose in those suits, the business could be crippled. On top of that, a Mothers Lounge employee hacked Kaleb's computer and discovered he was having an affair. The hacker then blackmailed Kaleb, forcing him to disclose his cheating ways to Jeanette. Although they stayed business partners, the lack of trust and resulting marital tension affected the business relationship. Employees who learned of the affair were likewise affected, brining employee morale to an all-time low. When news spread to customers, Kaleb was forced to resign as CEO of Mothers Lounge.

Obviously, then, this was the perfect time to engage in some estate planning. On the valuation date, four transactions went down: (1) Kaleb gave a 29.4-percent interest in Mothers Lounge to an irrevocable trust named after him; (2) Jeanette gave a 29.4-percent interest in

Mothers Lounge to an irrevocable trust named after her; (3) Kaleb sold his remaining 20.6-percent interest in Mothers Lounge to an LLC owned equally by his trust and Jeanette's trust in exchange for a promissory note in the amount of just over \$3.4 million; and (4) Jeanette sold her remaining 20.6-percent interest in Mothers Lounge to the same LLC for a separate note also in the amount of just over \$3.4 million. On federal gift tax returns, Kaleb and Jeanette reported that the gifted interests were worth almost \$4.9 million. The value of the gifts and the face values of the notes were based on an appraisal.

When the IRS issued notices of deficiency to each spouse, they timely challenged the determination through a petition to the Tax Court. Just before trial, Jeanette settled her case, leaving the court to deal only with Kaleb's alleged deficiency.

Kaleb came to trial with a new expert. That expert determined the business was worth \$18.678 million as of the valuation date. He then applied a 25-percent marketability discount and a 5-percent control discount, leading to his conclusion that the gifted interest was worth \$3.913 million and that the interest sold to the LLC was worth \$2.741 million. The IRS's expert, by contrast, valued the business at just over \$28.1 million. After applying a 30-percent discount, the IRS's expert said the gifted interest was worth over \$5.78 million and the interest sold to the LLC was worth just over \$4 million.

The Tax Court agreed with the parties that discounted cashflow method offers the best approach for valuing Mothers Lounge. (There were no sales of other comparable companies, and the value of the company as a going concern well exceeds the net value of its few assets.) Under the discounted cashflow method, the value of a business is the sum of the present value of its projected cashflows, the present value of its terminal value, and the value of any nonoperating assets. The court found the cashflow estimates provided by the taxpayer's expert to be more credible, which was a good start for Kaleb.

Kaleb's expert then wanted to "tax affect" the cashflow projections; that is, he sought to discount future earnings by assumed future federal income tax burdens that would be imposed on those earnings as if the business was a C corporation. Normally the Tax Court hates tax affecting when valuing an S corporation because S corporations don't face entity-level taxes. But because both experts applied it in this case, the court played along, though it was clear to observe that "we are not necessarily holding that the tax affecting is always, or even often, a proper consideration for valuing an S corporation." Ultimately, the court determined that Kaleb's expert correctly used a "fictitious entity-level tax rate" of 26.2 percent.

The court then had to determine the discount rate that would be used to calculate the present value of the estimated cashflows. After comparing the conclusions of the experts, the court found that the IRS's calculation of the risks involved to the business appropriately determined that the discount rate to employ in this case was 18 percent. The court then found that the business had about \$1.35 million in nonoperating assets, all in the form of excess cash.

On the discount front, Kaleb's expert prevailed here too, as the court adopted the 5-percent control discount and the 25-percent marketability discount. The IRS's expert sought to limit the control discount to nonoperating assets, but the court observed that the discount considers a shareholder's ability to receive a share of the total net asset value of the business, not just a share of nonoperating assets. The court found the 5-percent control discount was reasonable given the company's strong history of distributions.

With respect to the marketability discount, the court concluded that while both experts gave detailed explanations for their selected discount rates, it found the methodology used by the taxpayer's expert "slightly more persuasive" because it was based on companies similar to Mothers Lounge.

At bottom, then, the final value of the gift made by Kaleb to his trust was substantially closer to the value determined by his expert at trial. While that means there is still some gift tax deficiency, the amount is far less than what the IRS originally sought. It's thus fair to see the result as a significant win for Kaleb. But the prosecution of his case has done much to tarnish his business and personal reputation, so his win came at a steep cost.

XVII. MICROCAPTIVE INSURANCE ARRANGEMENT LACKED INSURANCE, SO DEDUCTIONS DISALLOWED (*Kadau v. Commissioner*, T.C. Memo. 2025-81, July 31, 2025)

The Tax Court has held that a microcaptive insurance arrangement did not involve "insurance," meaning that amounts paid from the taxpayer's wholly-owned S corporation to his wholly-owned captive insurance company were not deductible. The court also upheld corresponding accuracy-related penalties against the taxpayer, though it refused to uphold an additional deficiency assessed by the IRS, for while the payments made to the captive insurance company were not "insurance," they could be treated as nontaxable contributions of capital.

A. Background on the Taxation of Microcaptive Insurance Arrangements

A "captive insurance company," generally, is a subsidiary insurance company owned and managed by the individuals or entities it insures. It is intended to cover insurable losses incurred by its owners in business activities. Section 831(a) generally provides that an insurance company that is not a life insurance company is liable for tax under IRC §11 on its taxable income just like a C corporation. Captive insurance companies are common for both large and small business operations as they are often efficient vehicles for funding liability insurance.

But under IRC §831(b), a "small" captive insurance company, known on the streets as a "microcaptive insurance company" or, even more snazzily, a "microcaptive," can elect to be taxed only on its "taxable investment income" and not on its earned income from premiums. This creates a tax advantage: while the parent corporation deducts the premiums paid for

insurance as ordinary and necessary business expenses under IRC §162(a), the microcaptive does not include the premiums in taxable investment income.

In order to be a microcaptive eligible to make the election under IRC §831(b), the insurance company must a number of statutory diversification requirements that were not in effect during the years at issue in this case. Those requirements were added late in 2017 to address perceived abuses.

Furthermore, the tax benefits are available only where the amounts paid are premiums on bona fide insurance policies. If the arrangement is not one of true insurance, the arrangement does not produce the intended tax benefits. That's where this case comes into play.

B. Kadau's Microcaptive

During the years at issue (2012 through 2017), Curtis Kadau was the president and sole shareholder of an S corporation engaged in the production and sale of metal alloys. In 2012, he met with a group of promoters that recommended formation of a microcaptive. In October of that year, Kadau incorporated a captive insurance company in Nevis. He was its sole shareholder. The microcaptive hired the promoters as insurance managers. Over the next several years, the S corporation paid premiums to the microcaptive ranging from about \$39,000 to about \$257,000 on various liability policies. The S corporation also paid premiums to the promoters for "excess coverage policies."

The IRS disallowed a deduction for the amounts paid to the microcaptive and the promoters. It also imposed a 40-percent accuracy-related penalty under IRC §6662. And on top of that, the IRS determined a deficiency of over \$131,000 on the basis that the microcaptive had subpart F income on which Kadau should have paid tax as a United States shareholder.

C. Deduction Disallowed for Want of "Insurance"

In discussing whether the microcaptive arrangement constituted "insurance" for federal income tax purposes, the Tax Court (Judge Weiler) focused on four "nonexclusive factors" that are the hallmarks of insurance: (1) an insurance risk; (2) a shift in the risk of loss to the insurer; (3) a distribution of the insurer's risk among its policyholders; and (4) an arrangement that is insurance in the commonly accepted sense. The court noted that most microcaptive insurance cases focus on the last two factors, so the court followed suit here.

As to risk distribution, the court determined that the primary coverage policies issued by the microcaptive failed to achieve risk distribution because they were so few in number. "We have previously determined there to be an insufficient number of pooled risks when a captive insurance company issues only a handful of policies," the court noted. Kadau basically conceded this point but argued that the excess coverage policies issued by the promoters achieved risk distribution. But the court rejected this argument, finding a circular flow of funds (the S

corporation paid the premiums to the promoters but they turned around paid most of those amounts to the microcaptive, meaning the funds never really left Kadau's control), a lack of arm's length in negotiating the policies (the premiums were 2.5 to 3.5 times more expensive than premiums on comparable policies from unrelated insurers), and no substantial evidence that the promoters charged actuarially determined premiums.

The court then found that the payments made by the S corporation were not for insurance in the commonly accepted sense or for federal income tax purposes. The microcaptive did not operate as an insurance company, for it had no employees and performed little to no due diligence on premium prices or reinsurance agreements. Moreover, the microcaptive was thinly capitalized. Perhaps most significantly, the court noted except for the purported tax benefits, Kadau would have been in the same economic position had he simply self-funded insurance by placing the cash in a bank account. That was not a good look, and it contributed mightily to the conclusion that the arrangement was not insurance in the commonly accepted sense.

In light of the foregoing, the court determined the S corporation could not deduct under IRC §162(a) the amounts paid to the promoters or to the microcaptive.

D. Accuracy-Related Penalty Applies

Kadau made two arguments against application of the penalties, first that he had reasonable cause due to his good-faith reliance on professional advice and, second, that he had substantial authority for his reporting positions. The court rejected the reasonable cause defense, finding one phone call with a qualified actuary not enough to establish reasonable reliance. Kadau also claimed to have relied on the promoters, but the court found that advice "hardly qualifies as disinterested or objective if it comes from parties who actively promote or implement the transactions in question."

The court also rejected the substantial authority defense, finding this case involved "application of well-settled principles of taxation" and not novel questions of law. The court thus upheld the asserted penalty.

E. But No Added Deficiency

Kadau did prevail on one issue, however. The court rejected the IRS's contention that Kadau owed tax on the microcaptive's subpart F income. While the payments to the microcaptive were not premiums on insurance, they could be seen as contributions of capital and, therefore, not income. The burden of proof here was on the IRS, and there was no evidence that the payments made from the S corporation to the microcaptive "should not be reclassified as nontaxable contributions of capital." The court thus rejected the assessed deficiency of just over \$131,000.

The case offers much to consider in thinking about the formation of a microcaptive. One structuring a microcaptive should stand ready to prove risk distribution and adherence to commonly accepted notions of insurance so that the arrangement will be respected as true insurance. The case also shows that arrangements featuring a circular flow of funds, a lack of arm's length in setting actuarially-determined premiums, and operations inconsistent with those of bona fide insurance companies will be met with disapproval.

XVIII. IMPRISONED TAXPAYER DOES NOT OWE TAX ON FORFEITED IRA AFTER ALL (*Hubbard v. Commissioner*, 6th Cir., March 19, 2025)

The Sixth Circuit Court of Appeals has reversed the Tax Court's holding that a taxpayer had gross income from the forfeiture of his individual retirement account following a criminal conviction for charges that included allegations related to the account. The Tax Court had decided that the payment of the account to the federal government was deemed a constructive taxable distribution to the taxpayer.

The taxpayer, a Kentucky pharmacist, was indicted for various crimes related to the distribution of controlled substances, what the Sixth Circuit described as a "pill mill." Apparently, some of the ill-gotten gains landed in his simplified employee pension individual retirement account (a "SEP-IRA"), as the account was condemned and forfeited to the federal government upon the taxpayer's conviction following a jury trial. In addition to forfeiting assets, the taxpayer was sentenced to three years in prison. In 2017, while the taxpayer was incarcerated, the account's custodian, T. Rowe Price, issued the taxpayer a Form 1099-R reporting a taxable distribution of \$427,518 from the taxpayer's SEP-IRA, all of which was paid to the federal government.

The taxpayer did not file an income tax return for 2017. In 2020, the IRS determined a deficiency of over \$165,000 in connection with the failure to report and pay tax on the constructive distribution. The taxpayer timely petitioned the Tax Court for review, arguing that he did not owe federal income tax on the amounts forfeited to the United States since he neither actually nor constructively received them. But the Tax Court agreed with the IRS that the taxpayer constructively received gross income when the IRA was forfeited to the government. *Hubbard v. Commissioner*, T.C. Memo. 2024-16.

The Tax Court cited a long line of cases supporting the rule that by forfeiting funds, a taxpayer realizes the benefit of them and must therefore include in gross income the same amount the taxpayer would have to include if the taxpayer actually received the funds and then paid them over to the government. The taxpayer valiantly attempted to distinguish his case from those cited by the court, but the Tax Court was not persuaded. The Tax Court also upheld penalties for failing to file a return and for failing to pay tax in a timely manner, noting that "incarceration is not a reasonable cause for the failure to pay tax."

On appeal, however, the Sixth Circuit determined that it was wrong for the Tax Court to treat the taxpayer as if he had received the funds and used them to pay a fine to the government:

When courts impose a forfeiture, they can either grant the government ownership of a specific asset or enter a money judgment that allows the government to collect on any of the defendant's property. The forfeiture order [here] granted the IRS ownership of [the taxpayer's] IRA; it did not enter a money judgment against him. So when the IRS withdrew the funds from the IRA, it was not taking [the taxpayer's] money to discharge a debt. It was simply transferring its own money. ... Because the IRS owned and controlled the IRA and received the funds, it qualified as the payee or distributee.

Viewing the transaction "as an economic loss—not an economic gain" to the taxpayer, the appellate court concluded he did not have to report the distribution as gross income.

The Sixth Circuit acknowledged that if the federal district court had entered a "personal money judgment" against the taxpayer, then the Tax Court's treatment of the custodian's payment as constructive receipt by the taxpayer may well be correct, though it refused to decide this hypothetical because those facts were not before the court.

The IRS argued that not taxing the taxpayer on the distribution would "frustrate public policy" because it would relieve him of tax obligations he would otherwise have if he had withdrawn the IRA funds for his own use and benefit. The Sixth Circuit rejected the argument, observing that:

once courts get into this policy-making business, they may never get out. For example, if public policy demands that [the taxpayer] pay the taxes on the withdrawn funds, why shouldn't it demand that he pay the 10% early-distribution penalty because the IRS withdrew the funds before he turned 59 and a half?

The Sixth Circuit thus reversed the Tax Court and remanded the case for further proceedings.

XIX. ELEVENTH CIRCUIT CONFIRMS THAT PAYMENTS MADE TO A DECEDENT'S SPOUSE AND STEPCHILDREN WERE GIFTS, NOT DEDUCTIBLE CLAIMS AGAINST THE ESTATE (*Estate of Spizzirri v. Commissioner*, 11th Cir., May 16, 2025)

The Eleventh Circuit Court of Appeals has affirmed the Tax Court's ruling that settlement payments made to the decedent's fourth wife and each of her children pursuant to a prenuptial agreement were not deductible as claims against the estate.

The decedent was a lawyer that made his fortune investing in biotech companies. He lived an extravagant lifestyle, fathering several children with his four spouses and others. His fourth and final marriage lasted 18 years, though the parties were estranged in the final years (maybe because the decedent fathered two more children outside that marriage).

A prenuptial agreement, modified several times before the decedent's death, obligated the decedent to write a will that would leave the wife his New York City penthouse apartment and the right to reside free of charge at the decedent's home in Easthampton for five years after his death. The prenup also required that the decedent's will would bequeath \$1 million to each of the wife's three children.

Alas, the decedent's will contained no provision for the fourth wife or her children. During the probate of the decedent's estate, the wife and her children filed claims as creditors under the prenuptial agreement. The estate paid \$1 million plus interest to each of the stepchildren and also agreed to a settlement of the wife's claims.

On the federal estate tax return, the estate deducted the settlement payments made to the stepchildren and the value of the wife's right to reside in the Easthampton property as claims against the estate under IRC §2053(a)(3). The IRS disallowed the deduction, and now both the Tax Court and the Eleventh Circuit have upheld the disallowance.

The prenup stated that the required bequests to the wife and the stepchildren were "in lieu of any other rights which may be available to [the wife] as [the decedent's] surviving spouse." In effect, then, the promised bequests were testamentary gifts and not bona fide claims supported by an adequate and full consideration in money or money's worth. That is because IRC §2043(b) provides that "a relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration 'in money or money's worth.'" As the Tax Court observed, the prenup "makes plain that the consideration for the claims at issue is [the wife's] waiver of her marital rights, which runs directly contrary to the prohibition staked out in section 2043(b)." So the estate lost the deduction for the amounts paid pursuant to settlement of claims based on the prenup.

The Eleventh Circuit affirmed. It observed that IRC §2053(c)(1)(A) treats as a deductible "claim against the estate" only those claims that are *both* "contracted bona fide and for an adequate and full consideration in money or money's worth." While the Tax Court focused on the second part—holding that the claims of the wife and stepchildren were not based on adequate and full consideration—the Eleventh Circuit instead focused on the first part. It determined that "the payments were not contracted bona fide."

Regulations state that a claim is not bona fide "to the extent it is founded on a transfer that is essentially donative in character (a mere cloak for a gift or bequest)." Reg. §20.2053-1(b)(2)(i). The court observed that transactions between family members merit extra scrutiny, even where those family members are stepchildren and a likely unhappy spouse. Fortunately,

the regulations offer additional guidance for analyzing intrafamily claims, as the Eleventh Circuit explains:

To guide our evaluation of intrafamily transfers, the Treasury Regulations list five factors that suggest a transfer was contracted bona fide. §20.2053-1(b)(2)(ii). First, “[t]he transaction underlying the claim . . . occurs in the ordinary course of business, is negotiated at arm’s length, and is free from donative intent.” *Id.* §20.2053-1(b)(2)(ii)(A). Second, the claim “is not related to an expectation or claim of inheritance.” *Id.* §20.2053-1(b)(2)(ii)(B). Third, the claim “originates pursuant to an agreement between the decedent and the family member.” *Id.* §20.2053-1(b)(2)(ii)(C). Fourth, “[p]erformance by the claimant” stems from “an agreement between the decedent and the family member.” *Id.* §20.2053-1(b)(2)(ii)(D). Fifth, “[a]ll amounts paid in satisfaction or settlement of a claim or expense are reported by each party for Federal income and employment tax purposes . . . in a manner that is consistent with the reported nature of the claim or expense.” *Id.* §20.2053-1(b)(2)(ii)(E).

The Eleventh Circuit then found that each factor weighed against a finding that the claims of the spouse and stepchildren were contracted bona fide. The decedent agreed to make the payments in order to keep his spouse married to him and to “show largesse to her children,” not as a result of an arm’s length transaction in the ordinary course of business. Though they later became estranged, the relevant provisions of the prenup were negotiated when the parties got along, indicating the decedent was acting with donative intent when he agreed to make the payments. Moreover, the decedent’s wife expressly negotiated the payments in lieu of any claims to inheritance from the decedent’s estate. Finally, noted the court:

The payments to the stepchildren also lacked the other characteristics of a bona fide transaction. The claims, for example, did not originate from any transaction between the stepchildren and Spizzirri. ... Nor were the stepchildren obligated to perform under any agreement. ... The estate also failed to introduce any evidence that the stepchildren reported the estate's payments as income.

Having determined the claims were not contracted bona fide, the Eleventh Circuit did not feel compelled to address whether the claims were contracted for consideration in money or money’s worth.

The estate tax return further claimed the decedent had made no adjusted taxable gifts during his life. But the record revealed that the decedent in fact made taxable gifts in excess of \$193,000 in the last years of his life, including transfers to one of his daughters, one of his stepchildren, and to seven other women with whom the decedent enjoyed social or intimate relationships. The estate claimed the payments were not gifts but instead payments for “care and companionship services during the last years” of the decedent’s life. The estate offered testimony from three witnesses: one of the decedent’s lawyers, the executor, and one of the decedent’s daughters. Still, the Tax Court rejected this claim, noting that the decedent did not

issue or file Forms 1099 or W-2 to any of the recipients, and he did not report any of the payments as medical expenses on his federal income tax returns. The Tax Court found it telling that the estate did not call the recipients of the transfers as witnesses, suspecting their testimony might not have supported the estate's position. Ultimately, the testimony offered failed "to clear up the murky relationship between [the decedent] and the recipients of his payments, and thus is insufficient to establish that the payments at issue were not gifts." The estate did not press this issue on appeal, so the Eleventh Circuit's decision was limited to consideration of the IRC §2053(a)(3) deduction.

XX. ESTATE'S CLAIM OF REASONABLE CAUSE FOR FILING LATE ESTATE TAX RETURN SURVIVES SUMMARY JUDGMENT (*Estate of Sandonato v. United States*, D. R. I., May 14, 2025)

A federal district court has denied the IRS's motion for summary judgment in a case where an estate seeks a refund of a penalty imposed for the late filing of a federal estate tax return. The case illustrates that while a taxpayer seeking relief from a penalty for "reasonable cause" faces an uphill climb, courts will let a refund claim survive a motion for summary judgment if the taxpayer can at least prove there is a genuine issue of material fact.

Section 6651(a)(1) imposes a penalty for failing to file a return when required, providing that:

unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate...

In *United States v. Boyle*, 469 U.S. 241 (1985), the Supreme Court addressed the statute's exception where "reasonable cause" for failing to file exists. In relevant part, the Court declared that:

When an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. "Ordinary business care and prudence" do not demand such actions.

By contrast, one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due. In short,

tax returns imply deadlines. Reliance by a lay person on a lawyer is of course common; but that reliance cannot function as a substitute for compliance with an unambiguous statute. Among the first duties of the representative of a decedent's estate is to identify and assemble the assets of the decedent and to ascertain tax obligations. Although it is common practice for an executor to engage a professional to prepare and file an estate tax return, a person experienced in business matters can perform that task personally. It is not unknown for an executor to prepare tax returns, take inventories, and carry out other significant steps in the probate of an estate. It is even not uncommon for an executor to conduct probate proceedings without counsel.

It requires no special training or effort to ascertain a deadline and make sure that it is met. The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not "reasonable cause" for a late filing under §6651(a)(1).

(citation omitted, emphasis in original). The Court's holding confirms that relief from the failure to file penalty based on "reasonable cause" exception is not to be granted lightly.

This case involves the estate of Vincent Sandonato, who died in 2017. His sister, Rita Mayo, was named executor of his estate. In that capacity, she retained Vincent's long-time lawyer, Joseph Palumbo, as counsel for the estate. Palumbo wrote an "estate tax analysis" memo that he delivered to Rita and discussed with her in his office. Palumbo later became ill to the point that he stopped practicing law.

Unfortunately, Rita did not learn of Palumbo's situation until after the deadline for filing Vincent's federal estate tax return. Months after the deadline, Rita hired new counsel. The new counsel urged Rita to file an estate tax return right away, and she took that advice. Because the estate tax return was filed ten months late, the IRS imposed a penalty of nearly \$470,000 for failing to file on time and a penalty of over \$135,000 for failing to pay the tax on time.

The estate asked the IRS to abate the penalties, arguing it had "reasonable cause" for the late filing. After initially refusing to abate the penalties, the IRS eventually waived the failure to pay penalty in its entirety and some of the penalty for failure to timely file. Unhappy that both penalties were not fully abated, the estate initiated the present refund suit.

The court (Judge McConnell) observed that Palumbo's "estate tax analysis" memo did not definitively conclude that Vincent's estate needed to file an estate tax return. It notes that estate tax would be due only if certain real property is included in Vincent's gross estate. After noting that executors have a duty "to try to either reduce values of the assets subject to tax or come up with additional expenses to be deducted so that there would be no estate tax," the memo simply states that "[i]f we are able to keep the taxable estate below \$5.49 million, there would not be any need to even file an estate tax return." The court reads this advice as stating

that more information would be required in order to determine whether the estate had an obligation to file an estate tax return.

The IRS pressed for summary dismissal of the estate's claim, to which Rita countered that, in addition to the memo, Palumbo assured her in a later conversation that the estate did not have to file a return. The IRS argued this self-serving testimony was not valid to support a claim for reasonable cause, but the court held that whether the claimed conversation occurred goes to Rita's credibility, something the court should not address at the summary judgment stage. The court thus denied the IRS's motion for summary judgment. The court concluded:

Based on [Rita's] assertions that: (1) she lacked sophistication on tax matters and was unfamiliar with the Estate's assets' valuation; and (2) Attorney Palumbo was familiar with the Estate's assets and competent to manage the Estate's tax matters, a fact-finder could find that it was reasonable for her to rely on Attorney Palumbo's substantive tax advice indicating it was unnecessary to file a return. With the strong indication that [Rita] falls in the category of taxpayers who "are not competent to discern error in the substantive advice of an ... attorney" a reasonable fact-finder can find that it was reasonable for her not "to challenge [Attorney Palumbo], to seek a 'second opinion,' or to try to monitor [him] on the provisions of the [Tax] Code" when faced with Attorney Palumbo's confusing Estate Tax Analysis and ultimate conclusion that the Estate need not file a tax return.

The case highlights the importance of notifying clients when an advisor becomes too ill to continue practice. If Palumbo himself was unable to notify Rita that he could no longer continue serving as counsel for the estate, someone in his firm—whether a lawyer, paralegal, or staff—should have reached out to Rita sooner, especially where the matter could require action by a deadline date. If the estate's claim for full abatement proves unsuccessful, the estate might consider action against Palumbo's firm, assuming he was not engaged in the practice of law as a sole proprietor.

XXI. ONE CANNOT RELY ON UNREVOKED TECHNICAL ADVICE MEMORANDUM BASED ON PRIOR LAW (*Trail King Industries, Inc. v. United States*, D.S.D., July 24, 2025)

The United States District Court for the District of South Dakota has held that a taxpayer was not entitled to rely on a technical advice memorandum to avoid over \$4 million in federal excise taxes because the memorandum applied outdated law. The court thus granted summary judgment to the United States, effectively killing the taxpayer's refund claim.

Section 4051(a) imposes a 12-percent excise tax on the first retail sale of certain truck trailers and semitrailers. Under Reg. §48.4061(a)-1(d), trailers and semitrailers designed for "off-highway transportation" are excepted from the excise tax, and Reg. §48.4061-1(d)(2) defined an off-highway vehicle for purposes of this exception.

In 2004, as part of the American Jobs Creation Act, Congress enacted a statutory definition of an off-highway vehicle that was different and narrower in scope than the regulatory definition. The Act made the definition applicable for purposes of the IRC §4051(a) excise tax starting on October 22, 2004.

The taxpayer sold off-highway vehicles and paid over \$4 million in excise taxes over two-year period from 2017 through 2019. It then brought this refund claim, insisting that it was entitled to rely on the broader exception under the regulation thanks to a 2004 technical advice memorandum (TAM) issued during an audit of the taxpayer's returns from 2001 and 2002. That TAM, issued ten days after passage of the American Jobs Creation Act, found the taxpayer's trailers were exempt from the excise tax.

Apparently, the taxpayer believed that a TAM relating to sales in 2001 and 2002 somehow exempted it from excise tax on sales in 2017 through 2019—even though Congress had changed the statute—simply because the TAM was issued ten days after Congress changed the statute. Well, that belief was rejected by the court (Chief Judge Lange):

Trail King correctly observes that the 2004 TAM "was never modified, withdrawn, or revoked *by the IRS*." Doc. 21 at 18 (emphasis added) (cleaned up and citation omitted). But the question is whether the enactment of the AJCA on October 22, 2004, modified the 2004 TAM's conclusion such that the TAM would not apply for quarters after the AJCA's passage. The AJCA enacted a definition of "off-highway vehicles" different from the definition found in Treas. Reg. §48.4061(a)-1(d)(2)(ii) and applied in the 2004 TAM. As noted by the United States Tax Court in *Mvles Lorentz, Inc. v. Commissioner*, there are several differences between the two definitions with the AJCA's definition being more restrictive. *Mvles Lorentz, Inc.*, 138 T.C. at 49. Because the enactment of the AJCA modified the 2004 TAM's conclusion for quarters to which the AJCA applies, the 2004 TAM cannot supersede the AJCA's definition change or render the AJCA definition change inapplicable to Trail King.

The court went on to reject other claims made by the taxpayer, including waiver and estoppel.

Taxpayers can only rely on technical advice memoranda and private letter rulings only where they are the taxpayer involved in the matter and only as to the transactions specifically at issue in the rulings. Even if the law had not changed, the taxpayer here could not assume that a 2004 ruling based on events from 2001 and 2002 would be binding on the IRS as to events that occurred in 2017, 2018, and 2019. The fact that the law had changed only made this an even easier decision for the court.

XXII. AUTO-GENERATED ONLINE TAX COURT PETITIONS ARE DEEMED TO BE SIGNED BY THE TAXPAYER (*Donlan v. Commissioner*, 164 T.C. No. 3, February 19, 2025)

The Tax Court has held that a married couple timely petitioned the court for redetermination of an alleged federal income tax deficiency through the use of an electronic filing available to pro se taxpayers (that is, taxpayers who represent themselves before the Tax Court). The IRS moved to dismiss the matter for lack of jurisdiction because the petition did not contain the handwritten signatures of the taxpayers or facsimiles of handwritten signatures. Instead, the forms uploaded by the taxpayers contained their typed names and contact information on the form's signature blocks.

In a unanimous opinion, the Tax Court held that an electronic filing without a handwritten signature is proper. It thus denied the IRS's motion to dismiss. The court confirmed that it released an online petition generator for pro se taxpayers on July 31, 2024. That generator allows a taxpayer to answer a series of questions, which the tax Court's e-filing system then uses to generate a completed petition that the taxpayer can file by uploading. While the computer-generated petition contains a signature block, the court sagely observed that "a taxpayer cannot place a handwritten signature on a petition created with the online petition generator."

So how is a taxpayer supposed to comply with the signature requirement when using the online petition generator? This looks like a job for Tax Court Rule 23(a)(3), which states: "A person's name on a signature block on a paper that the person authorized to be filed electronically, and that is so filed, constitutes the person's signature." So there you go. When a pro se taxpayer uses the electronic petition option, then, the auto-generated signature block on the petition serves as the taxpayer's signature. The taxpayers here used the court's online petition generator, so their petition is deemed to have been signed by both of them.

Ever get the feeling you're reading a case from 2005 only to discover that it's in fact a case from 2025? It's remarkable (or maybe more accurately, "appalling") that the IRS would move to dismiss a case because an auto-generated e-filed petition did not contain a handwritten signature. Wait until the IRS learns that Tax Court filing fees can be paid by credit card!

XXIII. PROPOSED QDOT REGULATIONS UPDATE OBSOLETE REFERENCES (Prop. Reg. §§20.2056A-2, 20.2056A-4, 20.2056A-11, August 21, 2024)

Treasury has proposed amendments to Treas. Reg. §§20.2056A-2, 20.2056A-4, and 20.2056A-11 in order to remove outdated references and update certain procedures applicable to so-called "qualified domestic trusts" (QDOTs). If finalized, the proposed changes would apply to estates of decedents dying after the date on which the final regulations are published in the Federal Register.

A. Background on QDOTs

In general, the federal estate tax marital deduction is not available for property passing to a noncitizen spouse of a decedent. IRC §2056(d)(1). Property passing to a QDOT, however, does qualify for the marital deduction. IRC §2056(d)(2)(A). The requirements for a valid QDOT are contained in IRC §2056A. If a trust qualifies as a QDOT, property passing to the trust will qualify for the marital deduction, but a deferred estate tax will apply upon a distribution of principal from the QDOT during the surviving spouse's lifetime, with remaining principal subject to a deferred estate tax at the noncitizen spouse's death. The statute authorizes regulations to carry out the purposes of the QDOT rules. IRC §2056A(e).

B. Items to be Updated

Regulations first proposed in 1993 were largely finalized in 1995. The final regulations included a new temporary regulation, Treas. Reg. §20.2056A-2T(d). That temporary regulation was finalized in 1996, but references to the temporary regulation in other provisions of the QDOT regulations were not updated to reflect the fact that the temporary regulation had become permanent. So the new proposed regulations remove all of the outdated references to the temporary regulation and replace them with references to the current, final regulation.

The 1995 regulations also set forth certain procedures for electing QDOT status, which included mailing information to specific IRS offices and addresses. But thanks to internal reorganization over the years, those offices no longer exist. Accordingly, the proposed regulations correct the outdated procedures by providing correct offices and addresses.

In one place, the 1995 regulations refer to the fair market value of assets as "finally determined" for federal estate tax purposes, and the regulations define that concept with reference to the issuance of an estate tax closing letter. Treas. Reg. §20.2056A-2(d)(1)(iii). Since 2015, however, the IRS has not routinely issued estate tax closing letters. The proposed regulations thus provide that the fair market value of assets as finally determined for federal estate tax purposes is:

- (1) the value reported on an estate tax return once the statute of limitations on assessment of estate tax has expired without objection by the IRS;
 - (2) the value determined by the IRS once the statute of limitations on assessment of estate tax has expired without objection by the executor;
 - (3) the value determined in a written agreement between the estate and the IRS;
- or

(4) the value determined by a court for the purpose of determining estate tax liability, once the determination can no longer be appealed.

Prop. Reg. §20.2056-2(d)(1)(iii).

C. Observation

In issuing the proposed regulations, Treasury explained that there may well be other outdated references in the QDOT regulations, “but these matters do not cause the current regulations to substantively inaccurate.” Thus, these proposed regulations do not address those items. So where an example here or there uses an outdated exclusion amount but still accurately illustrates the application of a particular rule, the example is left unchanged. Apparently, Treasury can only update so much at any one time.

XXIV. RETURN OF THE TAX PROTESTORS?

Like measles, tax protestors have returned from what was thought to be extinction. A quick recap of several recent tax protestor cases illustrates the wisdom of these words from the Seventh Circuit Court of Appeals:

Like moths to a flame, some people find themselves irresistibly drawn to the tax protester movement’s illusory claim that there is no legal requirement to pay federal income tax. And, like moths, these people sometimes get burned.

United States v. Sloan, 939 F.2d 499, 499 – 500 (7th Cir. 1991).

A. *Christiansen v. Commissioner*, T.C. Memo. 2025-21 (March 10, 2025)

Here the Tax Court rejected claims that married couples were not required to pay federal income tax and that “voluntary self-assessment” means that federal income taxes are optional “gifts” to the federal government. The taxpayers, a married couple, had gross income from wages and unemployment compensation for each of the years at issue (2015, 2016, 2017, and 2018) but did not file federal income tax returns for those years until January of 2022. On those returns, they reported no gross income and no tax liability. On the lines for wages and other compensation, the couple wrote “26 C.F.R. §1.61-2” and “Control No. 1545-0771,” apparently under the theory that the regulation was not approved by the federal Office of Management and Budget (OMB) control No. 1545-0074, and therefore they were not required to report their gross income on their tax returns. The IRS issued a notice of deficiency for each of the years at issue based on the Forms W-2 and 1099-G it received and also determined that the couple was liable for penalties.

Before the Tax Court, the couple argued they owed no tax based on a four-pronged attack. They argued that (1) the federal income tax based on “voluntary self-assessment;” (2) there is no federal statute that requires them to pay tax; (3) the IRS failed to obtain OMB approval requiring them to report wage information and unemployment compensation as gross income; and (4) OMB approval is required before the IRS can use information reported on Forms W-2 to determine their tax liability. Citing a long line of cases, the Tax Court rejected these arguments as “frivolous.” The court also upheld penalties for late filing, even adding:

The Court has discretionary authority to impose a penalty payable to the United States of not more than \$25,000 on taxpayers whenever it appears that their position in a proceeding is “frivolous or groundless.” See §6673(a)(1)(B). We caution petitioners that a penalty may be imposed in any future case before this Court should they continue to pursue their misguided positions.

B. *French v. Commissioner*, T.C. Memo. 2025-57 (June 4, 2025)

In this case, the taxpayers, a married couple, admitted that the wife received over \$94,000 in compensation from her work at Fidelity Workplace Investing, LLC, in 2020. But they insist that they do not owe federal income tax on these wages because that would be a tax on labor, a direct tax that violates the Apportionment Clause of the United States Constitution. Quoting the Supreme Court’s recent decision in *Moore v. United States*, 144 S. Ct. 1680 (2024), the Tax Court (Judge Greaves) concluded that taxes on income need not be apportioned among the states according to relative population. They then argued that the compensation was not subject to tax because the IRS did not have “personal knowledge” of the wife’s day-to-day activities at work. The Tax Court held that the IRS need know what the wife did while on the job; that she received compensation for services is enough to subject those wages to federal income tax.

The court granted summary judgment to the IRS and imposed a \$1,000 penalty under IRC §6673(a) for advancing frivolous arguments, concluding with this admonition: “We warn petitioners that they risk a much more severe penalty if they advance frivolous positions in any future appearance before this Court.” Section 6673(a) allows the Tax Court to impose a penalty of up to \$25,000 where it appears that a taxpayer instituted or maintained a proceeding primarily for delay or where a taxpayer’s position in such proceeding is frivolous or groundless, or that a taxpayer unreasonably failed to pursue administrative remedies. As the IRS explains:

Courts provide a forum for litigation of taxpayers' bona fide disputes with the IRS. The courts’ ability to perform that function is impeded when a taxpayer files a petition for some other reason, such as to defy the law or to delay the inevitable. Consequently, Congress gave courts discretion to impose penalties on taxpayers who engage in such conduct, to deter frivolous litigation and to induce taxpayers to conform their conduct to settled principles of law before pursuing litigation.

IRS, *The Truth About Frivolous Tax Arguments — Section III* (March 2022), available at: <https://www.irs.gov/privacy-disclosure/the-truth-about-frivolous-tax-arguments-section-iii> (last checked June 17, 2025).

C. *Huber v. Commissioner*, T.C. Memo. 2025-59 (June 5, 2025)

Here, the Tax Court again granted summary judgment to the IRS, this time finding that the wages received in 2018 by the taxpayer-wife should have been reported on the couple's federal income tax return. They claimed the wife's earnings were not "legitimate activities of taxation," citing at least ten Code provisions but without any analysis as to how those provisions supported their conclusion. The court (Judge Jenkins) had little appetite for indulging this claim:

Courts generally do not address frivolous arguments with "somber reasoning and copious citation of precedent; to do so might suggest that these arguments have some colorable merit." *Crain v. Commissioner*, 737 F.2d 1417, 1417 (5th Cir. 1984). ... Because Petitioners offer only "tax protester" type arguments, which the Court has repeatedly rejected, this Court chooses not to address such arguments in detail here. See *Wnuck v. Commissioner*, 136 T.C. 498 (2011).

The court thus sustained the IRS's asserted deficiency of \$786. Though the total deficiency is not much, the court was careful to put the taxpayers on notice that they should avoid taking a similar reporting position going forward:

This Court also takes this occasion to caution Petitioners about the potential applicability of sanctions under section 6673(a)(1), which authorizes the Court to impose a sanction of up to \$25,000 when it appears to the Court that a taxpayer's position is frivolous or groundless. If frivolous arguments in this or any subsequent proceeding are further pursued, Petitioners may be sanctioned up to \$25,000.

D. *Fonda v. Commissioner*, T.C. Memo. 2025-60 (June 5, 2025)

In this case, the taxpayer received over \$125,000 in wages plus more than \$101,000 in retirement distributions in 2019. But given the taxpayer, "a longtime tax protester," has not filed a federal income tax return since 2012, it is no surprise that these amounts were not reported on a 2019 federal income tax return. After the IRS determined a deficiency based on a substitute return it prepared on the taxpayer's behalf, the taxpayer fled to Tax Court, arguing that the amounts he received were not subject to federal income tax.

The taxpayer tried every tired tax protester trope: that he is a nonresident alien not subject to federal income tax even though he was born in New York and lives in Texas; that because his name appears in ALL CAPS on his United States passport, the federal government can only tax that "legal personality" and not him because his birth certificate does not spell his name in ALL CAPS; that only residents of the District of Columbia and United States Territories

are liable for federal income tax; and that after he filed his last federal income tax return in 2012, he filed paperwork revoking both his “consent” to taxation and his “taxpayer status.” The Tax Court (Judge Lauber) dismissed all of these positions as “time-worn tax protester argument[s]” that have been, without exception, rejected by all courts.

Judge Lauber also imposed a penalty under IRC §6673(a)(1):

Lacking any legal support for his position, petitioner has cut and pasted gibberish from tax-protester websites. Although he is not a lawyer, had he made even a modest inquiry using an internet search engine he would have found the copious authorities refuting his stance. See *Wnuck*, 136 T.C. at 504 (“Anyone with the inclination to do legal research ... will confront such authorities.”).

Petitioner began advancing frivolous arguments at the commencement of this case, and he has not stopped since, despite our warnings that he should desist. We warned petitioner during the trial that he was advancing frivolous arguments that the courts had repeatedly rejected. He nevertheless adhered to his position. His persistent filing of frivolous papers has wasted the Government's time and ours. We will accordingly require that he pay to the United States a penalty of \$7,500.

These cases demonstrate that a court may impose a penalty under IRC §6673(a) on its own, even where the IRS does not request it. Hopefully, some would-be tax protesters out there hear about these cases and just pay the federal income taxes they owe.

XXV. TAX COURT DECISIONS FOCUS ON THE MEANING OF DEBT

Although Polonius counseled against borrowing and lending, it is a truth universally acknowledged that many transactions involve debt. From a federal income tax perspective, debt gives rise to a number of issues for both borrowers and lenders. Borrowers, for example, want to know when and to what extent the interest paid on a debt is deductible. Lenders, on the other hand, want to know whether and when they can deduct debts that have become worthless, or “bad.” No matter the rule, though, a threshold determination in every case is whether the debt at issue is, in fact, debt and not something disguised to look like debt. In two recent cases, both decided by Judge Morrison, the Tax Court grappled with whether a particular transaction gave rise to genuine debt.

A. *Stevens v. Commissioner*, T.C. Memo. 2025-45 (May 15, 2025)

In this case, the court had to determine whether two notes issued pursuant to option agreements were true indebtedness that supported very large interest deductions taken by the taxpayers. The transactions in the case were complex and nuanced. The details are well beyond the scope of this summary, but a short explanation of the basics should set the stage.

The taxpayers, a married couple, owned an S corporation that sold its transportation-brokerage business assets at a substantial gain. Looking to offset this gain with some quick tax deductions, the taxpayers met with a financial consultant who recommended that a third-party issuer “loan” a large sum to them. The taxpayers would then use the loan proceeds to buy an option from the issuer, the exercise of which would entitle them to a payment from the issuer equal to the loan balance. The idea was to generate substantial interest deductions that could be used to offset the gain passing through from the S corporation.

The taxpayers bought into the scheme, signing a promissory note in 2014 in the principal amount of \$99 million, due in 2016, with interest at 4.5 percent per quarter, compounded quarterly. The 2014 note stated it was issued as “partial payment” for a call option described in a separate agreement. Importantly, the security for the note was limited to the call option only and no other assets.

The taxpayers received conflicting advice about the legitimacy of the transaction. One opinion letter concluded that the 2014 note would be treated as bona fide indebtedness for federal income tax purposes, allowing them to deduct the accrued interest. But then their lawyer informed them that the author of that letter later advised against claiming any interest deductions. Still, they went ahead and claimed a deduction of over \$6.1 million on their 2014 federal income tax return and over \$20.2 million on their 2015 return.

When the 2014 note matured in 2016, it had a balance of over \$125 million. The taxpayers then signed a replacement note in the principal amount of \$126.6 million, due in 2046. Interest under this note would accrue at 1.5 percent per quarter. Like the 2014 note, the 2016 note was secured only by the call option and no other assets. This led the taxpayers to claim an interest deduction of over \$7.8 million on their 2016 federal income tax return.

The Tax Court concluded that the notes did not constitute indebtedness within the meaning of IRC §163. No matter whether the option was exercised or lapsed, “the 2016 note will inevitably disappear having no effect.” The court cited *Knetsch v. United States*, 364 U.S. 361 (1960), and *BB&T Corp. v. United States*, 523 F.3d 461 (4th Cir. 2008), in support of this conclusion. These cases held that where a transaction devoid of economic substance is entered into solely for tax benefits, the tax benefits should be disallowed.

The court also sustained a negligence penalty, rejecting arguments for reasonable cause and finding the penalty was properly approved by a supervisor. The taxpayers knew the author of the opinion letter later advised against claiming the deductions, said the court, but the taxpayers claimed them anyway. Moreover, the millions of dollars of interest deductions claimed at such a small economic cost (about \$900,000 for the option agreement plus some fees) were a clear sign the tax benefits were “too good to be true,” thus strongly indicating negligence.

B. *Anaheim Arena Management, LLC v. Commissioner*, T.C. Memo. 2025-68 (June 30, 2025)

In this case, the Tax Court grappled with whether advances made by the taxpayer could support a bad-debt deduction under IRC §166 of over \$51.4 million in 2015. In 2003, the taxpayer entered into a management agreement with the City of Anaheim, California, pursuant to which it would manage the Honda Center, a sports and entertainment arena, on behalf of the City. The agreement allowed the taxpayer to advance operating expenses, which the City would repay from the net revenue resulting from arena operations, together with interest. Several advances were made, all documented by promissory notes.

In 2016, the taxpayer concluded that the \$51.4 million in advances it made to the City would not be repaid. It then claimed a bad debt deduction on its 2015 federal income tax return for that amount. The IRS disallowed the deduction, leading to this proceeding.

The Tax Court held that the taxpayer could not claim the bad debt deduction because the advances made to the City were not bona fide indebtedness. Because an appeal in the case would be heard in the Ninth Circuit Court of Appeals, the Tax Court considered eleven factors applied by that court in *A.R. Lantz Co. v. United States*, 424 F.2d 1330 (9th Cir. 1970). These factors include the intent of the parties, the presence of formal documentation supporting the loan agreement, whether the borrower has sufficient capital to support the debt load, whether interest was charged and paid, the existence of a fixed repayment schedule, whether advances were subordinated to other debts, the borrower's ability to repay the advances from operating funds, and whether the borrower could have obtained external financing from another source.

Although the taxpayer had been careful to document every advance as a loan with a promissory note, all of the other factors indicate that the advances were not debt. The court thus sustained the disallowance of the bad-debt deduction. There was one silver lining for the taxpayer: the court did not uphold accuracy-related penalties because the taxpayer relied on advice from its accountant.

C. Lesson Learned

These cases should be read as a caution to taxpayers. Simply documenting an advance as a loan does not by itself make the advance a debt for federal income tax purposes. Taxpayers should make sure they can provide evidence that support the other characteristics of debt to ensure eligibility for both interest deductions and bad-debt deductions.

XXVI. CLAIMS COURT ALLOWS TREATY-BASED FOREIGN TAX CREDITS AGAINST NET INVESTMENT INCOME SURCHARGE (*Buryea v. United States*, Court of Federal Claims, December 5, 2024)

The Court of Federal Claims has held that a United States citizen could use the foreign tax credit under the United States-Canada income tax treaty (the “Canada Treaty”) to offset

liability for net investment income tax (“NIIT”) under IRC §1411. The case offers new hope to taxpayers, as at least one prior attempt to use treaty-based credits against NIIT liability proved unsuccessful.

A. Background on the Canada Treaty and the NIIT

Article XXIV of the Canada Treaty, entitled “Elimination of Double Taxation,” states in Paragraph 4 that:

Where a United States citizen is a resident of Canada, the following rules shall apply:

(a) Canada shall allow a deduction from the Canadian tax in respect of income tax paid or accrued to the United States in respect of profits, income or gains which arise (within the meaning of paragraph 3) in the United States, except that such deduction need not exceed the amount of the tax that would be paid to the United States if the resident were not a United States citizen; and

(b) For the purposes of computing the United States tax, the United States shall allow as a credit against United States tax the income tax paid or accrued to Canada after the deduction referred to in subparagraph (a). The credit so allowed shall not; reduce that portion of the United States tax that is deductible from Canadian tax in accordance with subparagraph (a).

The Canada Treaty defines “United States tax” in Article II as taxes “imposed on income by the United States” and “irrespective of the manner in which they are levied.” Anticipating future changes to the Code, Article II also provides that the Canada Treaty applies to “any taxes identical or substantively similar” to the taxes described elsewhere in the Article.

Section 1411 is the lone provision of Chapter 2A of the Code (“Unearned Income Medicare Contribution”). It imposes a 3.8-percent surcharge on a taxpayer’s “net investment income” for the taxable year (or, if less, the amount by which the taxpayer’s “modified adjusted gross income” for the year exceeds the “threshold amount”). The “threshold amount” is \$250,000 for married couples filing a joint return, \$125,000 for a married individual filing separately, and \$200,000 for everyone else. IRC §1411(b). For trusts and estates, the threshold amount effectively is the dollar amount at which the highest ordinary income tax bracket in IRC §1(e) begins. IRC §1411(a)(2). Generally, a taxpayer’s net investment income” is the sum of gross income from interest, dividends, annuities, royalties, rents, and passive activities minus the deductions allocable to such income. IRC §1411(c)(1).

B. Facts of the Case

The taxpayer, a United States citizen residing in British Columbia, recognized a substantial capital gain in 2015. He paid almost \$2 million in tax to Canada on that gain and claimed a United States foreign tax credit of nearly \$1.4 million to offset his United States tax liability. The gain also gave rise to NIIT liability, but, for reasons undisclosed, the taxpayer did not claim a foreign tax credit with respect to this additional liability. Late in 2016, he filed an amended federal income tax return, this time claiming a refund of more than \$263,000 thanks to applying a foreign tax credit to offset the NIIT liability. The IRS rejected the refund claim, finding that the Code does not allow a foreign tax credit against the NIIT and that the Canada Treaty did not provide an independent basis for such a credit. This ultimately led to the present lawsuit in which the taxpayer sought the refund he claimed.

C. Taxpayer Victory

The Claims Court granted the taxpayer's motion for partial summary judgment on the issue of entitlement to a foreign tax credit against the NIIT under the Canada Treaty. Although the foregoing provisions of the Canada Treaty would suggest that the taxpayer is entitled to a foreign tax credit to reduce NIIT liability, the IRS argued that under the "U.S. Law Limitation Clause" of the Canada Treaty, Article XXIV Paragraph 1(2), any treaty-based credit must be "in accordance with the provisions ... of the law of the United States." This Clause, the IRS argued, means that a treaty-based credit cannot exist independently of the Code. The IRS then argued that IRC §27 provides a foreign tax credit "against the tax imposed by this chapter" (i.e., Chapter 1, the federal income tax) to the extent provided in IRC §901. The NIIT, recall, sits in Chapter 2A. Thus, claimed the IRS, because the Code does not authorize a foreign tax credit for the NIIT, the Canada Treaty cannot authorize one.

The Claims Court rejected the IRS's attempt to elevate the U.S. Law Limitation Clause over the treaty-based credit:

More significantly, the government's interpretation has a glaring consistency problem: ***the government takes an ad-hoc approach to the U.S. Law Limitation.*** The government interprets the U.S. Law Limitation differently when applied to different paragraphs within Article XXIV. In fact, as the Court details below, the government concedes that there are Treaty provisions that the government must follow even though they are inconsistent with the I.R.C. That is a powerful concession in Mr. Bruyey's favor because if there are such Treaty provisions, how does the U.S. Law Limitation work? How can the government ask this Court to read the U.S. Law Limitation to apply to some paragraphs of Article XXIV but not others? On the other hand, Mr. Bruyey must contend with the meaning of the U.S. Law Limitation. (Emphasis in original.)

In fact, the court continued, the Canada Treaty:

will give way to the [Code] in only two circumstances. The first is where a later-enacted statutory provision “directly” conflicts with the Treaty. That “last-in-time rule” is a background, bedrock legal principle of treaty interpretation. The second circumstance is where the Treaty, by its terms, defers to the [Code].

Considering the last-in-time rule, the court determined that nothing in the language of the NIIT contradicted the existence of a treaty-based foreign tax credit. It rejected the IRS’s position that the placement of the NIIT in Chapter 2A rather than Chapter 1 mattered because the Canada Treaty “guarantees that any future amendment to United States law will not change the general principle” of the Treaty. The Claims Court reasoned that the Canada Treaty (like any treaty) will give way to the Code only where a later-enacted statutory provision “directly” conflicts with the Treaty or where the Treaty, by its terms, defers to the Code.

The court then held that the U.S. Law Limitation Clause does not preclude the taxpayer from claiming the treaty-based credit to offset the NIIT, finding the NIIT was “substantively similar” to the taxes to which the Canada Treaty clearly applies. Indeed, the Technical Explanation to the Canada Treaty states that Paragraph 1 of Article XXIV “provides a credit for these specified taxes whether or not they qualify as creditable under Code section 901 or 903.” Notice the Technical Explanation says it is the *Treaty* that “provides a credit” even though the Code does not. The Claims Court found this excerpt from the Technical Explanation to be powerful evidence in support of the taxpayer’s claim.

D. Observation

The decision in *Brueya* stands in contrast to the Tax Court’s holding in *Toulouse v. Commissioner*, 157 T.C. 49 (2021). In *Toulouse*, the Tax Court rejected the taxpayer’s claim that the United States-France Income Tax Treaty allows a foreign tax credit against the NIIT. Unlike the Claims Court, the Tax Court found it important that the NIIT was in Chapter 2A of the Code and not in Chapter 1. As the court observed, “The enactment of a 3.8% net investment income tax as part of chapter 2A is a clear expression of congressional intent that credits against section 1 not apply against the section 1411 tax.”

XXVII. SHERIFF WHO WITHDREW GOVERNMENT FUNDS IN PONZI SCHEME DID NOT HAVE EMBEZZLEMENT INCOME (*Franklin v. Commissioner*, T.C. Memo. 2025-8, January 22, 2025)

The Tax Court has held that a former county sheriff did not embezzle funds from a bank account dedicated to feeding inmates held in the county jail when she withdrew funds from the account and loaned them to a car dealership business with the promise of making big profits over just 30 days. Although the court determined the former sheriff did not commit

embezzlement, it upheld a penalty against the sheriff for failing to file a federal income tax return and also denied a deduction for legal and accounting fees incurred in connection with the alleged embezzlement activity.

Ana Franklin was elected Sheriff of Morgan County, Alabama, in 2010. She served two terms, stepping down from the post in 2019. Franklin's job description included, among other things, "an obligation to see that the inmates in the county jail were properly fed." The State paid \$1.75 per inmate per day along with other occasional allowances for this purpose. For federal inmates, the United States supplied a feeding allowance of \$5 per day. If these funds fell short, the sheriff was on the hook to cover the difference. But on the other hand, Alabama statutes provide that a sheriff may retain any surplus funds remaining after feeding prisoners and use the surplus funds for any police-related purpose.

When Franklin started the job, she set up accounts with various food vendors and established a line of credit, all in her own name and using her Social Security number. She also obtained signatory authority over the checking account into which government funds for jail food were deposited. Throughout her first term, Franklin and her staff managed to feed inmates with funds provided by the government. By the start of 2015 (the end of Franklin's first term), the balance in the account was over \$224,000. But shortly after her second term as sheriff commenced, the amount spent on jail food exceeded the allowances received from the government. Franklin thus had a problem: funds were draining, and she didn't want to pony up her own cash for feeding prisoners.

Enter Franklin's boyfriend (who was also a Morgan County police officer at the time, but let's not focus on the conflict of interest just now). At his recommendation, Franklin withdrew \$150,000 from the jail food account and loaned it to "a local used car dealership and title-pawn lending service" with the expectation that the funds would be repaid in 30 days with 17 percent interest. After all, the boyfriend had invested in the business, and he saw this as a great chance for recouping some of the losses on the jail food account. He even agreed to serve as guarantor for the loan.

Go figure, after 30 days the borrower had paid neither the principal nor any interest. The borrower's owner ghosted Franklin. She eventually learned that the whole arrangement was a Ponzi scheme (the opposite of a Fonzie scheme, which is cool). After the borrower filed for bankruptcy, the boyfriend did the upright thing and paid \$150,000 to Franklin, which she deposited into the jail food account in late 2016.

The IRS claimed that Franklin had \$150,000 of gross income from embezzling the funds from the jail food account, but the Tax Court held that because the loan was bona fide, Franklin had not made personal use of the money. As the court observed:

Although petitioner's withdrawal of the funds failed to adhere to certain formalities as a written instrument, the lack of such formalities is not by itself conclusive. Petitioner credibly testified, and her testimony was corroborated by that of [the boyfriend] and others, that she was concerned about the long-term viability of the jail food money account. On the promise of a 17% return within 30 days, petitioner withdrew the funds from the jail food money account by cashier's check and immediately signed the cashier's check over to [the borrower]. Other members of the Morgan County Sheriff's staff had access to the jail food money account, yet there is no indication that petitioner undertook any effort to hide the withdrawal of the funds from them or otherwise conceal her actions. Petitioner may have exhibited poor business judgment, both in withdrawing the funds and in lending them to [the borrower], but petitioner's poor judgment is not a factor in determining her intent.

(Citations omitted.) In essence, said the court, this was an “an unauthorized loan and not embezzlement income.”

It doesn't quite end there. On her 2018 federal income tax return, Franklin deducted nearly \$45,000 in legal and accounting services in connection with criminal tax charges stemming from the late filing of her 2015 federal income tax return. Those are miscellaneous itemized deductions, of course, and as of 2018 such deductions were suspended under what was then the new §67(g). So Franklin pivoted, claiming that managing the jail food account had become a trade or business activity, which would support the deduction of the legal and accounting fees as business expenses rather than personal expenses.

The Tax Court didn't buy it. Managing the account was part of her employment duties as sheriff, said the court; it was not a separate trade or business activity. Thus, the expenses were unreimbursed employee business expenses, a type of miscellaneous itemized deduction suspended under §67(g). On top of losing the deduction on the 2018 return, the court upheld a failure to file penalty under §6651(a)(1) with respect to her 2015 return.

XXVIII. EMPLOYMENT-RELATED TRAVEL EXPENSES LIKELY NOT DEDUCTIBLE (*Hussaini v. Commissioner*, T.C. Memo. 2025-82, August 4, 2025)

The Tax Court has held that an employee could not deduct unreimbursed employment-related travel expenses because the deduction was a miscellaneous itemized deduction not allowable during the taxable year at issue. The case is a reminder that the unreimbursed job expenses of an employee, like other miscellaneous itemized deductions, are no longer deductible to any extent under current law.

In 2020, the year at issue, the taxpayer worked for two companies as a computer engineer. His work required that he travel from his home in Iowa to client facilities in New Jersey

and Maryland because the clients were military contractors and the work had to be performed at locations with strict security protections in place. The taxpayer paid his own travel expenses, which his employers did not reimburse. Apparently, the hourly wages paid to the taxpayer accounted for the expected travel.

On his 2020 federal income tax return, the taxpayer deducted over \$46,000 in work-related travel in computing adjusted gross income (i.e., he claimed the travel expenses as an “above the line” deduction). The problem is that, while employees may deduct ordinary and necessary expenses paid or incurred in connection with their employment, unreimbursed expenses of an employee are usually a “miscellaneous itemized deduction” and not an above the line deduction. Prior to 2018, miscellaneous itemized deductions were deductible to the extent that, in the aggregate, they exceed two percent of the taxpayer’s adjusted gross income. IRC §67(a). But thanks to the 2017 Tax Cuts and Jobs Act, the deduction for miscellaneous itemized deductions was suspended for several years, including the year at issue. IRC §67(g).

The taxpayer argued that he should be treated as a reservist. That’s because unreimbursed expenses in connection with the performance of services as a reservist is treated as an above the line deduction under IRC §62(a)(2)(E). But the Tax Court (Judge Jenkins) rejected the claim, simply noting that “an employee of a company consulting on a military contract is not, by reason thereof, a Reservist, and petitioner has never been a Reservist.” The court thus sustained the deficiency determined by the IRS, though (without explanation) it refused to apply a penalty the IRS had imposed.

The 2025 One Big Beautiful Bill Act made the suspension in IRC §67(g) permanent. For the time being, then, most employees will not be able to deduct unreimbursed expenses in connection with employment.

XXIX. FINAL REGULATIONS ACCOUNT FOR OVERLAPPING ECONOMIC RISK OF LOSS IN ALLOCATION OF PARTNERSHIP RECOURSE LIABILITIES (T.D. 10014, December 2, 2024)

Treasury and the IRS have issued final regulations relating to the allocation of recourse liabilities of a partnership along with special rules for related persons. The regulations generally apply to partnership recourse liabilities incurred or assumed on or after December 2, 2024.

Section 752(a) treats an increase in a partner’s share of partnership liabilities as a deemed cash contribution to the partnership, increasing the partner’s “outside basis” (that is, the partner’s basis in the partnership interest). Likewise, IRC §752(b) treats a decrease in a partner’s share of partnership liabilities as a deemed cash distribution to the partner, which will be taxable to the extent the amount of the deemed cash distribution exceeds the recipient’s outside basis. Regulations under IRC §752 set forth the rules for determining a partner’s share of partnership liabilities for purposes of these rules. These regulations distinguish between recourse liabilities (where one or more partners, or a person related to one or more partners,

bears the “economic risk of loss”) and nonrecourse liabilities (where no partner or related person bears the economic risk of loss).

Under existing rules, a partner generally bears the economic risk of loss for a partnership liability:

to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.

Reg. §1.752-2(b)(1). Back in December, 2013, the IRS and Treasury issued proposed regulations to amend the existing rules for the allocation of recourse liabilities. Only now are the regulations being finalized, though luckily, according to the preamble, “no intervening legislative changes regarding allocations of partnership of liabilities have been made, no subsequent changes to regulatory rules concerning allocations of partnership liabilities address the issues in the proposed regulations, and the issues raised by the [two] commenters continue to remain relevant.”

A. Proportionality Rule for Overlapping Economic Risk of Loss Retained

The proposed regulations provided a “proportionality rule” to determine how partners share a partnership liability when multiple partners bear the economic risk of loss for the same liability (what the regulations call “overlapping economic risk of loss”). Under this proportionality rule, the economic risk of loss borne by a partner is the amount of the partnership liability (or portion thereof) multiplied by a fraction obtained by dividing the amount of economic risk of loss borne by the partner by the sum of the economic risk of loss borne by all partners with respect to that liability. The rule is retained in the final regulations. Reg. §1.752-2(a)(2). The final regulations illustrate the proportionality rule with an example:

(i) A and B are unrelated equal members of limited liability company, AB. AB is treated as a partnership for Federal tax purposes. AB borrows \$1,000 from Bank. A guarantees payment for the entire amount of AB’s \$1,000 liability and B guarantees payment of up to \$500 of the liability, if any amount of the full \$1,000 liability is not recovered by Bank. Under paragraph (b)(1) of this section, A bears \$1,000 of economic risk of loss for AB’s liability and B bears \$500 of economic risk of loss for AB’s liability. A and B have not entered into a loss-sharing agreement addressing their status as co-guarantors, and local law does not clearly establish responsibility as between them for the liability.

(ii) Because the aggregate amount of A's and B's economic risk of loss under paragraph (a)(1) of this section (\$1,500) exceeds the amount of AB's liability (\$1,000), the economic risk of loss borne by each of A and B is determined under paragraph (a)(2) of this section. Under paragraph (a)(2) of this section, A's economic risk of loss equals \$1,000 multiplied by $\$1,000/\$1,500$, or \$667, and B's economic risk of loss equals \$1,000 multiplied by $\$500/\$1,500$, or \$333.

Reg. §1.752-2(f)(9) Example 9.

B. Changes to Rules in Determining Whether a Person is Related to a Partner

Adopting the proposed regulations with only minor tweaks, the final regulations make three significant changes to the “related person rules” at play in determining a partner's economic risk of loss. First, they modify the attribution rules used to determine if a person is related to a partner. The regulations already provided that a person is related to a partner if they have a relationship described in IRC §267(b) or IRC §707(b)(1), as modified. Reg. §1.752-4(b)(1). Normally the stock attribution rules in IRC §267(c)(1) would be used for this purpose, but the regulations now provide that IRC §267(c)(1) will be disregarded in determining whether stock owned by a partnership is treated as owned proportionately by its partners when the corporation directly bears the economic risk of loss. Reg. §1.752-4(b)(1)(iv)(A). The corporate stock attribution rules will also be disregarded in determining whether an interest in a lower-tier partnership owned by an upper-tier partnership is considered as owned proportionately by the partners of the upper-tier partnership when the lower-tier partnership directly bears the economic risk of loss. Reg. §1.752-4(b)(1)(iv)(B).

Second, the regulations introduce a “related partner exception” providing that:

if a person who owns ... an interest in a partnership directly bears the economic risk of loss ... for a partnership liability, or portion thereof, then other persons owning interests ... in that partnership are not treated as related to that person for purposes of determining the economic risk of loss borne by each of them for such partnership liability, or portion thereof.

Reg. §1.752-4(b)(2).

Finally, the regulations contain a “multiple partner rule” that states when a person who directly bears the economic risk of loss for a liability is related to more than one partner, each partner related to such person is considered to bear the economic risk of loss for the liability in proportion to the partner's interest in partnership profits. The preamble to the final regulations uses this example to illustrate the need for the rule:

For example, corporations X, Y, and Z are partners in an entity treated as a partnership for Federal tax purposes. The partnership agreement provides that the partners share equally in all items of income, gain, loss, deduction, and credit of XYZ partnership. A, an individual, wholly owns X and Y. Z is an unrelated third party. Partnership borrows \$1,000 from a bank and A and Z both guarantee the entire amount of the liability. Without the multiple partner rule, each of X and Y has \$1,000 of EROL from A's \$1,000 guarantee and Z has \$1,000 of EROL from its guarantee. Each would be allocated one-third of the liability under the proportionality rule. In contrast, by applying the multiple partner rule, each of X and Y has \$500 of EROL. When the proportionality rule is applied, X and Y are each allocated one-fourth of the liability and Z is allocated one-half of the liability. This is the correct result because there is one guarantee from A's related group and one guarantee by Z.

The final regulations also provide a helpful ordering rule for clarifying how these three new rules interact. Reg. §1.752-4(e). First, assuming at least one partner bears the economic risk of loss for a partnership liability, one first applies the related party exception. Then, the multiple partner rule is applied before finally applying the proportionality rule to determine the amount of economic risk of loss each partner bears when the amount borne by multiple partners exceeds the amount of the liability. The regulations contain an elaborate example illustrating the application of the ordering rule. Reg. §1.752-4(f).

C. Effective Date

While the final regulations apply to any liability incurred or assumed by a partnership on or after December 2, 2024, a taxpayer can elect to apply the final regulations to all partnership liabilities with respect to all returns filed after December 2, 2024. Treasury and the IRS justify this rule providing greater certainty for partnerships with respect to older liabilities. Reg. §1.752-5(a).

XXX. FINAL REGS IMPLEMENT TAX ON GIFTS AND BEQUESTS FROM CERTAIN EXPATRIATES (T.D. 10027, January 14, 2025)

Treasury and the IRS have issued final regulations relating to taxpayers who owe taxes on gifts or bequests received from certain individuals who gave up their United States citizenship or residency. Although these regulations come nearly 17 years after Congress enacted the tax, there remains no method for reporting transfers subject to the tax or the computation of the tax owed. For the most part, the final regulations are effective as of January 1, 2025, though some provisions are applicable as of January 14, 2025, the date of publication in the Federal Register.

A. Statutory Background

Section 2801 was added to the Code by the Heroes Earnings Assistance and Relief Tax Act of 2008. (Note the Act's cutesy acronym.) It imposes a tax at the highest applicable gift or estate tax rate on “covered gifts” and “covered bequests” received by a United States citizen or resident from a “covered expatriate.” See §2801(a). The Code defines a covered gift as any property acquired directly or indirectly by gift from a covered expatriate. Likewise, a covered bequest is property acquired by reason of the death of a covered expatriate. See §2801(e)(1). Any tax imposed is to be paid by the recipient. See §2801(b).

While the federal wealth transfer taxes (the federal estate, gift, and generation-skipping transfer taxes) are excises imposed on a transferor, the IRC §2801 tax is imposed on the recipient. There appears to be no mechanism by which a covered expatriate has a duty to inform the recipient that a transfer of property is subject to this tax, nor anything requiring the executor of a covered expatriate’s estate to inform a beneficiary that a bequest or devise triggers the tax.

Section 877A(g)(1) defines a covered expatriate as an individual who expatriates on or after June 17, 2008, provided that, on the expatriation date, the individual: (1) has an average annual net income tax liability for the previous five tax years in excess of \$124,000 (an amount adjusted for inflation); (2) has a net worth of at least \$2 million; and (3) fails to certify compliance with all United States tax obligations for the previous five tax years.

B. 17 Years Later, We Have Regulations ... But No Form

Proposed regulations implementing this new tax were published in 2015, seven years after the enactment of §2801. Now, nearly ten years later, those proposed regulations have been finalized. The final regulations make several changes to the proposed regulations in response to the 16 comments submitted by taxpayers. Two of those changes are summarized here.

The first change relates to the definition of a covered bequest. Under Prop. Reg. §28.2801-2(f), any property acquired directly or indirectly by reason of the death of a covered expatriate, regardless of the situs of the property and whether the property was acquired by the covered expatriate before or after expatriation from the United States would be treated as a covered bequest. A comment submitted to the IRS observed this definition was too broad, in that Congress’s apparent intent was to limit the §2801 tax to property that would have been included in the covered expatriate’s gross estate had such person been a United States citizen at death. For example, property passing to an expatriate’s child from a trust created by the expatriate’s parent after the expatriate’s death would be subject to the §2801 tax under the proposed rule even though it would not be includible in the expatriate’s gross estate had the expatriate retained United States citizenship.

To correct this problem, the final regulations identify three categories of property included in the definition of a covered bequest: (1) property acquired by a recipient on or after June 17, 2008, directly or indirectly by reason of the death of a covered expatriate, that would have been included in the covered expatriate's gross estate if the covered expatriate had been a United States citizen immediately before death; (2) property received from a covered expatriate that would have been included in the covered expatriate's estate, even if not acquired directly or indirectly by reason of the death of a covered expatriate (this would include, for example, property includible under IRC §2035); and (3) distributions made by reason of the death of a covered expatriate from a non-electing foreign trust to the extent the distributions are attributable to covered gifts and covered bequests made to the foreign trust on or after June 17, 2008. Reg. §28.2801-2(f).

In addition, the final regulations modify the definition of "indirect" property acquisitions. Under Prop. Reg. §28.2801-2(i), property is indirectly acquired where it is: (1) acquired through ownership of an interest in a corporation or other entity, (2) acquired through one or more foreign trusts, entities, or persons not subject to the §2801 tax, (3) paid in satisfaction of a debt or liability, (4) acquired through a power of appointment over property not in trust granted by a covered expatriate to one who is not a covered expatriate, and (5) acquired as a result of "any other indirect transfer." Among other things, commenters groused that items (2) and (5) were overbroad as written.

In response to these concerns, the final regulations more generally provide that an indirect transfer occurs where property is gratuitously passes from or by the covered expatriate through another person or entity. The final regulations also convert the five-part list from the proposed regulations to a nonexclusive list of four examples describing the application of the general definition of an indirect transfer. Reg. §28.2801-2(i).

The regulations contemplate that the §2801 tax will be computed on Form 708, *United States Return of Tax for Gifts and Bequests Received from Covered Expatriates*. Frustratingly, however, the form has yet to be released. Apparently, a United States recipient will use the form to report covered gifts and covered bequests received during a calendar year. Stay tuned for further developments...but maybe don't hold your breath. It seems these things take time.

XXXI. PROPOSED REGULATIONS UPDATE EMPLOYER "LINE OF BUSINESS" RULES (REG-132805-17, August 6, 2025)

The IRS has issued proposed regulations that offer guidance regarding the "line of business" of an employee for purposes of applying the exclusions from gross income for no-additional-cost services and qualified employee discounts. REG-132805-17, 90 F.R. 37824-37829 (August 6, 2025). The proposed regulations update existing regulations that determine whether

an employer operates more than one line of business with reference to an outdated industry classification system. The proposed regulations would take effect once finalized.

Among the employee fringe benefits excluded from gross income are the “no-additional-cost service” and the “qualified employee discount.” See IRC §132(a)(1) – (2). A no-additional-cost service is a service provided by an employer to an employee where the employer incurs no substantial additional cost (including foregone revenue) in providing the service. IRC §132(b)(2). A qualified employee discount is any discount offered to an employee to the extent the discount does not exceed, in the case of property, the employer’s “gross profit percentage,” or, in the case of services, 20 percent. IRC §132(c)(1).

For both exclusions to apply, however, the service or property provided to the employee must be offered for sale to customers in the ordinary course of the “line of business” of the employer in which the employee performs services. See IRC §§132(b)(1) and 132(c)(4). Thus, for example, if an employee works for a hotel owned by a company that also operates an airline, the employee may be able to exclude the value of a free or discounted hotel room provided by the employer but not the value of a free or discounted flight provided by the employer. In clear cases, the “line of business” limitation is easy to apply. But some cases are harder, thus necessitating guidance.

Regulation §1.132-4(a)(2), promulgated in 1989, states that an employer’s line of business is determined by reference to the Enterprise Standard Industrial Classification Manual (“ESIC Manual”) prepared by the Statistical Policy Division of the Office of Management and Budget. The regulation also provides that an employer is deemed to have more than one line of business if the employer offers for sale to customers property or services in more than one two-digit code classification referred to in the ESIC Manual.

The proposed regulations replace the ESIC Manual with the North American Industry Classification System (NAICS), principally because it is more recent. The NAICS was last revised in 2022, while the ESIC Manual has not been updated since 1974. The IRS believes the NAICS is “a more accurate and detailed reflection of present economic realities.” Indeed, the ESIC Manual does not reflect modern industries. The preamble to the proposed regulations explains that cell phone services, internet services, and smart phone applications would all be classified as “Communication” under the ESIC Manual, while the NAICS appropriately recognizes these as separate lines of business.

Under the proposed regulations, an employer is deemed to have more than one line of business “if the employer offers for sale to customers goods or services in more than one four-digit code classification referred to in the NAICS (i.e., NAICS industry group).” Prop. Reg. §1.132-4(a)(2)(i). The proposed regulations retain a rule that allows two or more lines of business to be treated as a single line of business in certain cases, including where employees commonly work in more than one line of business and it would be difficult to determine which employees perform services for which line of business, like where employees of a restaurant-deli work both at a service counter and in the restaurant. Prop. Reg. §1.132-4(a)(3).

XXXII. PRINCIPAL IN PONZI SCHEME PARTNERSHIP CANNOT DEDUCT ATTORNEY FEES OR ALLEGED THEFT LOSS (*Shaut v. Commissioner*, T.C. Memo. 2024-103 (November 6, 2024))

The Tax Court has held that a taxpayer could not deduct his legal expenses after a company he managed was sued for fraud, rejecting claims that the fees were deductible either as a theft loss or as a business expense. The court also disallowed a claimed theft loss for the taxpayer's own investments in the activity, finding a lack of documentation both for the amounts invested and the amounts not recovered.

In 2014, the taxpayer, an environmental lawyer, invested \$250,000 in a partnership that supposedly would be engaged in developing patentable technology. In short order, the taxpayer became the partnership's president, though only for about six months. Following another investment, the taxpayer became a managing director of the partnership. In that position, he recruited many others to make million-dollar investments in the partnership.

In 2016, some investors determined that some of the partnership principals were engaged in misrepresentation and mismanagement. This led to around 17 separate lawsuits in which the taxpayer was named as a defendant. Most of the suits were resolved by 2018. Two of the principals were prosecuted and imprisoned in 2019 for their roles in what proved to be a Ponzi scheme.

In defending his good name, the taxpayer claims to have spent about \$600,000 in legal fees in addition to losing some \$720,000 invested in the enterprise. On his amended return for 2019, the taxpayer claimed a fraud loss deduction of \$1,320,000, though the taxpayer could only substantiate legal bills of about \$539,000 and lacked documentation for some of the claimed investments in the partnership. The IRS did not accept the amended return.

The Tax Court explained that an uncompensated theft loss is deductible under §165 where the taxpayer proves the existence of a theft, the amount of the deductible loss, and the year in which the theft was discovered. The court held that the taxpayer here did not prove that the loss was discovered in 2019. The taxpayer testified that he made his investments in earlier years and that most of the litigation surrounding the alleged misrepresentation and mismanagement was concluded by 2018. As the court said:

[I]t is evident that [the taxpayer] knew before 2019 that [the partnership] was a financial failure, that improper activity occurred, and that he would not recover his investment. For these reasons alone, [the taxpayer] failed to carry his burden of demonstrating that his purported theft losses were "discovered" in 2019, thus entitling him to a casualty loss deduction for that year.

Furthermore, the court ruled, the taxpayer did not prove he was a victim of theft. Indeed, the court believes he was in on the scheme, though it does not say so in as many words:

Although he claims no intimate involvement in the [partnership's] operations after his role as president ended, we find [the taxpayer's] explanation implausible and not credible. [He] has extensive business expertise; he started multiple successful businesses. After his role as the president..., he served the crucial role of raising millions of dollars for [the partnership]. Indeed, he brought on investors who were ultimately victims of the...scheme. His self-serving testimony alleging theft is insufficient in this case to meet his burden of proof.

Even if the taxpayer “was somehow unaware” of the wrongdoing, the court continued, he did not prove that his investments in the partnership “were anything more than a bad business decision.” Couple that with the lack of evidence substantiating the claimed loss and the court’s decision is easy: the taxpayer does not qualify for a theft loss deduction.

The taxpayer argued he should be allowed to deduct the attorney fees paid in defending himself against wrongdoing as a business expense. The court observed that while it is not entirely clear to which business the legal fees relate, the taxpayer “appears to suggest that his legal fee deduction should be permitted as a business expense for” the partnership.

The problem, though, is that most of the invoices submitted to substantiate the deduction were for years before 2019. Only those business expenses “paid or incurred during the taxable year” are deductible under §162(a). “Even more problematic,” the court noted, the taxpayer’s claim that the legal fees are a business expense contradicts his claim that “he was merely an individual who helped raise money” for the partnership and that he played no role in day-to-day operations.

When claiming to be both a principal and a victim (an officer and a gentleman?) of an enterprise, one should expect considerable skepticism from the IRS and courts. Inconsistent testimony and incomplete documentation doomed the taxpayer’s chances for salvaging a deduction from this scheme.

XXXIII. OUTSIDE BASIS ADJUSTMENTS CAN BE MADE EVEN IN YEARS CLOSED BY THE STATUTE OF LIMITATIONS (*Surk, LLC v. Commissioner*, T.C. Memo. 2024-99, October 29, 2024).

The Tax Court has held that even though a taxpayer got away with deducting passthrough losses in excess of the taxpayer’s basis in the partnership in years now closed by the statute of limitations, the IRS can still make basis computations for an open taxable year with reference to how those losses should have been reported in the earlier year.

In the name of readability, this summary uses rounded numbers in almost all cases and does not include the effect of matters not relevant to the decision. The taxpayer, a partnership, owned a majority interest in an LLC. In 2014, the taxpayer deducted over \$1.1 million as its share of the LLC's net losses for the year, even though the partnership's basis in the LLC interest was just over \$540,000. That was improper under IRC §704(d), which limits a partner's deduction for passthrough losses to the partner's basis in the partnership interest (known to partnership tax mavens as a partner's "outside basis"). At most, the taxpayer should have deducted just over \$540,000 and carried forward another \$600,000 in suspended loss. In any case, the taxpayer's outside basis at the end of 2014 should have been zero:

2014: \$1.14 million loss	What was reported	What should have been reported
Starting Outside Basis	540,000	540,000
Passthrough Loss Deducted	(1,100,000)	(540,000) ← limited by IRC §704(d)
Ending Outside Basis	0	0
<i>Carryover Loss</i>		\$600,000

The next year, the taxpayer's share of the LLC's net losses came to over \$2.7 million. The taxpayer deducted this amount in full even though its outside basis in the LLC had been reduced to zero in the prior year because of the allowable passthrough deduction. None of this passthrough loss should have been allowed (increasing the suspended loss to \$3.3 million), and the taxpayer's correct outside basis as of the end of 2015 was still zero:

2015: \$2.7 million loss	What was reported	What should have been reported
Starting Outside Basis	0	0
Passthrough Loss Deducted	(2,700,000)	0 ← limited by IRC §704(d)
Ending Outside Basis	0	0
<i>Carryover Loss</i>		\$3.3 million

Then, in 2016, the taxpayer's outside basis in the LLC grew by over \$3.8 million thanks to an election under §754. The taxpayer's share of the LLC's net loss for that year was \$3 million, but for some reason the taxpayer computed its outside basis at just \$1,730. It thus deducted \$1,730 of the passthrough loss and carried forward a roughly \$2.999 million loss. But the taxpayer *should* have deducted the entire passthrough loss, as there was enough outside basis to absorb it. Indeed, the taxpayer could then have deducted \$800,000 of the \$3.3 million suspended loss. That would leave the taxpayer with an outside basis of zero and a remaining suspended loss of \$2.5 million:

2016: \$3 million loss	What was reported	What should have been reported
Starting Outside Basis	0	0
IRC §754 Election Adjustment	3,800,000	3,800,000
Passthrough Loss Deducted	(1,730)	(3,800,000) <i>incl. 800,000 carryover</i>

Ending Outside Basis	0	0
<i>Carryover Loss</i>	\$2.999 million	\$2.5 million

In 2017, the fun continued. The taxpayer's share of the LLC's net loss was over \$4.9 million, but after calculating its outside basis at \$5.3 million(!), the taxpayer deducted the full passthrough loss plus almost \$400,000 of the carryforward loss from 2016. Because the taxpayer's basis should have been zero, of course, none of the passthrough loss for 2017 would be deductible that year. Instead, it would add to the suspended loss, raising it from \$2.5 million to \$7.4 million.

2017: \$4.9 million loss	What was reported	What should have been reported
Starting Outside Basis	5,300,000	0
Passthrough Loss Deducted	(5,300,000) <i>incl. 400,000 carryover</i>	0
Ending Outside Basis	0	0
<i>Carryover Loss</i>	\$2.599 million	\$7.4 million

The IRS determined that the taxpayer lacked outside basis sufficient to deduct its share of the LLC's 2017 loss as well as any portion of the suspended loss. The taxpayer argued that this had the effect of re-opening 2014 and 2015 even though the statute of limitations for those years had passed. But the Tax Court rejected this argument:

As stated above, under section 705(a) a partner must calculate outside basis annually and must decrease its outside basis for the current-year loss as well as all prior-year losses since the partnership began. Treasury Regulation § 1.704-1(d)(2) adopts the section 705 basis adjustment rules although it limits the negative basis adjustment to allowed losses. Thus, it is immaterial that respondent did not issue an FPAA for 2014 and 2015 or that those years are closed. Respondent is calculating [the taxpayer's] outside basis for yearend 2017.

Moreover, respondent is not seeking to make an assessment for a closed year or to disallow the excess loss deductions for 2014 and 2015. The question before the Court is how the excess loss deductions factor into the annual outside basis calculation. Events from non-docketed, prior, closed years may be considered to calculate outside basis for the docketed year.

Although the court determined the IRS was only focusing on the right result for 2017 and not those in any prior year, the court treated the passthrough losses claimed by the taxpayer for 2014 and 2015 as "allowed" for basis purposes because the taxpayer claimed the losses on its tax returns and the IRS did not challenge them.

This case underscores the principle that a taxpayer's adjusted basis is usually computed with reference to how items in prior years *should* have been reported for federal income tax purposes, and not necessarily according to how such transactions *are in fact* reported. While that principle worked in favor of the IRS in this case, it can also benefit the taxpayer. In PLR 9504032, for example, the taxpayer overstated the amount of excluded cancellation of indebtedness ("COD") income resulting from a bankruptcy, which in turn led the taxpayer, in applying IRC §108(b), to reduce its net operating loss carryovers going forward by an amount greater than what should have been the case. The IRS allowed the taxpayer to increase the net operating loss carryover figure based on the correct (and lower) amount of excluded COD income, even though the statute of limitations for the year in which the COD income arose had run.

XXXIV. CASES INVOLVING THE DEDUCTION FOR HOBBY LOSSES

A. Salt Miner Digs Himself Into a Hole Deducting Losses from Hay Farming and Horse Racing (*Bucci v. Commissioner*, 2d Cir., February 23, 2025)

The Second Circuit, in a summary order, has affirmed an oral bench opinion of the Tax Court holding that three activities engaged in by the taxpayer were hobbies. The substantial losses resulting from those activities, then, could not be used to offset the millions in income the taxpayer received from his salt mining business.

Joseph Bucci co-founded (and owns about one-third of the stock in) a corporation that owns the largest salt mine in the United States. He and his wife, Elaine, filed federal income tax returns for 2016 and 2017, the former reporting taxable income of \$8.3 million and the latter reporting taxable income of \$8.2 million. Those returns reported losses from three separate activities: farming, real estate, and horse racing. The IRS disallowed the losses from these activities under IRC §183, finding they were hobbies.

Section 183(a) generally provides that if an activity engaged in by an individual or an S corporation is "not engaged in for profit, no deduction attributable to such activity shall be allowed" for federal income tax purposes. Section 183(c) then provides that activity is "not engaged in for profit" if the activity is neither a business (with expenses deductible under IRC §162) nor an activity engaged in for profit (the expenses of which are deductible under IRC §212).

Whether a taxpayer engages in activity for profit is a question of fact. To assist in the determination, Reg. §1.183-2(a) lists nine factors that should be used to determine whether a taxpayer entered into the activity with the objective of making a profit, no one of which is determinative. Further, a court has the power to give more weight to some factors than to others, depending on the applicable facts.

Through a bench opinion, Judge Holmes applied the nine factors to each of the three activities after first observing:

The Seventh Circuit has called this open-ended list of objective factors of subjective intent “goofy” and has chosen not to “wade through the nine factors” but instead take a more holistic approach, *Roberts v. Commissioner*, 820 F.3d 247, 250 – 254 (7th Cir. 2016). This case, though, is appealable to the Second Circuit, so we’ll go back to the metaphorical salt mine of a long-standard analysis and address each specific factor as well as any other additional facts we find important to determine if the Buccis ever engaged in any of these activities for profit.

The first activity was Joseph’s hay farming. He uses the hay to feed his horses and allows his neighbors to use the rest for their dairy activities. Rather importantly, he sells none of it. But that didn’t stop him from claiming a \$250,000 loss from hay farming in 2016 and a \$200,000 loss in 2017. After methodically applying all nine factors to what was concededly “an easy case,” the court determined this was not a for-profit activity and that the losses should be disallowed.

The second activity was Joseph’s real estate activity, which he claimed to be an investment activity of buying and selling property. The activity, however, generated no income for 2016 or 2017. It did generate modest losses (\$5,000 for 2016 and just under \$7,000 for 2017), but after applying the nine factors the court determined this too was a hobby activity.

The third activity was horse racing, specifically, Joseph’s dream to enter a horse in the Kentucky Derby. There were modest successes in the years at issue, as Joseph’s horses won purses totaling just under \$200,000 each year. But even with these victories, the activity generated a net loss of over \$600,000 for 2016 and over \$400,000 for 2017. This was consistent with other years, where the average net loss was \$560,000. “This is not a money-making operation in other words,” observed the court. Holistically speaking, horse racing is “simply an expensive, if for him affordable, dream.” Still, the court applied the nine factors, finding that the activity is not engaged in for profit. “Mr. Bucci may be the rock salt king of America and horse racing is often called the sport of kings, but it is not on this record the business of kings.”

The Buccis took an appeal to the Second Circuit, but they fared no better in that venue. The court held that the Tax Court applied the correct legal standard and that it was not an error to deny their second request for a continuance in order to obtain counsel because Joseph conceded that retaining a lawyer in the matter was something he “should have got ... done maybe earlier.”

The Buccis argued that the IRS conceded to a profit motive for all of the activities in its deficiency notice, but the Second Circuit saw no evidence of this. The couple claimed that because the IRS treated the loss from the sale of horses as capital losses, it was conceding that

horse racing was an investment activity. But the Second Circuit observed that the sale of assets used in a hobby can give rise to capital gains and losses too, and the deficiency notice expressly stated the IRS's determination that the racing activity was a hobby.

The Buccis finally argued that the Tax Court misapplied the nine factors to each activity, but the Second Circuit dismissed this claim as quibbling with the lower court's fact findings and weighing of the factors. Such quibbles do not satisfy the requirement to show "clear error" by the Tax Court.

B. Lawyer Cannot Deduct Race Car Activity Costs as Advertising Expense (*Avery v. Commissioner*, 10th Cir., December 9, 2024)

The Tenth Circuit Court of Appeals has affirmed the Tax Court's decision in *T.C. Memo. 2023-18* that a lawyer with a solo practice could not deduct some \$355,000 in expenses incurred over a six-year period in connection with his race car hobby as "advertising expenses" under IRC §162(a) even though the taxpayer claimed the racing activity promoted his law practice.

The case involves a taxpayer, a lawyer with a solo litigation practice based in Denver, who was heavily involved in car racing throughout the Midwest. He purchased a 2009 Dodge Viper for \$102,500 that he drove in many races until his divorce, after which he "didn't have the funds to race." On the back tail of the race car was a decal for the "Avery Law Firm." The taxpayer also maintained a website for his "Viper racing team" that was linked to his law firm's Facebook page. Before the Tax Court, the taxpayer testified that he hoped his racing activity would attract auto accident victims as potential clients. As the Tax Court explained:

Petitioner believed that being involved in car racing might enable him to meet lawyers, doctors, and other professionals who could help his career. Car racing, he said, was a good "conversation starter" with these individuals. But he could identify only two instances in which his car-related activity actually intersected with his law practice. Through one racing connection he met a Pizza Hut franchisee who had a dispute with a vendor; petitioner subsequently "consult[ed]" with that franchisee. Several years previously he had met a surgeon who later served as an expert witness in a personal injury case he tried in Denver. But he met that doctor at an Indiana car show, not at a racing event.

On late and amended federal income tax returns for the years 2008 through 2013, the taxpayer claimed a total of \$355,000 in "advertising expenses," all related to the car racing. At trial, though, the taxpayer could only substantiate \$51,634 of this amount.

Substantiation aside, there are other problems with the claimed deduction. Let's take a brief pit stop to consider the deduction of business expenses generally. Section 162(a) permits

deduction of “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.” An expense is “ordinary” if the transaction giving rise to it is “of common or frequent occurrence in the type of business involved.” *Welch v. Helvering*, 290 U.S. 111, 113-14 (1933). An expense is “necessary” if it is “appropriate and helpful” in carrying on the taxpayer’s business. *Id.* at 113. In deciding whether a particular expense is ordinary and necessary, courts look for a reasonably proximate relationship between the expense and the business. If a cost is primarily personal in nature, no deduction is allowed. *Henry v. Commissioner*, 36 T.C. 879, 884 (1961). Even where a cost qualifies as a business expense, the taxpayer must keep adequate records that substantiate the expense, and the failure to maintain and produce such records weighs heavily against a deduction. See, e.g., *Rogers v. Commissioner*, T.C. Memo. 2014-141.

In this case, fueled by a desire to minimize his tax liability, the taxpayer tried to deduct the cost of the Dodge Viper and parts, but the argument quickly broke down. The Tax Court noted that these costs were “potentially recoverable” as depreciation expenses, but even so, the costs would not be deductible as ordinary and necessary business expenses. As the court observed:

We agree with respondent that petitioner’s racing-related costs were not ordinary and necessary expenses of his business as an attorney. It is neither “necessary” nor “common” for attorneys to incur such costs. Petitioner greatly enjoyed car racing, which he found more exciting than his previous hobby of acquiring collector cars and participating in car shows. But we find that both activities were hobbies. No deduction is allowed for personal expenses of this kind. ... [M]ost of his racing activity occurred during 2008 – 2010, when he lived in Indiana. He raced on tracks in Indiana, elsewhere in the Midwest, and on the East Coast. He did not convince us that racing at these venues had any synergy with his Denver-based litigation practice.

The court also found it troubling that the decal for his law firm “appeared in relatively small print on his Dodge Viper.” Given the activity was one engaged in primarily for personal enjoyment and not to advertise his law firm, then, even the substantiated expenses were not deductible.

On appeal, the taxpayer argued it was error for the Tax Court to focus on his enjoyment of car racing in deciding that the costs incurred in connection with the racing activity were not “ordinary and necessary” to his law firm business. But the Tenth Circuit found this argument was a lemon, unsupported by any authorities. What’s more, observed the Tenth Circuit, it is not apparent that the Tax Court really considered the taxpayer’s enjoyment as a factor affecting the “ordinary and necessary” analysis. But even beyond that, said the appellate court, the taxpayer’s personal enjoyment *does* relate to the determination of his primary motive for engaging in the activity. On this point, the court concludes:

As long as personal enjoyment remains one factor among others, we see no realistic threat of the situation he posits, where the Tax Court disallows otherwise legitimate business expenses related to a work vehicle solely because the owner enjoys driving it. We therefore reject his argument.

The taxpayer also claimed the Tax Court erred in handling posttrial proceedings in violation of his due process rights. But the Tenth Circuit, retracing the procedural history after the Tax Court's decision, revealed that the taxpayer failed to participate in the proceedings following trial. Thus the lower court's entry of a final decision instead of ordering a remand to the Independent Office of Appeals was on the right track.

Finally, the court rejected the taxpayer's last argument that the drag of litigation led to the imposition of more interest and larger penalties, all in violation of his due process rights. The taxpayer cited no authority for this argument, and the appellate court found nothing to support it either. The court thus chose not to address the theory any further.

XXXIV. ONE MUST START A BUSINESS TO CLAIM A BUSINESS LOSS (*Root v. Commissioner*, T.C. Memo. 2025-51, May 22, 2025)

The Tax Court has held that the taxpayers, a married couple, could not carry forward a claimed net operating loss ("NOL") from 2014 because the activity giving rise to the NOL was not a trade or business. The case is a helpful reminder that losses from activities that fail to launch are not deductible. To have business losses, business operations must have begun.

A. A Short Primer on NOL Carryforwards

Section 172(a) allows a taxpayer to deduct in any taxable year the sum of any NOL carryovers and NOL carrybacks to that taxable year. An NOL, defined in IRC §172(c), is the excess of allowable deductions over gross income. In the case of individuals, IRC §172(d)(4) generally allows an NOL deduction only where the NOL is attributable to the individual's "trade or business." Further, IRC 165(c) limits an individual's deduction for losses to: (1) losses incurred in a trade or business; (2) losses incurred in a transaction entered into for profit that is not connected with trade or business; and (3) certain losses arising from casualty or theft. Thus, in order for an individual to claim the benefit of an NOL carryback or NOL carryforward, the NOL must originate from an allowable deduction related to a trade or business.

B. Facts of the Case

After the taxpayers found success developing a fruit puree company, they sought to make money from a different kind of spread: a recreational ranch. To that end, they purchased a total of four parcels of land in Klamath County, Oregon. In 2000, they hired an architect to design a "lodge/residence" with a semi-attached guest wing and a semi-attached council house.

When construction began in 2003, however, the property was zoned solely for farm use. While the lodge could be built as a residence for the taxpayer's personal use, commercial construction would require permission from the county.

Construction was completed in 2006, but the taxpayers soon found themselves in a jam (and not the fruity kind). The property flooded thanks to defects in the windows, roof, and weatherproofing. The couple discovered the walls of the lodge were infested by hundreds of bats as well as rats and mice. As a result of the infestations, the property reeked. The taxpayers then discovered defects with the foundation. When they hired a forensic architect to evaluate the lodge in an attempt to *preserve* it (I'll see myself out), they learned the stone fireplace built with large boulders was structurally unsound, putting any users of the lodge in great danger if there was an earthquake. Ultimately, in 2010, county officials condemned the lodge as unfit for occupancy. Having "lost faith in the project," the taxpayers caused the lodge to be demolished.

The taxpayers then sued the architect and several of the subcontractors involved in the construction. By the end of 2014, they had recovered roughly \$3 million via arbitration and litigation, though they had paid about \$4 million in legal fees to obtain these recoveries. On their original joint return for 2014, the couple claimed a \$10,000 net profit from a consulting business they called "Root Properties LLC." But on an amended 2014 return filed in 2018, they claimed an NOL of over \$5.1 million, determined as the total design and construction costs for the lodge, plus the legal fees, less the settlement and litigation recoveries. Then, on their 2017 and 2018 joint returns, they claimed NOL carryovers from 2014. The IRS examined the 2017 and 2018 returns, resulting in the disallowance of the claimed carryovers.

C. Tax Court Opinion

The taxpayers argued their losses in connection with the lodge were business losses and, thus, deductible under IRC §165(c)(1). For that to be the case, announced the Tax Court (Judge Toro), the taxpayers had to prove: (1) they had a profit motive; (2) they were regularly and actively engaged in the activity; and (3) their business activity "must actually have commenced." Focusing on the last requirement first, the Tax Court held that the lodge was not a trade or business of the taxpayers because it never commenced.

The court cited an "oft-quoted test" for determining when a business activity begins, a test from *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir. 1965):

[E]ven though a taxpayer has made a firm decision to enter into business and over a considerable period of time spent money in preparation for entering that business, he still has not "engaged in carrying on any trade or business" within the intendment of section 162(a) until such time as the business has begun to function as a going concern and performed those activities for which it was organized.

Under this test, it is not required that a business has to generate revenue, but “the business must perform the activities for which the venture was organized.” Such was not the case here:

Although the Roots did complete some construction on their property, the lodge was never brought to a state in which guests could stay or tenants could rent it. As the Roots themselves agree, “the Lodge was never in a condition in which it could be used to provide exclusive upmarket lodging for paying guests.” Pet'r's Op. Br. 21; see also Tr. 55 (“We didn't have a viable structure to keep guests. We hadn't gotten that far.”). Even if it had been suitable to house guests, the Roots never opened the lodge up to potential guests.

Further, throughout its existence, the lodge lacked the tools and infrastructure to accept customers. There was no website or booking portal for the lodge. The kitchen did not have the necessary permitting to offer food to customers. And there was no system for billing any lodge guests. Beyond just lacking revenue, the Roots' lodge was never capable of operating as a business. Simply put, the Roots never realized their plans of operating a guest lodge on their property.

On that ground alone, then, the claimed NOL carryforwards would be disallowed. But as the finder of fact, the Tax Court continued its analysis, considering whether the taxpayers were regularly and actively engaged in the lodge activity such that it could qualify as a trade or business. Here too the couple came up short. As the court observed:

At trial, the Roots described a small number of events held on their property while the lodge was being constructed and shortly thereafter. They did not, however, present any evidence regarding the amount of time or attention these events required for planning, preparation, and hosting. Given how infrequently the events occurred, it seems doubtful that they would have required regular involvement on par with that required to conduct a trade or business. Nor did the Roots demonstrate regular involvement in another manner, such as by showing that they had hired employees to undertake business activities on their behalf.

Not only that, but the taxpayers continued to own and operate their fruit puree business all throughout the design and construction process, not selling that business until 2008. But by that point, “the lodge’s defects had become apparent” and it was clear the activity never would launch.

Having held the NOL carryforwards were not allowable, the court then upheld the imposition of a substantial understatement penalty under IRC §6662(a). The court found the taxpayers lacked substantial authority for their reporting position that the activity was a business and that they lacked reasonable cause for the resulting underpayment of tax. It seems the taxpayers were confident enough in their main argument that they devoted no effort to avoid the penalty that would apply if they lost. After all, there was no evidence offered as to the

qualifications of those who advised the taxpayers, and the tax preparers were not called as witnesses.

XXXV. JOCKEY’S CLAIM FOR EXCLUSION DOESN’T LEAVE STARTING GATE (*Molinari v. Jockey’s Guild, Inc.*, D. Mass., July 30, 2025)

A federal district court has dismissed a complaint filed by a disabled jockey alleging that funds paid to him by the defendant pursuant to a state statute that earmarks some gambling revenues for the health and welfare of retired and disabled jockeys were wrongfully reported to the IRS as gross income. The court held it was proper for the defendant to issue Forms 1099 to the plaintiff reporting the amounts the defendant paid to the plaintiff.

The plaintiff worked as a jockey at Suffolk Downs in Boston but was disabled at the times relevant to this lawsuit. As a member of the Jockey’s Guild, a nonprofit organization that represents jockeys throughout the United States, he received payments from the organization that had been distributed to it by the State of Massachusetts for the purpose of providing health and welfare benefits to former jockeys. The record indicates that the plaintiff received about \$2,400 in 2020 and about \$4,300 in 2023. The defendant instructed the plaintiff to submit proof of any out-of-pocket medical expenses he incurred or else it would issue him a Form 1099 reporting the payments as income. The plaintiff did not submit any documentation, so the defendant issued him Forms 1099.

Interestingly, this is not a case in which the IRS is seeking payment of federal income tax; apparently, the plaintiff included the reported amounts in gross income and paid any required tax. Instead, the plaintiff’s beef is with the defendant for issuing Forms 1099 reporting the payments as income.

The court (Judge Kobick) was unclear exactly what claim the plaintiff was bringing, ultimately determining that the plaintiff was most likely suing for the fraudulent filing of an information return. But in order to prevail on that claim, the plaintiff has to show that the payments were not income. The plaintiff argued that “income” only refers to “money or value that an individual or business entity receives in exchange for providing a good or service or through investing capital.” Alas, that definition does not align with the Internal Revenue Code. Noting that IRC §61(a) defines gross income as “all income from whatever source derived,” the court held that the payments made by the defendant were income to the plaintiff unless a specific provision of the Code excludes them.

Furthermore, the plaintiff did not identify any applicable exclusion. At best, said the court, the payments could be excluded under IRC §105 to the extent they reimbursed the plaintiff for out-of-pocket medical expenses, but the plaintiff did not allege he used the funds for that purpose. Accordingly, it was proper for the defendant to report the payments as income on Forms 1099. The court also rejected claims of breach of fair representation and negligent infliction of emotional distress.

XXXVI. CHANGING STORIES MIDSTREAM RARELY WORKS (*Sehati v. Commissioner*, T.C. Memo. 2025-3, January 15, 2025)

The Tax Court has held that family members diverted income from their jewelry businesses to an undisclosed account, rejecting their claim that the account held funds from the sale of jewelry gifted to them by the family matriarch. The case is a morale boost to those of us that follow the rules: cheaters don't always prosper.

Joseph and Lilly, a married couple, own a company that operates two jewelry kiosks in a California shopping mall. Two of Joseph's brothers own a separate jewelry store located near the mall. The three brothers together own other companies that invest in real estate. In the course of examining their federal income tax returns, the IRS discovered an undisclosed bank account that, during the years at issue (2012 through 2014), received many deposits of unreported income belonging, according to the IRS, partly to Joseph and Lilly and partly to the two brothers. Before the Tax Court, everyone swore that the deposits derived from sales of jewelry given to the three brothers by their mother, and—wouldn't you know—the sales were for amounts at or just below basis. Yet the Tax Court was skeptical:

Although petitioners' description of the alleged gifts conjures up images of a treasure trove of gold and jewels, petitioners never mentioned this remarkable theory during the examination to respondent's agent, who was instead told by two of them that the income represented loan or inheritance proceeds.

Unsurprisingly, the Tax Court, calling "the gift jewelry story ... entirely fanciful," upheld the deficiencies determined by the IRS, as well as fraud and accuracy-related penalties. Specifically, Joseph and Lilly owed a total deficiency of about \$1.5 million and fraud penalties of over \$1 million, while each of the two brothers owed deficiencies of over \$500,000 and fraud penalties ranging from about \$300,000 to over \$480,000.

The testimony offered from the taxpayers was "inconsistent," "vague," and "simply lacked credibility." Some of the checks deposited into the account refer to watches or wine glasses in the memo line, yet no witness testified that watches or wine glasses were among the items listed. And it was weird how customers of the jewelry stores always paid with credit cards, yet when they bought items from the "gifted" jewelry, they paid by check or in cash. "A more plausible explanation," said the court, "is that [the jewelry businesses] diverted income from cash and check sales in the regular course of business from their operating accounts in an attempt to conceal income."

XXXVII. A HALF-WIN BEATS NO WIN (*Zojac v. Commissioner*, T.C. Memo. 2025-33, April 10, 2025)

The Tax Court has held that a taxpayer could exclude half of the amount received as settlement proceeds from a city as damages received on account of personal physical injury under IRC §104(a)(2). Although the parties had not allocated the settlement proceeds between physical injury claims and non-physical injury claims, the Tax Court felt that allowing an exclusion for half of the total settlement award was fair, albeit rough justice.

In 2004, police in Bolton, Massachusetts, arrested the taxpayer on charges of domestic battery against his then wife. He spent the weekend in jail before being released after his wife refused to press charges. The taxpayer sought medical attention while he was incarcerated but did not receive any.

In 2005, the taxpayer sent a claim letter to the Town of Bolton seeking \$100,000 in damages resulting from the arrest and incarceration. He claimed to have suffered physical and emotional injuries in addition to violations of his constitutional rights. He said that during the arrest he suffered injuries to his wrists, knees, and ankles. He also claimed the reckless driving of the arresting officer exacerbated pre-existing back injuries and that those injuries were made worse because of the conditions of his holding cell.

In 2007, the taxpayer and the Town of Bolton agreed to a settlement whereby the city would pay \$35,001 in exchange for the taxpayer's release of all claims resulting from the arrest and incarceration. The city paid the settlement to the taxpayer that year, but the taxpayer did not report any of it as gross income. The IRS determined a deficiency in connection with the 2007 return, concluding, among other things, that the settlement was includible in gross income.

In support of its position that the settlement was taxable, the IRS introduced evidence from a 2009 lawsuit in which the taxpayer sued his by-then-former wife. In his complaint, the taxpayer said the settlement was compensation for "false arrest; false imprisonment; illegal search and seizure; intentional infliction of emotional distress; civil rights violations; malicious prosecution; abuse of process; conspiracy; and defamation of character." The IRS made much of the fact that nothing in that list described a physical injury or physical sickness. But the Tax Court concluded that this evidence was irrelevant. Whether the settlement was paid on account of physical injury, said the court, "concerns the intent of the payor, not the payee." So it does not matter what the taxpayer thinks the settlement covered. What matters is the intent of the Town of Bolton in paying the settlement to the taxpayer.

The only evidence of the city's intent, observed the court, was the taxpayer's original claim letter. That letter included claims for physical injury in addition to civil rights violations. The claim letter stated the taxpayer suffered cuts and bruises and that the arrest exacerbated

his lower back and knee conditions. Thus, “at least some of the (sic) portion of the payment was made by the Town of Bolton to settle its potential liability for its agents’ infliction of pain and physical injury.” Okay, fine. But how much? Reaching deep into its magic hat, the Tax Court pulls out this conclusion:

Using our best judgment, we find that \$17,500 of the \$35,001 payment is attributable to the Town’s concern about its liability for petitioner’s physical pain and injuries resulting from the actions of its police officers.

Accordingly, the taxpayer was allowed to exclude \$17,500 of the settlement from his 2007 gross income under IRC §104(a)(2).

Lest you think the taxpayer got off easy, the court then went on to sustain a ton of other adjustments the IRS made to the taxpayer’s return, including claimed deductions for moving expenses, depreciation, mileage expenses, meals and entertainment expenses, and legal and professional fees.

XXXVIII. PUBLIC POLICY DOCTRINE PRECLUDES DEDUCTION FOR LOSS OF FUNDS SEIZED FROM TAXPAYER’S S CORPORATION (*Hampton v. Commissioner*, T.C. Memo. 2025-32, April 10, 2025)

The Tax Court has held that funds seized from two bank accounts titled in the name of the taxpayer’s S corporation did not give rise to a pass-through loss deduction. While the S corporation certainly sustained a loss of the seized funds, the loss was not deductible under the public policy doctrine.

In 2013, the taxpayer pleaded guilty to bribery, fraud, and money laundering activities. A federal district court ordered the taxpayer to forfeit just over \$2.2 million. In 2016, U.S. Marshals seized money from several bank accounts in the name of the taxpayer and his wholly-owned S corporation. On his 2016 federal income tax return, the taxpayer deducted a pass-through loss from the S corporation’s portion of the seized funds. When the IRS disallowed the deduction, the taxpayer sought redetermination in the Tax Court.

In deciding that the taxpayer could not deduct the loss, the Tax Court invoked the public policy doctrine, the rule that an otherwise deductible loss can be disallowed where the deduction “would frustrate sharply defined national or state policies proscribing particular types of conduct.” As the court observed:

Courts have uniformly held that forfeitures in connection with a criminal conviction are precisely the sorts of penalties for which the Supreme Court has held ... that a deduction would frustrate public policy by reducing the “sting” of the penalty.

Allowing the taxpayer to deduct the loss of the corporation's forfeited funds "would unquestionably reduce the 'sting' of the penalty for him," the court concluded.

The taxpayer argued that the public policy doctrine should not apply because the corporation was never charged with wrongdoing. While he conceded that he cannot deduct the loss from the forfeiture of his own accounts, he claimed he should still be able to deduct the loss from the innocent corporation as its sole shareholder. But the court didn't buy it:

Mr. Hampton wholly owned and controlled the corporation ... and he offered only minimal evidence that corporate formalities were followed. More importantly as previously noted, over the years [the corporation's] sole source of business income was the commissions generated by Mr. Hampton that were 'assigned' to [the corporation]. It was those 'assigned' commissions that led to the criminal indictment, plea, and forfeiture at issue in this case. It is impossible to see how [the corporation] was independent of Mr. Hampton such that the forfeiture loss deduction should be allowed.

Thus, concluded the court, the government's seizure of the accounts was proper, and the resulting loss is not deductible by the taxpayer.

XXXIX. PRIVATE RULING ROUNDUP

Readers should keep in mind that a private ruling is binding only as to the taxpayer that requested it; they may not be cited as precedent before the Tax Court, and readers may not rely on them as they are not otherwise binding on the IRS. The IRS can, and often does, change its mind on any given issue examined in a private ruling. Still, professionals can gain insight into the IRS's current stance on relevant and interesting issues by reviewing these rulings.

A. Possible Blueprint for Getting Assets Out of a QTIP Trust

In *Private Letter Ruling 202504006* (released January 24, 2025), the IRS considered the tax consequences stemming from the proposed division of a marital trust for which the decedent's executor made a qualified terminable interest property (QTIP) election. The trustee and all of the beneficiaries agreed to divide the trust into "Trust 1" and "Trust 2." Trust 1 will hold assets with a value not to exceed the surviving spouse's remaining basic exclusion amount, and Trust 2 will hold the balance. The spouse, through an agent, would then disclaim the spouse's interest in Trust 1, causing those assets to be distributed to the remainder beneficiaries. The IRS ruled that: (1) the division of the QTIP trust into Trust 1 and Trust 2 will not cause any of the trusts or their beneficiaries to recognize any income, gain, or loss; (2) after the division, Trust 1 and Trust 2 will continue to be QTIP trusts under §2056(b)(7); (3) the spouse's disclaimer of her interest in Trust 1 will be treated as a gift of all of the assets of Trust 1

under both §§2511 and 2519 (but that's okay because the gift will be covered by the spouse's exclusion amount); (4) the spouse's disclaimer of her interest in Trust 1 will not be treated as a gift of any assets held in Trust 2; (5) the assets of Trust 1 will not be included in Spouse's gross estate under §2044(a); and (6) the spouse's disclaimer of her interest in Trust 1 will not cause her interest in Trust 2 to be valued at zero under §2702. This seems like a helpful blueprint for getting assets out of a QTIP trust during the surviving spouse's life without triggering liability for gift tax.

B. In Vitro Fertilization Costs Not Deductible as Medical Expenses

In *Private Letter Ruling 202505002* (released January 31, 2025), the IRS stuck with its position that costs and fees arising from in vitro fertilization and the use of a gestational surrogate are not deductible medical expenses for a married couple that incurs them, though the IRS did concede that expenses of reproduction technology performed directly on the couple are deductible. The ruling involved a wife diagnosed with conditions requiring medication that is "contraindicated in pregnancy." The couple planned to hire a pregnancy surrogate that would carry a donated egg from a third party fertilized with sperm from the husband. The IRS said that the costs related to the surrogate affected the structure and function of the surrogate's body and not the wife's body; thus, the expenses did not qualify for a deduction under §213.

C. Interesting Plan for Dividing Retirement Accounts Between Charitable and Private Beneficiaries

In *Private Letter Ruling 202506004* (released February 7, 2025), the IRS considered proposed transactions involving a decedent's revocable living trust that was the beneficiary of all of her retirement accounts. The trust instrument provides that upon her death, the trust shall terminate, with a certain percentage of the value of trust assets payable to individual beneficiaries and the remainder to charities selected by the trustee. After the decedent's death, the trustee formed a charitable foundation to select the charities and make the distributions. The ruling states that the trustee proposed to receive a lump sum of cash from the retirement accounts, which the trustee will pay over to the foundation. Any amounts remaining in the retirement accounts after the charitable withdrawal would then pass to inherited IRAs for the individual beneficiaries in a trustee-to-trustee transfer. The IRS ruled that as long as the trustee pays the lump sum to the foundation in the same taxable year as the withdrawal, the trust will qualify for a charitable income tax deduction under §642(c)(1) equal to the amount of gross income received by the trust from the distribution. Interestingly, the IRS also ruled that the transfer (and division) of the remaining retirement accounts via trustee-to-trustee transfers into inherited IRAs for the benefit of the individual beneficiaries "will not result in taxable distributions or payments under §§402(c) or 408(d)(1) to Trust." Note that by citing §402(c), this ruling includes transfers of 401(k) accounts even though the trust is not a designated beneficiary. That seems contrary to the statutory regime, but there it is.