Recent Developments
By the Trusts and Estates Team of Moore & Van Allen PLLC

Federal Statutes

Statutory exception added to excess business holding tax for independently-operated, philanthropic businesses owned by a private foundation.

The Philanthropic Enterprise Act of 2017 was signed into law on Feb. 9, 2018 as part of the Bipartisan Budget Act of 2018. The act was originally proposed as part of Public Law 115-97 (the major 2017 federal tax act) and was heavily championed by the Newman’s Own Foundation, which owns 100% of a for-profit business that produces and sells food products. The act adds Section 4943(g) to the Code creating an exception to the excess business holdings rule for private foundations owning a for-profit company if the following three tests are satisfied: (i) the ownership test, under which 100% of the voting stock of the business must be held by the private foundation and the foundation’s interests must have been acquired by means other than by purchase (i.e., by gift or inheritance), (ii) the all-profits-to-charity test, under which the business must distribute an amount equal to its “net operating income,” as defined in the Code, to the foundation within 120 days after the close of the business’s tax year; and (iii) the independent-operation test, under which (a) no substantial contributor or family member can be a director, officer, trustee, manager, employee, or contractor of the business, (b) a majority of the foundation’s board of directors must be neither directors or officers of the business nor family members of a substantial contributor to the foundation, and (c) no loans can be outstanding from the business to a substantial contributor or family member.

Federal Administrative Developments

Service to issue guidance regarding attempted charitable deductions for contributions to state funds and receipt of state and local taxes credit.

In Notice 2018-54 (May 23, 2018), the Service indicated that contributions by taxpayers to state funds in return for a credit for state and local taxes that would otherwise be required to be paid will not qualify as a charitable contribution deduction for federal income tax purposes. Forthcoming Regulations will invalidate any such deduction based the contribution and subsequent receipt of a tax credit as being a form-over-substance attempt to circumvent the new $10,000 limit on federal deductions for state and local taxes.

Service issues guidance regarding sale of life insurance policies.

In Notice 2018-41 (May 1, 2018), the Service issued transitional guidance and proposed regulations regarding the new Code Sections 6050Y and 101(a)(3) added by Public Law 115-97. The notice outlines the new reporting requirements under Code Section 6050Y for purchasers and issuers of insurance policies under life settlement contracts. In addition, the notice highlights the impact of Code Section 101(a)(3), which provides that in the case of a transfer of life insurance under a life settlement contract between the policy owner and third party unrelated to the insured, the amount of death benefits excludible from gross income under Code Section 101(a)(1) shall not exceed an amount equal to the sum of the actual value of the consideration paid in the sale and the premiums or other amounts paid by the transferee, despite the exception to such limitation under Code Section 101(a)(2) for transfers of insurance policies between related parties in which the transferee’s basis is determined with respect to the transferor’s basis in such policy. Further, the Treasury and the Service issued proposed regulations regarding the reporting requirements under Code Section 6050Y and indicated that reporting will not be required under final regulations have been issued, at which time taxpayers will be granted extended time to file such reports for transactions occurring before the final regulations are released. The Service requested comments to the proposed regulations, and the comments period ended on June 13, 2018.

Service to issue guidance regarding income tax treatment of income from alimony trusts.

In Notice 2018-37 (April 12, 2018), the Service indicated that it intends to issue Regulations clarifying the income tax treatment of alimony trusts in light of the changes to the taxation of alimony payments under Public Law 115-97 and the corresponding repeal of Code Section 682. The forthcoming Regulations will provide that Code Section 682, as in effect prior to its repeal, remains applicable to the income tax treatment of alimony trusts created pursuant to divorce or separation instruments entered into on or before Dec. 31, 2018 and will continue to apply thereafter unless the parties to a divorce or separation instrument later modify the instrument and agree that the new tax regime applies to the modified terms. Comments have also been requested for any related clarification needed as to the grantor trust status of an alimony trust.

Service announces intention to issue regulations regarding the new net investment income tax applicable to educational institutions.

In Notice 2018-55 (June 8, 2018), the Service announced its intention to release regulations regarding the determination of an educational institution’s basis in property held on Dec. 31, 2017 for purposes of calculating the net investment income tax imposed on educational institutions under Code Section 4968 and the ability of such educational institutions to net capital gains and losses for purposes of calculating such tax. The Service has requested comments regarding the proposed regulations, and the comments period will end on Sept. 6, 2018. The Service intends to propose regulations stating that an educational institution’s basis in property held on Dec. 31, 2017 for purposes of calculating the net investment income tax is no less than the fair market value of such property as of Dec. 31, 2017, plus or minus any adjustments to basis made after Dec. 31, 2017. Until proposed regulations are released, taxpayers may rely on the notice for determining the basis of such property.
Service clarifies methods used to contact taxpayers.

In Fact Sheet 2018-12 (May 31, 2018), the Service detailed the methods of communication it uses to contact taxpayers, as well as methods not used by the Service, in order to help taxpayers avoid scams.

Service releases new online charity search tool.

In IR-2018-116 (May 7, 2018), the Service described the functions of its new online charity search tool, Tax Exempt Organization Search (TEOS). TEOS replaces EO Select Check. It offers access to more information than EO Select Check, including recent Forms 990 for charities and favorable determination letters issued by the Service since 2014.

Service releases updated and consolidated guidance for donors and grant-makers regarding reliance on tax-deductibility of contributions to charities.

In Rev. Proc. 2018-32 (May 16, 2018), the Service released new guidance and consolidated Revenue Procedures and other guidance previously released regarding the ability of donors and grant-makers to rely on the tax-deductible status of contributions to charities as known to the public. The Service detailed sources where donors and grant-makers could locate a list of tax-exempt organizations and described the extent to which such individuals could rely on those sources. The released guidance also provides several safeguards for donors and grant-makers to ensure that their contributions will be tax-deductible.

Service revokes tax-exempt status of foundation operating for private benefit of foundation insiders.

In PLR 201816012 (April 20, 2018), the Service revoked the tax-exempt status of a foundation when suspicious payments to and purchases on behalf of the foundation's officers were not substantiated on audit. After the delay of a government contract, which was the foundation's main source of funding, the foundation suspended its services. When services resumed, they were on a much smaller scale. During the period of suspension and reduced service, the foundation continued to make significant distributions to the officers operating the foundation, including the payment of the officers' personal credit card bills and travel expenses. Although the foundation claimed such payments were reimbursement for expenses paid on behalf of the foundation by the officers, the foundation did not substantiate these claims. Because the burden rests on the foundation to justify these expenses and it failed to satisfy such burden, the Service found that the payments were a series of excess benefit transactions under Code Section 4958(c) as the officers, who were disqualified persons under Code Section 4958(f) with respect to the foundation, received a direct economic benefit. The Service thus revoked the foundation's tax-exempt status under Code Section 501(c)(3), as the excess benefit transactions were substantial in relation to the foundation's operations and the foundation did not attempt to correct any of such transactions.

Service rules that modification of GST exempt trust meeting safe harbor modification standards for grandfathered GST trusts has no GST tax consequences.

In PLR 201814005 (April 6, 2018), the Service found that no GST, gift, or income tax consequences would result from the court-approved modification of a post-1985 GST exempt trust when (i) the primary beneficiary's mandatory income interest in the trust would be converted to a discretionary income interest, but any unpaid income would be accumulated in an account separate from trust principal, which account would be payable to the primary beneficiary's estate upon the primary beneficiary's death, (ii) the primary beneficiary's powers of withdrawal over half of the trust principal at age 25 and all of the trust principal at age 30 would be converted into testamentary general powers of appointment over half of the trust principal if the primary beneficiary had reached age 25 at death and all of the trust principal if the primary beneficiary had reached age 30 at death, (iii) the standard of distribution for the beneficial interest of one of the trust's contingent remainder beneficiaries would be amended to conform to the requirements of a special needs trust, and (iv) the remainder beneficiary of the contingent special needs trust would be amended to be a charity. The Service indicated that even though no guidance exists regarding the GST tax consequences of modifying a GST exempt trust, any such modification that stays with the safe harbor prescribed by Regulations Section 26.2601-1(b)(4)(i) for the modification of grandfathered GST exempt trusts would not have adverse GST tax consequences.

Conversion of income trust to total return unitrust pursuant to state statute did not affect GST tax exempt status of trust.

In PLRs 201820007 and 201820008 (May 18, 2018), the Service ruled that the decanting of two post-1985 GST exempt trusts did not result in the loss of the GST exempt status of the new trusts. In addition to certain administrative changes to the terms of the original trusts made by the decanting, the resulting trusts provided that in default of an exercise of a child's testamentary limited power of appointment, the trust assets would pass to the child's issue in further trust in per stirpital shares, with each trust beneficiary having a testamentary general power of appointment at death, as opposed to the trust assets passing to the child's issue outright under the terms of the original trusts. Because a testamentary general power of appointment resulting in the inclusion of the trust property in the respective estates of the trust beneficiaries was "viewed as functionally equivalent to granting outright ownership," the terms of the resulting trusts were found not to shift a beneficial interest in the trust property to a lower generation or extend the time for vesting of any beneficial interest beyond the periods provided for in the original trusts and therefore not adversely affect the GST exempt status of the trusts.

In PLR 201825007 (June 22, 2018), the Service found that neither the conversion of a grandfathered GST exempt trust from an income trust to a total return unitrust nor the state statute that determined the income tax character of unitrust distributions to the income beneficiary affected the GST exempt nature of the trust. Because the conversion and the tax characterizations were authorized by state statute and met the requirements for determining what constitutes income under Regulations Section 1.643(b)-1, the conversion did
ance, the total premiums paid on the policies, and the cash surrender value of the policies as of the day before the insureds’ deaths. In addition, during the insureds’ lifetimes, the decedent could terminate the split-dollar agreements, but only with the consent of the trustee of the irrevocable trust (the requirement of the consent of the irrevocable trust to terminate the split-dollar agreements being referred to as the “termination restriction”). Upon any such termination, the irrevocable trust could choose to retain the policies or to surrender the policies to the bank to satisfy the loan. If the irrevocable trust retained the policies, the decedent would receive the greater of the total premiums paid on the policies or the cash surrender value of the policies. If the irrevocable trust surrendered the policies, the decedent would receive the excess of the cash surrender value after the satisfaction of the loan. When the decedent died the following year, the decedent’s estate valued the decedent’s interests under the split-dollar agreements at approximately $183,700, which represented the total present value of the proceeds anticipated to be payable to the decedent upon the deaths of the insureds. The Service claimed in return that the policies were includible in the decedent’s gross estate under Code Sections 2036 and 2038 and were valued for estate tax purposes at $9,611,624, representing their total cash surrender value as of the decedent’s death, in accordance with Code Section 2703.

The decedent’s estate requested summary judgment that Code Section 2036, which includes transferred property in a decedent’s taxable estate when the decedent retained the power to designate the persons who could possess or enjoy the property, and Code Section 2038, which includes transferred property in a decedent’s taxable estate when the decedent retained the power to alter, amend, revoke or terminate the transfer, did not apply because the decedent retained no such powers with respect to the property transferred, as the decedent could only terminate the split-dollar agreement with the consent of the irrevocable trust. The Tax Court denied such summary judgment because under the express terms of those Code sections, the decedent’s powers are applicable even if they can only be exercised in conjunction with another person. The estate then argued that, even if the decedent were found to have retained sufficient rights with respect to the trust property for Code Sections 2036 and 2038 to apply, the exceptions under those sections for bona fide sales for adequate and full consideration should apply. According to the estate, the decedent’s transfer of the loan proceeds to the irrevocable trust was a bona fide sale because the arrangement was established for the legitimate business purpose of providing sufficient liquidity for the transfer of the decedent’s son’s business upon his death. The court found that there were insufficient facts to establish such business purpose and further found that the transfer was not for full and adequate consideration because, by the estate’s own calculations, the decedent’s rights under the split-dollar agreements were worth less than 2% of the amount of the loan proceeds initially transferred to the trust.

The estate also requested summary judgment that Code Section 2703, which disregards for gift and estate tax valuation purposes certain restrictions on the transfer or use of property in transfers between family members, does not apply to the split-dollar agreements (the estate’s desired result being that the termination restriction discounted the decedent’s interest in the life insurance policies). The court denied such summary judgment, finding that Code Sections 2703(a)(1) and (2) applied to disregard the provisions of the split-dollar agreements for valuation purposes because the split-dollar agreements were agreements to acquire or use property at a price less than fair market value and the termination restriction was a restriction on the decedent’s right to use the trust property. The court re-
ected the estate's assertion that the termination restriction was part of the property being transferred, as it was a term of the contract creating the decedent's rights under the split-dollar agreements, rather than a restriction on the property being transferred. The court also rejected the estate's argument that Code Section 2703 is not applicable to split-dollar agreements because split-dollar agreements are more analogous to promissory notes, to which Code Section 2703 does not apply, finding that the irrevocable trust did not bargain for its benefits under the split-dollar agreements and was not required to pay any interest payments. In addition, the court rejected the estate's analogy comparing the split-dollar agreements to partnerships, finding that the split-dollar agreements were not separate state law entities. The court also rejected the estate's argument that Code Section 2703 only applies to options or buy-sell agreements, as the estate cited no relevant authority supporting such claim.

Finally, the estate argued that summary judgment should be granted rejecting the Service's positions described above because including the policies' cash surrender value in the decedent's estate would result in a double counting of transferred property for gift and estate purposes as under Regulations Section 1.61-22, following the decedent's death, the decedent's successors under the split-dollar agreements would be deemed to make annual gifts of the cost of current life insurance under the agreements. The court disagreed, noting that any such gifts would be made by persons other than the decedent, and only the decedent's transfers were applicable for purposes of double-counting. The court also noted that Regulations Section 1.61-22 does not govern the estate tax consequences of split-dollar agreements.

*Court denies summary judgment on issue of application of Code Section 2703 in inter-generational split-dollar agreements.*

In *Estate of Morrissette v. Comm'r*, No. 4415-14 U.S. Tax Court (June 21, 2018), the Tax Court followed its decision in *Estate of Ca-hill v. Comm'r* (discussed above) in denying an estate's request for summary judgment that Code Section 2703 does not apply for purposes of valuing a decedent's rights under split-dollar agreements for estate tax purposes. Involving the same split-dollar agreements at issue in *Estate of Morrissette v. Comm'r*, 146 T.C. 171 (2016), the decedent had the right to terminate the split-dollar agreements only with the consent of the trustee of the irrevocable trust that owned such policies under the split-dollar agreements.

*Taxpayer's death before conclusion of annuity term resulted in entirety of grantor retained annuity trust (GRAT) assets being included in taxable estate.*

In *Badgley v. U.S.*, 121 AFTR 2d 2018 (N.D. Ca. May 17, 2018), the federal district court for the Northern District of California found that the full value of assets owned by a GRAT was to be included in a taxpayer's estate under Code Section 2036(a)(1) when the taxpayer, who was the grantor of the trust, died during the annuity term. The executor of the taxpayer's estate argued that a right to GRAT annuity payments did not necessarily constitute a retained interest in trust income, which would otherwise cause the trust assets to be included in the taxpayer's estate pursuant to Code Section 2036(a)(1), because the taxpayer had no express right to trust income, as compared to the right to a fixed annuity amount, and because of the related uncertainty of the source of GRAT annuity payments as between trust income and trust principal. The court rejected those arguments, however, after examining the Supreme Court's broad, “pragmatic” treatment of Code Section 2036(a)(1) and its predecessor statutes in related controversies and other persuasive authority and considering the tax avoidance measures that GRATs might enable if the executor's position were sanctioned. Relatedly, the court determined that Regulations Section 20.2036-1(c)(2)(i), which expressly provides for the property of a GRAT to be included in a taxpayer's estate if the taxpayer predeceases a GRAT term, is a reasonable and therefore valid interpretation of Code Section 2036(a)(1).

*Property held in taxpayer's grantor trust was subject to tax lien for taxes owed by taxpayer.*

In *U.S. v. Nelson et al.*, S.D.S.D. CIV 17-4002 (May 25, 2018), the United States District Court for the District of South Dakota, Southern Division, in adhering to precedent, found that a federal tax lien could be attached to the taxpayer's home held in the name of an irrevocable grantor trust created by the taxpayer because the trust was merely a nominee for the taxpayer. In the absence of applicable South Dakota law, the court applied a traditional six factor test to determine if the trust was a nominee of the taxpayer, with such factors including (i) whether consideration was paid in transferring the property to the nominee, (ii) whether there is a close relationship between the nominee and the transferor, (iii) whether the transferor retained possession of the property transferred, and (iv) whether the transferor continues to enjoy the benefits of the transferred property. Because no consideration was paid when the property was transferred in the name of the trust, the taxpayer personally paid property taxes on and granted a right of way over the property held in the trust, and the taxpayer continued to reside in the home held by the trust, the court found that the trust was a nominee for the taxpayer and, as such, the tax lien could attach to the property.

*Fraudulent transfer by debtor under federal tax judgment reversed despite Service's claim for reversal being untimely under state law.*

In *U.S. v. Wight*, W.D. Wash. No. 2:16-cv-01556 (June 11, 2018), an individual owed the Service more than $2 million at the time the individual's sister died. The individual was named the personal representative and sole beneficiary of the sister's estate. In her capacity as personal representative, the individual gratuitously transferred a $405,000 parcel of real property from the estate to her grandson. The Service moved to set aside the transfer as fraudulent, and the court agreed. The grandson claimed that the Service's claim was time-barred by the four-year statute of limitations applicable to claims under the Washington Uniform Fraudulent Transfers Act (UFTA). However, the court found that the UFTA statute of limitations did not apply because the Service's right to collect arose under federal law. The court noted that though the statute of limitations for the collection of tax debt is typically ten years, once such tax liability has been reduced to judgment (as it had been in the case of the individual), no statute of limitations applies to the collection of the debt at all.

*Divided First Circuit panel upholds taxpayer-favorable Roth IRA transaction system involving domestic international sales corporations.*

In *Benenson v. Comm'r*, 1st Cir. Nos. 16-2066, 16-2067 (April 6, 2018), two taxpayers shifted millions of dollars in C corporation
revenue into Roth IRAs over a six-year period. The taxpayers made nominal initial contributions to two Roth IRAs, and the Roth IRAs then formed a domestic international sales corporation (DISC), a type of organization defined under Code Section 992 that can receive tax-free commissions with respect to the export sales of another corporation (which corporation can be related to the DISC). A DISC owned by the same shareholders as the exporter corporation essentially provides the shareholders a corporate income tax break with respect to the DISC commissions, since the commissions are deductible by the exporter corporation and are not taxable to the DISC. The Roth IRAs in Benenson contributed their DISC shares to a holding company, and then the DISC began collecting commissions from an exporter corporation owned by the family of the Roth IRA owners. The DISC commissions were taxed at the corporate income tax rate when distributed to the holding company but were not further taxed when the net proceeds were then distributed to the Roth IRAs (the holding company did not cause unnecessary tax because the DISC rules would have made distributions directly from the DISC to the Roth IRAs taxable at the applicable corporate income tax rate). As a result of the transaction system, each Roth IRA accumulated more than $3 million within six years. The Service recharacterized the system as the taxpayers making contributions to the Roth IRAs in excess of the annual contribution limit, and the Tax Court agreed. However, the Sixth Circuit overturned the Tax Court's ruling as applied to the exporter corporation in 2017, and the First Circuit here agreed with the Sixth Circuit as applied to the Roth IRA owners. The majority of the three-judge First Circuit panel found that because all elements of the transaction complied with the Code, and the intent of the Code provisions regarding DISCs and Roth IRAs was to enable taxpayers to pay less tax, the transaction was not inconsistent with Congressional intent. The dissenting judge would have applied the common law “substance over form” doctrine to quash the transaction.

**Taxpayer not required to file federal income tax returns during years of bona fide residency in United States Virgin Islands.**

In *Estate of Travis L. Sanders et al. v. Comm'r*, T.C. Memo 2018-104 (July 5, 2018), the Tax Court found that a taxpayer satisfied the four part test to establish himself as a bona fide resident of the United States Virgin Islands (the “USVI”) in two out of three tax years at issue. If an individual is a bona fide resident of the USVI, then he or she must only file income tax returns in the USVI, whereas if an individual is not a bona fide resident of the USVI and he or she receives income from sources in the USVI, the individual must file income tax returns both in the USVI and in the United States. During two of the three tax years at issue, the taxpayer’s (i) intent, (ii) physical presence, (iii) social, family, and professional relationships, and (iv) own representations indicated that he was a bona fide resident of the USVI and, thus, the notice of deficiency issued by the Service for those tax years was inapplicable. Because the taxpayer was not a bona fide resident of the USVI in one of the tax years at issue, and he was thus required to file an income tax return in the United States for such year, the statute of limitations for the Service to assess a deficiency for that taxable year had not commenced, and the notice of deficiency the Service did issue for that year was not time-barred. However, the court found that because the taxpayer relied on the advice of an accountant and attorney in not filing a federal return for that year, the taxpayer acted with reasonable cause and was thus not subject to the imposition of penalties under Code Section 6651(a)(2).

**Settlement agreement for repatriation of off-shore trust assets for bankruptcy estate invalidated.**

In *Olson v. Marshack*, 2018 U.S. Dist. LEXIS 74693, 2018 WL 2059648 (C.D. Ca. April 30, 2018), the federal district court for the Central District of California, on appeal from the district's bankruptcy court, reversed the bankruptcy court's decision approving a settlement agreement entered into by a bankruptcy trustee involving assets held in a Cook Islands trust created by the debtor. The bankruptcy trustee, having difficulty repatriating assets from the trust to satisfy claims against the debtor's bankruptcy estate even after the debtor was jailed for contempt of court, had agreed with the debtor's father, as guardian ad litem for the debtor's two minor children who were the beneficiaries of the trust, to provide for the return of the trust assets and direct 80% of the assets to the bankruptcy estate and 20% to a new California created trust for the benefit of the children. The bankruptcy court had approved the settlement under the reasoning that any recovery of the trust assets would be advantageous over none of the trust assets being available for satisfaction of creditors’ claims. The district court rejected the approval of the settlement, however, on the basis that the trust property was not part of the bankruptcy estate, since it had been transferred to the Cook Islands trust prior to the filing of the bankruptcy petition, and that the bankruptcy court took into account irrelevant factors in approving the settlement. The trust property was not part of the bankruptcy estate at the time of the settlement agreement because no formal fraudulent transfer claim had been pursued by the bankruptcy trustee. Even if the trust property had been part of the bankruptcy estate, the bankruptcy court gave too much deference to the parties’ reliance on the terms of the settlement in repatriating the trust assets, approved the settlement without any involvement in the negotiations or the agreement by the primary creditor of the bankruptcy estate or the court, ignored the debtor’s misconduct and disregard of the bankruptcy court's orders to repatriate the trust assets, and gave too much weight to the potential effects of refusing to follow the terms of the settlement on the incentives for other debtors to cooperate in bankruptcy proceedings involving offshore trust assets. The court found, therefore, that on an equitable basis, the settlement should not be approved and should not allow the debtor to benefit, even indirectly, from a portion of the trust assets continuing to be held in trust for her children.

**Tax Court voids charitable deduction for contribution of land to city due to implied quid-pro-quo arrangement.**

In *Triumph Mixed Use Investments III v. Comm'r*, T.C. Memo 2018-65 (May 15, 2018), the Tax Court disallowed an $11.04 million charitable deduction for the contribution of land to a city, finding that the real estate development partnership that transferred the land had received consideration for contributing the land in the form of development rights approved by the city. The transfer instruments declared that the transfer was gratuitous, and the city was not bound to approve the development rights as a direct result of the transfer, but the court found that the circumstances indicated a quid-pro-quo arrangement. The court found that because the development rights had more than incidental value and the development partnership
had made no effort to ascertain the value of the development rights as consideration received for the transfer of the land, the entire charitable deduction was forfeited.

Court denies tax-exempt status to foundation providing consulting services.

In Abovo Foundation, Inc. v. Comm’r, T.C. Memo 2018-57 (April 30, 2018), the Tax Court denied tax-exempt status to a foundation formed by a doctor to provide medical consulting services and patient safety initiatives allegedly intended to reduce the U.S. government’s burden under the Patient Safety Act. The court found that the foundation’s services and initiatives would not reduce the government’s burden, but rather would serve the doctor’s interest by paying him an annual salary in excess of $217,000 and expanding his professional network to advance his consulting practice.

Court revokes tax-exempt status of organization not operating solely for charitable purposes and privately benefitting founder.

In Association for Honest Attorneys v. Comm’r, T.C. Memo 2018-41 (April 3, 2018), the Tax Court revoked the tax-exempt status of an organization that was purportedly formed to educate the public about the legal system and to discourage litigation. The court found that the founder, who was not a licensed attorney, did not provide educational services and instead accepted payments for providing legal services. In a separate case, the founder was convicted of the unauthorized practice of law and violations of the Kansas Consumer Protection Act. In addition to failing to operate exclusively for charitable purposes, the court found that the organization operated for the primary benefit of the founder. The founder used the organization’s checking account to pay for personal expenses such as grocery shopping, car purchases, home repair services, and tuition for the founder’s son. Because the organization did not operate exclusively for charitable purposes and was operated primarily for an individual’s private benefit, rather than for the public at large, the court revoked the organization’s tax-exempt status under Code Section 501(c)(3).

Excess distributions to one of two S corporation shareholders did not cause termination of S election.

In Mowry v Comm’r, T.C. Memo 2018-105 (July 5, 2018), a taxpayer and his brother owned an S corporation in 49% and 51% shares, respectively. The taxpayer discovered that his brother was siphoning off company funds for personal expenses, such that the taxpayer’s actual share of distributions from the company over a two-year period was about 15%. To avoid being liable for income taxes with respect to a 49% share of the company’s income during the two-year period, the taxpayer petitioned the Service to find that the company’s S election had been effectively terminated pursuant to the excessive distributions to the brother because such distributions in essence reflected that the corporation had two distinct classes of stock, in violation of S corporation rules. The taxpayer claimed that the company was a C corporation during the two-year period and that therefore the taxpayer should only be taxed on the dividends the taxpayer received from the company. However, the company’s governing documents contained no evidence of any second class of stock, and the taxpayer had himself represented that the corporation was an S corporation on his income tax returns for the years in question. Therefore, the court held that the corporation was an S corporation during the applicable years.

Court denies deduction of net operating losses when taxpayer had insufficient basis to claim such losses.

In Bobby R. Hargis et ux. v. Comm’r, 10th Cir. Ct. App. (June 22, 2018), the Court of Appeals for the Tenth Circuit upheld a Tax Court decision denying the deduction of net operating losses claimed by taxpayers claimed from pass-through entities because the taxpayers did not have sufficient basis in those entities to take such losses. The husband owned an interest in several S corporations that operated nursing homes. The S corporations borrowed funds to finance the operating of the nursing homes, with the husband serving as guarantor or co-borrower on each of the loans. The court found that these loans were not an economic outlay of the husband and did not increase the husband’s basis in the S corporations because he did not make the loans directly to the S corporations, had not been required to satisfy the guaranty, and may never be required to pay the debt as co-borrower. Because the husband’s basis in the S corporations was not increased by the loans, the court denied the net operating losses in excess of the husband’s basis under Code Section 1366, which limits the deduction of net operating losses to a shareholder’s adjusted basis in an S corporation. The wife owned an interest in several LLCs which were treated as partnerships for tax purposes. Although the wife claimed that she had loaned money to the LLCs and should thus receive an increased basis under Code Section 752, she did not supply any documentation to support such claims. Because the wife was unable to substantiate her claim for an increased basis in the LLCs, the court denied the net operating losses in excess of her established basis under Code Section 704, which limits the deduction of net operating losses to a partner’s adjusted basis in a partnership.

Court upholds partnership late-filing penalty for an LLC solely owned by a married couple.

In Argosy Technologies, LLC v. Comm’r, T.C. Memo 2018-35 (March 22, 2018), the Tax Court upheld a penalty for failure to timely file partnership returns for an LLC solely owned by a married couple when the LLC had held itself out to be a partnership. The married couple argued that the late-filing penalty could not apply to the LLC because it was not a partnership, as it was solely owned by a married couple and should therefore be treated as a single-member LLC. The court noted that, during the tax years at issue, the LLC filed partnership tax returns, albeit untimely, and elected for any audit to be conducted under the TEFRA partnership audit regime to the extent such regime was still in force. In addition, the court indicated that an LLC owned by a married couple is not a disregarded entity by default and noted that the couple never filed an election under Code Section 761(f) for the LLC to be treated as a qualified joint venture rather than as a partnership.

Taxpayer not entitled to deduct personal living expenses of taxpayer’s college-student children employed by taxpayer’s business.

In Wax v. Comm’r, T.C. Memo 2018-63 (May 10, 2018), the Tax Court disallowed $84,000 in business deductions claimed by a taxpayer with respect to “meals and entertainment” and “employee
Couple unable to claim insolvency after transferring assets to son while still retaining access to assets.

In Hamilton v. Comm’r, T.C. Memo 2018-62 (May 8, 2018), a married couple transferred more than $300,000 to their son in the same year that they experienced a discharge of indebtedness of more than $150,000. The funds transferred to the son were placed in an account in the son’s name, but the son’s mother had access to the account and regularly transferred funds from the account to the couple’s account and used those funds to pay the couple’s expenses. The couple claimed that they owed no income tax with respect to the discharge of indebtedness due to insolvency, but the Tax Court found that under Utah law, the assets of the son’s account were owned by the couple and held by the son only as nominee for the couple, and therefore the couple was not insolvent and owed income tax with respect to the discharge of indebtedness.

Court denies equitable innocent spouse relief when requester did not suffer economic hardship and may have intentionally concealed assets.

In Hale v. Comm’r, T.C. Memo 2018-93 (June 26, 2018), after a taxpayer died, his widow learned that the couple was liable for unpaid joint income taxes for six consecutive years, resulting in a tax liability of more than $1.8 million. The taxpayer’s probate estate did not have sufficient assets to satisfy the tax liability, but the taxpayer had purchased approximately $8 million in life insurance on his own life, the proceeds of which were paid to the widow following the taxpayer’s death. After receiving the proceeds, the widow transferred more than half of the proceeds to her parents. The widow then filed a request for “innocent spouse relief” from the income tax liability and did not disclose the insurance proceeds with the rest of her assets in such request. However, subsequently, a portion of the insurance proceeds were applied to satisfy the tax liability, and the widow then sought a refund based on the innocent spouse relief request. The court applied the weighted factors test for equitable innocent spouse relief from Revenue Procedure 2013-34 and found that although the widow reasonably expected the taxpayer to make the income tax payments indicated under their joint returns (the taxpayer having controlled virtually all of the couple’s finances), the widow’s lack of economic hardship and apparent attempt to conceal the insurance proceeds indicated that relief would not be proper.

Taxpayer prevented from suing Service for intentional infliction of emotional distress.

In Kennedy v. Comm’r, E.D. Pa. No. 5:18-cv-00257 (June 18, 2018), a taxpayer sued the Service for intentional infliction of emotional distress after the Service sent the taxpayer a letter asserting that he owed approximately $76,000 in taxes. The court ruled that the taxpayer could not advance the claim because the Federal Tort Claims Act provides that the United States does not waive its sovereign immunity with respect to claims “arising in respect of the assessment or collection of any tax.” The court took note of Code Section 7433, which permits a cause of action if a Service employee negligently, recklessly, or intentionally disregards the provisions of the Code in collecting federal taxes, but the taxpayer represented in court filings that such Code section was not relevant to his case.

North Carolina Statutes

Costs of actions under Uniform Power of Attorney Act are comparable to costs for estate administration actions.

Under North Carolina Session Law 2018-40 (June 22, 2018), N.C.G.S. Section 7A-307 was amended to clarify that the same court costs required to be paid for an estate administration, an estate proceeding under N.C.G.S. Section 36C-2-203, or a trust proceeding under N.C.G.S. Section 28A-2-4 are imposed upon a judicial proceeding under the North Carolina Uniform Power of Attorney Act pursuant to N.C.G.S. Section 32C-1-116(a).

North Carolina Cases

North Carolina Supreme Court confirms “as applied” unconstitutionality of North Carolina trust taxation statute.


Banks have no duty to decline or report “suspicious” transfers requested by legally competent customers with reduced mental capacity.

In Napoli v. Scottrade, Inc., N.C. Ct. App. No. 17-783 (June 5, 2018), after a guardian sued her ward’s bank and brokerage firm to recover more than $80,000 that was transferred by the ward before the ward was adjudicated incompetent, the North Carolina Court of Appeals upheld the dismissal of the claim against the bank, finding that banks do not have (i) a duty to deny access to funds to a customer with reduced mental capacity but who has not been adjudicated incompetent when the customer requests transfers that may be “suspicious” or (ii) a general duty to report any such requested transfers. The court rather found that banks have an affirmative duty to comply with such requests. The court provided that the relationship between a depositor and bank is a creditor-debtor relationship and is not a fiduciary relationship absent special circumstances (which were not found in this case). The court took note of N.C.G.S. Section 108A-115, which requires banks to notify law enforcement when they have reasonable cause to believe an elderly or disabled person is being financially exploited, but the court ruled that no duty could be implied with respect to the instant case pursuant to such statute because the statute became effective after the transfers in question took place.

Other State Developments

Grantor of grantor trusts has no claim under Ohio law for “equitable reimbursement of income taxes.”
In Millstein v. Millstein, Ohio Ct. of Appeals No. CV-17-883760 (June 14, 2018), a grantor created two irrevocable trusts that by their terms were grantor trusts for income tax purposes, such that the grantor was responsible for paying the trusts’ income taxes. The grantor later determined he did not want to continue to pay the trusts’ income taxes, but having no way to unilaterally terminate the trusts’ grantor trust status, and in the absence of full cooperation from the trustee and beneficiaries of the trusts to such end, the grantor sued the trustee of the trusts for “equitable reimbursement of income taxes.” The trial court dismissed the claim, and the Ohio Court of Appeals upheld the dismissal. The Court of Appeals noted that under the Ohio Trust Code (which is similar to the North Carolina Uniform Trust Code), only the trustee or a beneficiary of a trust may bring an action to modify the trust “to achieve the settlor’s tax objectives,” and the court reasoned that when a party’s rights are clearly defined by law, equity will not provide a remedy circumventing such law. The court further noted that the grantor himself established the trusts as grantor trusts and that “equity will not aid a volunteer.”

**Florida court denies termination of trust desired by beneficiaries.**

In Horgan v. Cosden, No. 2D17-1354, District Court of Appeals of Florida Second District (May 25, 2018), the District Court of Appeals of the Florida Second District granted summary judgment in favor of a co-trustee challenging the termination of an irrevocable trust. The beneficiaries and a co-trustee of the trust, who was also the sole income beneficiary of the trust, entered into a settlement agreement to terminate the trust and to pay the remaining trust assets to the beneficiaries of the trust in accordance with their actuarial interests in the trust. When the remaining co-trustee, who was not a party to the agreement, refused to terminate the trust, the income beneficiary co-trustee filed a petition for judicial termination of the trust. Though a lower court had granted summary judgment in favor of the income beneficiary co-trustee, the Court of Appeals here overruled, finding that (i) termination of the trust would violate the trust’s settlor’s intent, (ii) the purposes of the trust had not become wasteful as argued by the income beneficiary co-trustee, and (iii) termination of the trust was not in the best interests of the beneficiaries. Noting that the settlor’s intent governs in trust interpretation, the Court of Appeals found that the settlor intended to provide for the income beneficiary over the course of the income beneficiary’s lifetime and then to make distributions to the remaining beneficiaries upon the income beneficiary’s death. The inclusion of a spendthrift provision in the trust and the settlor’s failure to make a lump sum distribution to the income beneficiary, in contrast to other beneficiaries who received a lump sum, was evidence of such intent. The court also noted that the trust was not wasteful due to trustees’ fees and administrative expenses, as such fees and expenses were reasonable, and the settlor was aware of the nature of such fees and expenses since she addressed them in the trust document. The court stated that finding in favor of the income beneficiary co-trustee would allow beneficiaries to circumvent clear settlor intent simply by arguing that they wanted to receive money early in order to avoid the imposition of trustee fees.

**Automatic revocation of beneficiary designation incident to divorce under Minnesota law does not violate Contracts Clause of United States Constitution even when beneficiary designation pre-dates statute dictating revocation.**

In Sveen v. Melin, U.S. S. Ct. No. 16-1432 (June 11, 2018), the Supreme Court held that a Minnesota statute providing that divorce automatically revokes any beneficiary designation one ex-spouse has made in favor of the other (such as with respect to a life insurance policy) may operate with respect to a beneficiary designation made prior to the statute’s enactment without violating the Contracts Clause of the United States Constitution. The Contracts Clause prohibits state laws “impairing the obligation of contracts.” The court reasoned that (i) the statute advances, rather than impairs, the interests of the only party to a life insurance or similar contract that cares about the beneficiary designation, (ii) a third-party beneficiary whose interest is subject to revocation has no expectation to continue to benefit from such a contract when the beneficiary has recently become divorced from the policy or account owner, especially given the power of courts to order changes in beneficiary designations pursuant to divorce, and (iii) because the original beneficiary designation can be reinstated if desired, any interference by the statute with such a contract constitutes a minimal paperwork burden, like a recording requirement, the likes of which have been found before to be permissible under the Contracts Clause.

**Texas Supreme Court rules that cause of action does not exist for intentional interference with inheritance.**

In Archer v. Anderson, 2018 Tex. LEXIS 611, Tex. S. Ct. (June 22, 2018), the Texas Supreme Court determined in a 5-4 decision that no cause of action for intentional interference with inheritance exists under Texas law, resolving a difference of opinion among lower Texas courts regarding the existence of such cause of action. Intentional interference with inheritance is recognized under the Restatements (Second) and (Third) of Torts, as well as under North Carolina law, but the Texas Supreme Court reasoned that the causes of action for undue influence and duress under probate law and the equitable remedy of constructive trust to prevent unjust enrichment provided sufficient protection for victims of the type of harm that intentional interference with inheritance is intended to address. The court found the intentional interference with inheritance tort problematic because it presumes that prospective beneficiaries of an estate have some right to a decedent’s property prior to the decedent’s death, when, as a general matter of estate law, the decedent retains the full discretion until death to direct the disposition of the decedent’s property in any manner, whether fair or unfair. The court was not motivated to permit the intentional interference with inheritance tort to fill “gaps” in the opportunity for recovery under other causes of action, indicating by example that the limitations on actions for undue influence and duress precipitated by probate procedures represent legislative choice as opposed to legislative oversight. The minority opinion agreed with the majority of the court that no recovery for intentional interference with inheritance should be available in the instant case but disagreed that the cause of action should be barred entirely, citing manipulation of the elderly as a growing issue and supporting flexibility in the power of courts to prevent such manipulation.

**Child loses right to inherit from parent under West Virginia law when parent’s parental rights over child are terminated.**

In Hall v. Hall, No. 17-0452 (W.Va. S. Ct. of Appeals May 11, 2018), the Supreme Court of Appeals of West Virginia upheld the lower
court’s decision denying a child the right to inherit from her parent when that parent’s parental rights had previously been terminated. Several years before the parent’s death, the parent was charged with abuse and neglect of the child and voluntarily released his parental rights with respect to the child. The parent subsequently died intestate, unmarried, and with no descendants other than the child. Analogizing to West Virginia’s child welfare statute that continues a parent’s obligation for child support even after a parent’s parental rights are terminated, the child petitioned to take as the parent’s sole descendant under West Virginia’s intestacy statute. The court rejected the child’s argument, finding that the necessary parent-child relationship, as defined in the intestacy statute and not under the child welfare statute, did not exist when a parent’s rights had been terminated. As such, the child could not take as an intestate heir of the parent.

**Former trustee of California trust must disclose communications with legal counsel engaged on behalf of trust to successor trustees of trust.**

In *Morgan v. Superior Court*, 23 Cal. App. 5th 1026 (May 29, 2018), the court invalidated a trust provision purporting to protect a former trustee of the trust from having to disclose communications between the former trustee and his legal counsel, which communications were apparently made by the former trustee in his capacity as trustee, to successor trustees of the trust. The court indicated that when a trustee communicates with legal counsel on behalf of a trust, the attorney-client privilege belongs to the trust (and its office of trustee), and not to any particular trustee. The court noted that if a trustee “scrupulously and painstakingly” documents that an attorney-client relationship is undertaken by the trustee in the trustee’s individual, and not fiduciary, capacity, and the trustee pays all legal fees in connection with such relationship from the trustee’s own assets and not the assets of the trust, then communications in the context of such relationship could be protected from disclosure to successor trustees of the trust.

**Georgia governor vetoes self-settled asset protection trust legislation.**

On May 8, 2018, Georgia governor Nathan Deal vetoed Georgia HB 441, which would have specifically permitted self-settled asset protection trusts under Georgia law. In his veto statement, the governor provided that “[Georgia should] want to ensure that the creditor-debtor relationship is an equitable one that facilitates economic prosperity and mobility, and self-settled spendthrift trusts—without proper safeguards—have the potential to negatively impact this balance.”

**Maryland decouples state estate tax exemption from federal estate tax exemption.**

Under Maryland Senate Bill 646 (April 5, 2018), the State of Maryland revised its state estate tax under Section 7-309 of the Code of Maryland so that the state estate tax no longer couples with the federal estate tax starting in 2019 and, instead, provides for a state estate tax exemption of $5,000,000 plus any deceased spouse unused exemption amount from a taxpayer’s last predeceased spouse.

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