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Central Intelligence

June 2024

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INSURANCE PRODUCTS	MAY LOSE VALUE	NOT A DEPOSIT
NOT BANK GUARANTEED	NOT FDIC INSURED	
NOT INSURED BY ANY GOVERNMENT AGENCY		

LIFE-5115 6/24

Supreme Court upholds inclusion of life insurance proceeds when valuing business in *Connelly*

Connelly v. United States, **602 U.S. **** (2024).**

Facts

Upholding the Eighth Circuit Court of Appeals (which we reported in our **June 2023 edition**), the Supreme Court handed down its decision on June 6, 2024. The facts recited by the Supreme Court were much abbreviated. Decedent and his Brother were the sole shareholders of a Company; Decedent owned 77% and Brother owned 23% of the company. Decedent and Brother wanted to keep Company in the family, and entered into a buy-sell agreement that gave the surviving shareholder the option to purchase the deceased shareholder's interest; if the surviving shareholder did not exercise that option, Company was obligated to purchase the shares. Company purchased $3.5 million of life insurance on each shareholder to fund that obligation. Upon Decedent's death, Brother did not purchase Decedent's shares, and Company redeemed them, valuing Decedent's shares at $3 million (thereby valuing the company at $3.89 million). Brother, as executor of Decedent's estate, filed an estate tax return using that value; upon audit, the IRS included the full death benefit in the value of Company, arriving at a value of $6.86 million (about $5.3 million for Decedent's interest). The IRS disregarded Company's contractual obligation to purchase Decedent's shares with the insurance proceeds. As a result, the IRS issued a notice of deficiency; Decedent's estate paid the deficiency, but appealed the decision to the District Court. The District Court agreed with the IRS and upheld the deficiency, as did the Eighth Circuit Court of Appeals. Decedent's estate appealed to the Supreme Court, which granted certiorari.

Holding

Decedent's estate argued that Company's obligation to purchase Decedent's shares offset the life insurance proceeds; as a result, they did not include them when valuing the company for estate tax purposes. The IRS countered that Company's redemption obligation was not a liability that reduced Company's value. The Court agreed with the IRS, finding that a redemption does not reduce the value of those shares in and of itself. The Court noted that the estate tax is calculated at the time of death, and concluded that at Decedent's death, Company had not yet redeemed his shares. The Court also explained that the reduction in the number of shares after a redemption reduced the value of a business, but not the value of each share. While the Court allowed that this decision could affect succession planning, it found that was a consequence of this particular design and that there were other arrangements available to businesses, such as a cross-purchase agreement.

Takeaway

While the Court claims this is a narrow ruling, the decision barely mentions the facts of the case and is likely to have a significant impact on the use of entity redemption agreements for succession planning. We will have to wait to see how broadly courts interpret this ruling in subsequent cases — and since no client wants to be the case that tests the scope of the decision, practitioners will likely move away from entity redemption agreements, especially for clients with estate tax exposure.

DC Circuit upholds IRS imposition of penalties on foreign holdings, overturning Tax Court

Farhy v. Commissioner, **No. 23-1179 (D.C. Cir. May 3, 2024).**

Facts

Taxpayer designed a scheme to underreport his income by creating Belize-based corporations and transferring assets to them. In addition to failing to correctly report and pay his income taxes, Taxpayer also failed to report his control of foreign financial accounts and corporations that he used. In 2012, in exchange for immunity from criminal prosecution for tax code violations, Taxpayer signed a non-prosecution agreement (Agreement). Under the Agreement, Taxpayer agreed to pay all applicable taxes, interest, and penalties and to fully cooperate with tax enforcement efforts. The Agreement did not protect him from civil prosecution. The IRS notified Taxpayer in 2016 of his failure to report his ownership of foreign corporations pursuant to IRC §6038(a) for tax years 2003–2010. In 2018, the IRS assessed penalties of $60,000 per year under §6038(b). Taxpayer requested a hearing after receiving notice of the IRS's intent to levy his property to collect the penalties owed; the Appeals Office upheld the proposed levy. Taxpayer petitioned the Tax Court to invalidate the levy on the basis that the IRS could not assess penalties under §6038 but had to file a separate civil action. The Tax Court agreed with Taxpayer, and the government appealed.

Holding

The question before the Court was what mechanism Congress granted to the IRS to collect the penalties authorized in §6038(b). The Court reviewed extensively the IRS's power of assessment; the IRS can only enforce penalties that have been "assessed," essentially those that are officially and finally determined. The Court noted that "all taxes" are generally "assessable," as are many penalties, including those under Chapter 68. But there are certain tax-related penalties that are not assessable. The distinction is important, because assessable penalties generally preclude review – taxpayers are forced to first pay the penalty, and then sue for a refund. Congress, therefore, has provided for pre-collection review in two circumstances: a tax deficiency and a lien or levy of a taxpayer's property or rights to property. The Code does not explicitly say whether §6038 violations are assessable penalties. The IRS argued that §6201, which authorizes the IRS to assess "all taxes (including interest, additional amounts, additions to the tax, and assessable penalties)" was non-exhaustive and encompassed penalties outside of Chapter 68, including those under §6038. The IRS contended that the only limit to the IRS's authority under §6201 had to be expressly written in the Code. Taxpayer argued that §6201 only applied to penalties that were characterized either as a "tax" or "assessable." The Court declines to adopt either approach. After reviewing the "text, structure, and function" of §6038, the Court concludes it can be read as creating an assessable penalty, thereby falling directly within the IRS's explicit authority to collect under §6201. The Court also notes that Congress has acquiesced "to the IRS's practice of assessing section 6038(b) penalties" for over 40 years, and that "'congressional failure to revise or repeal the agency's interpretation is persuasive evidence that the interpretation is the one intended by Congress.'"

Takeaway

The Tax Court heard a similar case before the DC Circuit issued its decision, and found once again that §6038(b) penalties were not assessable (*Mukhi v. Commissioner, 162 T.C. 8 (2024)*). That case, if appealed, would go before the Eighth Circuit. In the meantime, taxpayers outside of the D.C. Circuit can still challenge the imposition of §6038(b) penalties.

IRS issues final rules simplifying rules for late allocation of generation-skipping transfer tax

Internal Revenue Service, RIN 1545-BH63, effective May 6, 2024.

More than 16 years after publishing their proposed rules on the requirements to make a late allocation of generation-skipping transfer (GST) tax, and 23 years after the initial law was passed, the IRS has issued a final rule on the topic. The final rule departs only slightly from the proposed rule; in fact, the long delay is likely because the proposed rules were working – there were only five comments received during the rulemaking. Like under the proposed rules, the IRS will look at the facts and circumstances to determine whether to grant relief for a late allocation of election through a private letter ruling. The final rule reduces both the number of affidavits and the amount of information required. This rule applies to extensions of time to make a late allocation of GST exemption, remove an automatic allocation of GST to a direct or indirect skip, and elect to treat a trust as a GST trust for purposes of §2632(c). The estate will need to provide evidence that the taxpayer acted in good faith and that the grant of relief will not prejudice the interests of the government. The IRS will propose additional regulations subsequently to address the practical effect of a grant of relief under this section and to clarify the interaction between affirmative and automatic allocations of GST.

Corporate Transparency Act update

While the Eleventh Circuit Court of Appeals considers the constitutionality of the Corporate Transparency Act (CTA), FinCEN has continued its efforts to educate the public on what the Act requires. On April 18, 2024, they updated their Frequently Asked Questions (FAQs) to provide guidance. Of interest to our readers, the FAQs addressed trusts in several questions, although many questions remain unanswered. The FAQs clarified that the CTA will look through trust arrangements to find beneficial owners who either exercise substantial control or own more than 25% — this could be a settlor, beneficiary, or trustee. Owners of corporate trustees may also be beneficial owners, and there may be situations where the corporate trustee's information is reported instead. The FAQs also acknowledge that the information on trusts "may not be an exhaustive list of conditions under which an individual owns or controls ownership interest in a reporting company through a trust." Other questions addressed by the FAQs include who a beneficial owner can be (only individuals — not trusts, corporations, or other nonnatural persons); is an entity created by a means other than filing with the secretary of state or similar office is subject to the CTA (no); and when and how federal agencies may gain access to the information.

Outside of FinCEN's education efforts, there have been several notable developments since the Northern District of Alabama ruled the CTA unconstitutional in March 2024. Additional suits challenging the CTA have been filed in Maine, Massachusetts, Michigan, and Texas. Congressional Republicans have introduced a bill in the house to repeal the CTA, and Senator Tuberville has said he will introduce a bill in the Senate. Several states (California, New York, and Pennsylvania) have also introduced their own versions of the CTA.

IRS issues proposed regulations regarding reporting requirements for foreign trusts

Internal Revenue Service, RIN 1545-BI04.

The IRS has issued proposed regulations to amend the reporting requirements for foreign trusts with one or more US beneficiaries, as well as for recipients of large foreign gifts. The proposed regulations would change the rules governing loans from foreign trusts to US persons and how US persons use trust property under §643(i). They also revise reporting requirements for recipients of large foreign gifts and transfers to or from foreign trusts. The regulations also provide guidance on penalties under §6677 when reporting requirements are not met. This is part of the IRS's effort to monitor transactions with foreign trusts, which date back to the 1990s.

Comments on the proposed regulations are due by July 8, 2024, and a public hearing will be held on August 21, 2024.

Tax Court denies dentist's deductions for farming losses because not engaged in for profit

***Schwarz v. Commissioner,* T.C. Memo 2024-55 (May 13, 2024).**

Facts

Taxpayers are Texas residents who own substantial real estate holdings. Husband is a dentist and oral surgeon with his own practice, which is professionally managed, but he maintained a keen interest in ranching and farming. Beginning in the 1980s he, along with a dryland farmer he had hired, introduced a technique to increase the deer's nutritional intake over the summer, to increase the size of the antlers. His deer won hunting competitions, and he received recognition for his conservation work. By the late 1980s, after seeing the success of his technique, Taxpayers sought to purchase additional ranch land. They began to purchase and sell land — often using Husband's technique to improve the land before selling it. They also subdivided land and offered financing. Taxpayers began offering deer hunts on their ranch in 1994, and later began breeding deer. In 2002, they again expanded their activities, creating Entity, a "custom farming, hunting, fishing and ecotourism operation," which later became a partner in several real estate ventures. Entity offered hunting, fishing, and event packages, which it began to sell in 2005. Taxpayers created lakes for fishing and hired a fisheries expert to advise them, although did not always follow the expert's advice. Entity's farming activities included clearing land, plowing, planting, building fencing, and constructing roads. The farming activities of Entity incurred losses from 2005 through 2020; Taxpayers' separate entities that were engaged in real estate were profitable. Despite Taxpayers extensive land holdings and operations, their recordkeeping was less than ideal and filled with errors. The IRS issued a notice of deficiency and Taxpayers appealed.

Holding

Section 162 generally permits deductions for business-related expenses, but §183(a) denies that deduction "if such activity is not engaged in for profit." Showing a profit motive requires that the taxpayer "entertained an actual and honest profit objective" and that their "expectation of profit must be in good faith." Courts will look at all the surrounding facts and circumstances, with greater weight given to objective

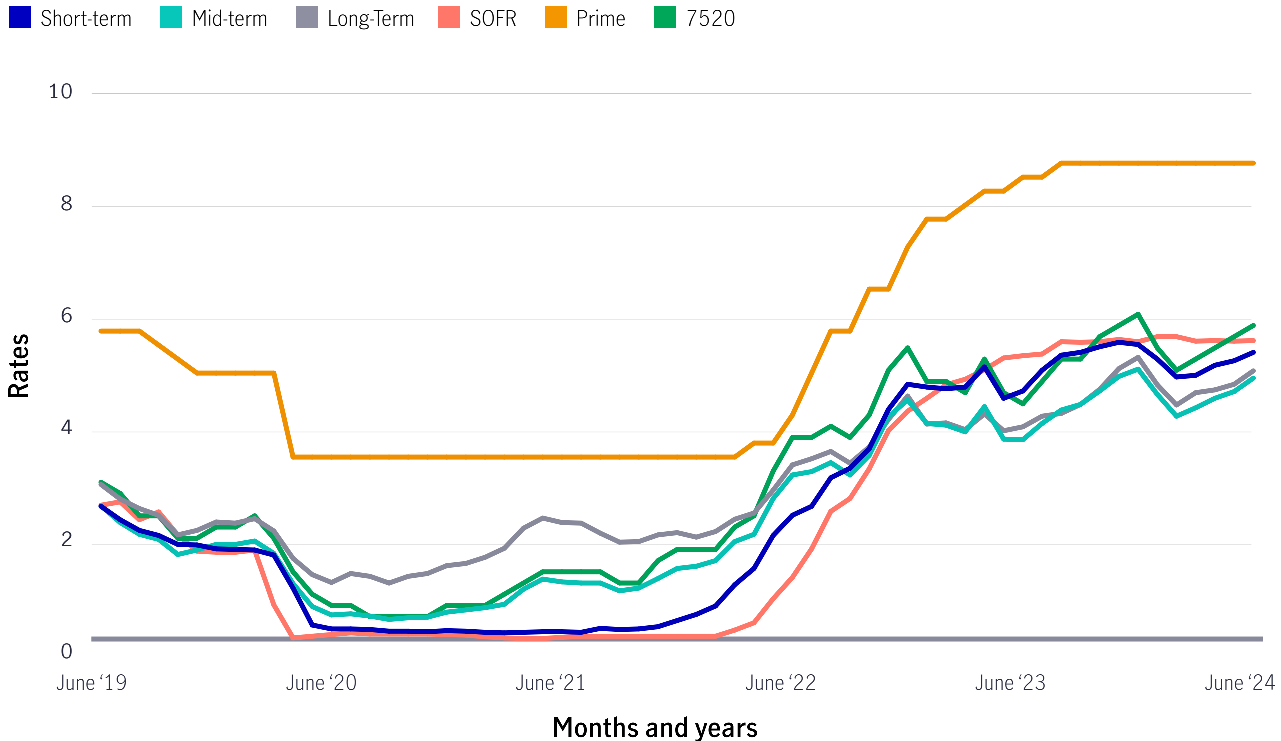
facts than to subjective intent. Where multiple activities are involved, they may be treated as one activity "if the activities are sufficiently interconnected." Taxpayers argued that their farming activity and real estate activities should be considered as a single activity, but the Court found that the structure of the entities suggested otherwise. Taxpayers' poor recordkeeping also hurt, as the timing of improvements was vague and there was little proof of any farming work done on the real estate investment properties. Finding that the farming and real estate activities were not sufficiently connected, the Court considered the farming activities independently and found they were not profit-driven. To support this conclusion, the Court noted that the farming activity had a history of losses; the business purpose was based on Husband's passions, not profit-making; and Taxpayers had other income from real estate and dentistry. As a result, Taxpayers could not deduct their losses from farming. The Court found Taxpayers were not liable for accuracy-related penalties because they had used a tax professional and therefore had a reasonable cause defense for the underpayment.

Takeaway

The hurdle to prove a hobby is engaged in for profit is high, and a frequent target of audits. Even here, where the taxpayer was regionally recognized for his work with hunting and farming techniques, and his enterprise generated millions of dollars in revenue, the totality of the facts did not support a profit-motive. Sometimes, it's just an expensive hobby.

The following are historical graphs of various rates that are commonly used by the Advanced Markets group

Short, Mid, Long Term Applicable Federal Rate (AFR), 7520, SOFR, Prime Rates from June 2019 – June 2024



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

	Short-term AFR	Mid-term AFR	Long-term AFR	7520	SOFR	Prime
June 2024	5.12%	4.66%	4.79%	5.60%	5.33%	8.50%
May 2024	4.97%	4.42%	4.55%	5.40%	5.32%	8.50%

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

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MLINY061324227-1