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Appeals Court Includes Irrevocable Trust Withdrawal Right as Marital Asset in Divorce, Disregarding Trust Spendthrift Provision

Amy Levitan v. Daniel J. Rosen, No. 18-P-847, Mass. App. Ct., May 6, 2019.

Facts: All parties are domiciliaries of Massachusetts at all relevant times. XW is a beneficiary of an irrevocable Trust created by her father in 1984, which trust contains so-called spendthrift provisions. According to its provisions, upon the death of XW's father, Trust property was divided into three equal shares, one each for XW and her two siblings. Independent Trustee holds sole discretion to distribute income and principal as the trustee deems appropriate. In addition, XW has the power to withdraw up to five percent of the assets in her subtrust; XW exercised this right to its full extent in 2014-2016. XW also holds a limited power to appoint assets in her subtrust for the benefit of the grantor's issue, including her own children. Any assets remaining upon XW's death are to be distributed outright to her issue per stirpes. The spendthrift provisions, as contained in Trust, prohibit the distribution of XW's share to creditors and third parties, specifically including a spouse. Trust provisions direct the Independent Trustee "to withhold any payment or distribution of income or principal (even though such payment or distribution is otherwise required hereunder) if the [independent trustee] in its sole discretion deems that such payment or distribution would not be subject to full enjoyment by [XW]." In 2013, XW began divorce proceedings from XH after 16 years of marriage. Assembling the marital estate for equitable distribution, XW contended that no part of her interest in Trust was includible because of the spendthrift provisions. The judge at trial disagreed in part and held that her interest to the extent of her withdrawal power, i.e., five percent of assets held by her subtrust under Trust, was not governed by the

spendthrift provisions and was therefore includible. The judge ruled that the remainder of her trust share "was not a marital asset subject to division." The judge awarded XW the withdrawal rights as part of the equitable division of the marital estate, and XH received other assets of equal value (balance of a 401(k) plan provided by his employer). XW appealed this determination, which was heard by the Appeals Court of the Commonwealth of Massachusetts.

Holding: Trust was established in Florida and interpretation of its provisions in the presence of an ambiguity is to be done in accordance with Florida law. The Court noted that Florida case law provides that "Florida has a public policy favoring spendthrift provisions in trusts and protecting a beneficiary's trust income... ." However, the Court found facial conflict between XW's right of withdrawal and the Independent Trustee's discretion under the spendthrift provision to withhold "any payment or distribution of income or principal (even though such payment or distribution is otherwise required hereunder)." Massachusetts law governs the assembly of the marital estate for equitable division purposes, on the other hand. That law defines the marital estate as including all property to which the parties hold title however acquired. The Court examined Massachusetts case law that determined the includability of trust rights in the marital estate for these purposes, generally holding that such rights are includable where the beneficiary held a "fixed and enforceable" property right and not a right that "too remote or speculative to be included." Although significant Massachusetts case law exists that would exclude XW's interest beyond her withdrawal right, the Court determined that XW's entire interest in her subtrust under Trust was includable. The Court founded this determination on the provision of Trust that XW was the sole current beneficiary of that subtrust (although not the only beneficiary) and thus distributions for her benefit could not be diminished by the rights of other current beneficiaries. The Court accomplished this in part by citing case law that excluded an interest due to an open beneficiary class rather than the absolute discretion of a trustee. Having made these determinations, the Court went on to note that because XW's interest in Trust was subject to the spendthrift provisions and could only be distributed to her (and not appropriated by the probate court or XH), the full amount of those Trust assets accrued to her side of the equitable division of marital estate, and distribution of the remaining marital assets should be made accounting for that assignment. (The value of assets in XW's subtrust dwarfed the value of "other" assets in the marital estate.)

Tax Court Affirms IRS Assessment Looking Through Complex Off-Shore Tax Scam

Samuel Wegbreit, et ux. V. Commissioner, TC Memo 2019-82, July 8, 2019.

Facts: Taxpayer formed Investment Company in 1989 with a partner, and after a very few years Investment became extremely successful, growing in income very rapidly. For example, in 1997 Investment's gross income was approximately $600k, but grew steadily to about $8.4 million in 2004. As a result of his income growth, in 2003, Taxpayer sought advice on how to reduce his growing income tax liability. Taxpayer met Advisor and discussed the following potential arrangement: 1. Taxpayer would create an irrevocable trust; 2. Taxpayer would transfer his interest in Investment, including his right to income therefrom, to the trust (although Taxpayer would continue to run Investment as its officer and employee); 3. Trust would transfer interest in Investment to an off-shore life insurance company in exchange for private placement life insurance on Taxpayer's life; and 4. Trust would be for the benefit solely of Taxpayer's Spouse and children. Taxpayer and Advisor caused this plan to be created precisely as anticipated. Trust was created with Advisor as trustee, and Taxpayer had no power to amend, revoke, withdraw from, or borrow from Trust. Spouse had the power to withdraw up to 5% of Trust assets annually. Almost immediately, a Cook Island life insurance company ("CILI") purported to issue a life insurance policy on Taxpayer's life. Two copies of the policy with the same policy number were ultimately produced in evidence, but each reflected substantially different initial premiums ($13,220 or $236,356) and death benefits ($2.8 million or $4.7 million). Neither was signed at all, much less by anyone associated with any life insurance company. No application for the life insurance policy could be produced at trial. Shortly thereafter, CILI policy was surrendered in exchange for a policy purported issued by a Bermudan life insurance company ("BLI") with an initial premium of $1.6 million and a death benefit of $6 million.

Advisor as trustee of Trust made up a "1035 letter of assignment" to document the purported exchange. Advisor created an off-shore Hedge Fund and caused Trust to invest and created a new LLC and transferred all interest in it to BLI policy. As a result of Taxpayer's transfer of his interest in Investment to Trust, his reported income plummeted. He reported $32K in 2005, $6K in 2006, and $0 in 2007-2009. In the meantime, Advisor channeled large sums of cash from CILI, BLI, Hedge Fund, and LLC to Taxpayer, who used the funds for his personal purposes. Often, this took the form of Taxpayer taking very large loans against the life insurance policies owned by Trust. Largely (but not exclusively) because of two bungled Roth IRA conversions, in 2008 IRS began to investigate Taxpayer's tax reporting and financial affairs. As a result, in 2012, IRS issued Taxpayer a notice of deficiency claiming unreported income of approximately $14 million between 2005 and 2009 (including the premature distributions resulting from the bungled IRA conversions) and added accuracy-related penalties. The IRS determined that Trust was a sham and should be therefore disregarded as a vehicle to perpetrate fraud against the US, all income from Trust assets should be attributed to Taxpayer, and that neither CILI nor BLI were "life insurance" as defined by IRC §7702. Thus, the exchange of these assets could not qualify for tax-free like-kind exchange under IRC §1035. Taxpayer appealed to the Tax Court.

Holding: The Court agreed with IRS determinations. The Court found, based on the record of Taxpayer's actions, that Taxpayer never surrendered control of Investment to Trust or any other entity but continued to treat it and its value as his own property. For this reason, all increases in value of, and income from, Investment were properly includable in Taxpayer's gross income for income tax purposes for all relevant years. The Court found that CILI and BLI were not "life insurance" under the Internal Revenue Code and that the "loans" made against the "policies" were not loans at all but taxable withdrawals. The Court found that Taxpayer's actions in attempting to convert his and his spouse's IRAs to Roth IRAs constituted a taxable premature distribution from those IRAs that should have been reported as part of Taxpayer's gross income for income tax purposes. Most damning, the Court found that Taxpayer and his spouse created false and misleading documents relating to a series of sham transactions for the sole purpose of concealing their income and misleading IRS in an attempt to evade tax they knew to be due and owing on the income for 2005 through 2009. IRS easily met its burden of showing that an underreporting occurred in each of the years under review, at which point the burden shifts to Taxpayer to show why the IRS is incorrect in its determination. The Court found it nearly impossible to review what record existed because Taxpayer's actions made little of his record reliable. These actions included backdated documents, forged notarizations or those with altered and incorrect dates, missing pages, duplicate versions of controlling documents, etc. In the end, the Court found that the reliable evidence that did exist is clear and convincing as to unreported income and fraudulent intent.

Tax Court Revokes Tax-Exempt Status of "Charity" Set Up to Circumvent Do-Not-Call List Rules

Giving Hearts, Inc., v. Commissioner, TC Memo 2019-94, July 29, 2019.

Facts: Audacity, thy name is Business. In 1987, Taxpayer created Windows, a company that provided and installed replacement windows and did general home improvements. Windows got home improvement jobs from various sources such as referrals, advertising, and trade shows, but relied primarily on telemarketing from an in-house staff of 16 telemarketers making telephone solicitations. In 2003, however, registration for the National Do No Call Registry began, and shortly thereafter enforcement of the Telephone Consumer Protection Act (enacted in 1991!) began. As a result, Windows business suffered. Taxpayer began to research exemptions in the Registry program and learned that charitable organizations are not subject to all the same restrictions under the Registry program. Taxpayer's Spouse thus created Charity and applied for recognition as a charitable organization and exemption from income tax under IRC §501(c)(3). Charity received tax-exempt status as such from IRS in 2009. Charity's articles of incorporation state that it is organized "exclusively for charitable, religious, educational, and scientific purposes, including, for such purposes,

the making of distributions to organizations that qualify as exempt organizations under section 501(c)(3) of the Internal Revenue Code, or corresponding section of any future federal tax code." Charity almost immediately thereafter established its "Corporate Sponsorship Program" with the aim of providing telemarketing opportunities for businesses "to help generate leads" and "give back to a charity." Under the program, Windows' telemarketing staff would make calls on behalf of Charity and state that "for every home owner that accepts a product demonstration and free estimate our charity [Charity] will receive a donation from Windows." Calls were made without regard to whether the telephone number called was registered on the National Do Not Call Registry. For each call made on behalf of Charity, Windows would pay Charity $5. (Windows subsequently claimed a charitable deduction for all such fees paid.) Potential customers receiving such call began to complain instantaneously to the state attorney general who reported the activity to IRS. In 2012, IRS informed Charity that it was initiating an examination of its eligibility for charitable status. Almost defiantly, shortly thereafter Charity began to offer its Corporate Sponsorship Program to other for-profit businesses relying on telemarketing to solicit business. Charity reported receiving charitable contributions for the taxable years 2010, 2011, 2012, 2013, 2014, 2015, and 2016 reporting that it received charitable contributions of $1,102, $6,421, $5,480, $7,081, $8,334, $7,003, and $5,445, respectively. IRS revoked Charity's status as a charitable organization under IRC §501(c)(3). Taxpayer and Charity appealed this determination to the Tax Court.

Holding: The Court affirmed the IRS determination revoking Charity's tax-exempt status. The Court begins, as it often does, by reiterating the rule that a determination by the IRS enjoys a presumption of correctness and that Taxpayer bears the initial burden of establishing that the IRS's determination is erroneous. IRC §501(c)(3) describes a qualifying organization, in relevant part, to include "[c]orporations... organized and *operated exclusively for* religious, charitable, scientific, testing for public safety, literary, or educational purposes." [Emphasis added.] An organization that qualifies under §501(c)(3) not only is exempt from Federal income tax, but also may solicit and accept donations which are normally deductible under IRC §170(c)(2) by the donor against his or her Federal income tax. IRS does not dispute that Charity was organized for exempt purposes but instead stated in its determination that Charity does not operate exclusively for those exempt purposes (the so-called "operational test"). Specifically, IRS maintains that Charity operates as a conduit to generate sales leads and revenues for commercial businesses. The Court agreed that Charity operates, at least in part, to further a charitable purpose; Charity collects donations from Windows and transfers those funds to other charitable organizations. The Court noted that Charity correctly asserts that the IRC does not preclude the use of for-profit enterprises, such as Windows, to solicit or collect charitable donations. However, IRC §501(c)(3) requires that an organization be "operated exclusively" for an exempt purpose to be eligible for tax-exempt status. IRS Reg. §1.501(c)(3)-1(c)(1) sets forth the requirements of the operational test: "An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose." In this regard the presence of a single substantial purpose that is not described in §501(c)(3) precludes exemption from tax under IRC §501(a) regardless of the number or the importance of the purposes that are present and described in §501(c)(3). The Court found that Charity's corporate sponsorship program, by design and in effect, permits for-profit businesses to invoke its name as part of a telemarketing pitch intended, first and foremost, to generate sales leads and revenues and that, although telemarketing calls are ostensibly made on Charity's behalf, the real purpose of the calls is business promotion. Considering all of the facts and circumstances, the Court concluded that Charity was primarily engaged in generating sales leads and revenues to advance commercial enterprises, with charitable donations arising only as a consequence of the businesses' success in securing for-profit commitments.

Taxpayer Must Treat All Accretions to Wealth as Taxable Income Unless Specifically Exempted by Tax Code

Christopher M. Dufresne v. Commissioner, TC Memo 2019-93, July 25, 2019.

Facts: Taxpayer was a domiciliary of California at all relevant times and is the son of a well-known psychic who appeared on television, wrote books, and gave lectures ("Mother"). Taxpayer worked full time as a psychic counselor for Mother's business, S Corp. Taxpayer performed psychic readings as often as seven days a week on behalf of S Corp. Clients were charged $200 for a 30-minute reading. After several years of illness, Mother died in 2013, at which time she was the majority owner of S Corp. Records show that Taxpayer owned a 0.1% interest in S Corp with no access to its books and records at the time of Mother's death. Taxpayer was the sole beneficiary of Mother's estate and became the sole owner of S Corp. Taxpayer states that he did not discuss Mother's financial affairs with her, and he was not aware of her net worth. Mother was in debt at the time of her death. S Corp was dissolved within two years of her death. Between tax years 2004-2010 inclusive, Taxpayer earned $14 million, but his income dropped precipitously in the following years (Taxpayer reported income in 2010: $528,850; 2011: $120,200; 2012: $107,600; 2013: $0; and 2014: $88,850). However, during these leaner years (2010-2013), Taxpayer made unreported cash deposits totaling $1,505,546. Taxpayer claims that these cash deposits were repayments he received from Mother for loans of approximately $1,490,388 he made to Mother for the purpose of paying past due Federal income taxes and for the purchase of real estate properties. From 1985 to 2007, Taxpayer purchased five substantial real estate Properties in southern California and Cabo San Lucas, Mexico. Taxpayer produced a letter, with Mother's signature, dated January 1, 2008, which stated that she owed him $1,182,670 for five real estate purchases. All properties were held in Taxpayer's name and Taxpayer reported rental income from and took deductions attributable to Properties. Mother lived in one such Property and paid rent to Taxpayer. Mother owned several properties in her own name and Taxpayer and Mother co-owned two condominiums. Taxpayer did not provide any formal documentation establishing the existence or provisions of the loans he claims that he made to Mother, although he did produce correspondence to him from Mother that made reference to loans, though of different amounts. In 2014, IRS initiated an examination of Taxpayer's returns for 2010-2013 and subsequently issued Taxpayer a notice of deficiency showing unreported income in the period of examination of $1,505,546 and assessing penalties for substantial understatement of income. Taxpayer appealed to the Tax Court.

Holding: The Court upheld the determinations of IRS that the cash deposits made by Taxpayer during the years examined were taxable income and therefore should have been reported by Taxpayer on his returns. IRC §61 provides generally that gross income for income tax purposes includes all accretions to wealth from whatever source. Other sections of the Code may provide an exemption, exclusion, deduction, or credit with respect to income from a specified source, but all income is included in gross income and is taxable unless excepted by the Code. The Court cited case law standing for the proposition that where a taxpayer fails to keep sufficient record of its financial affairs, IRS may employ any reasonable method to reconstruct the taxpayer's income and thereby lay the requisite evidentiary foundation. In the present case the Court found that by doing so, IRS met its burden of making the facial determination establishing that Taxpayer received property from some source to make the cash deposits. For these purposes, record of a bank deposit is prima facie evidence of income to the depositor. Burden then shifts to Taxpayer to establish if possible that the property received was either not includable or, although includable in gross income, is not taxable under some affirmative exception provided by the Code. The Court found that Taxpayer failed to meet his burden to establish either alternative. The thin and incomplete record provided by Taxpayer was not credible to establish that the cash deposits were, in fact, partially nontaxable return of loan principal primarily because the alleged loans were not defined or documented as one would expect an arrangement dealing with large sums would be. The Court considered eight individual factors to determine whether the record supported the existence of bona fide loans

between Taxpayer and Mother, and all but two indicated that there was not. The credibility of the evidence suffers also because the alleged loans coincide in time with the failing health and finances of Mother and the contemporaneous decline in Taxpayer's income from S Corp. Taxpayer's testimony also did not comport with the record; the majority of the sums he claims to have lent Mother were for the purchase of Properties, and yet all remained in his sole name and Taxpayer treated Properties as his own. IRS determination could not be overturned on such scant evidence.

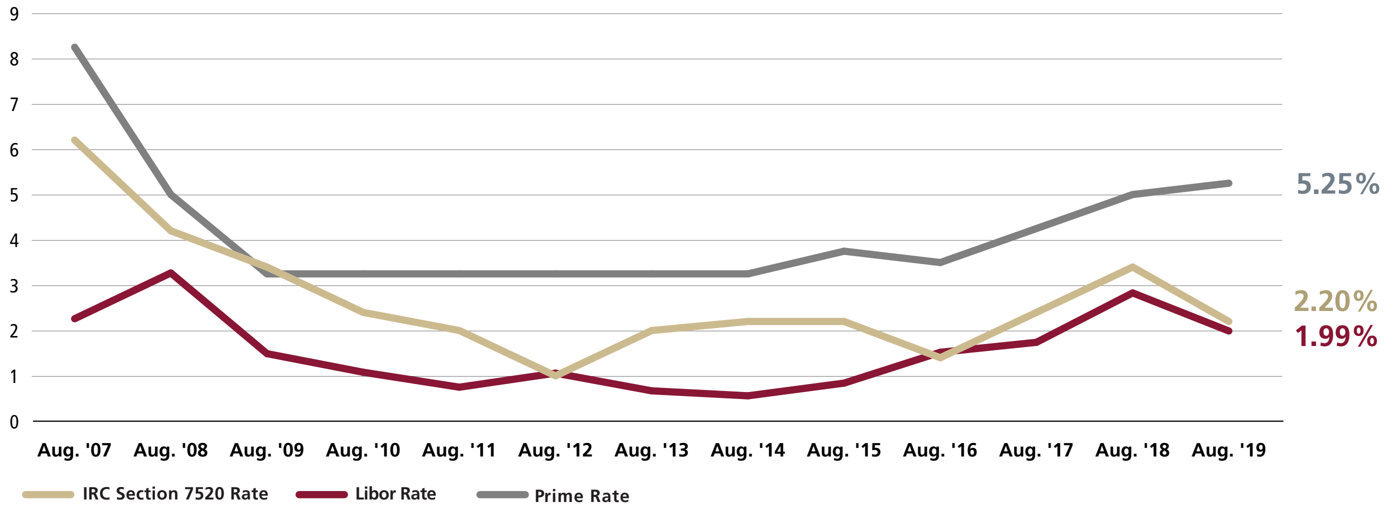
IRS Rules That Trust-Owned Shares in Business Units of a Corporation Qualify as a Family Business for Purposes of IRC §6166 Estate Tax Deferral

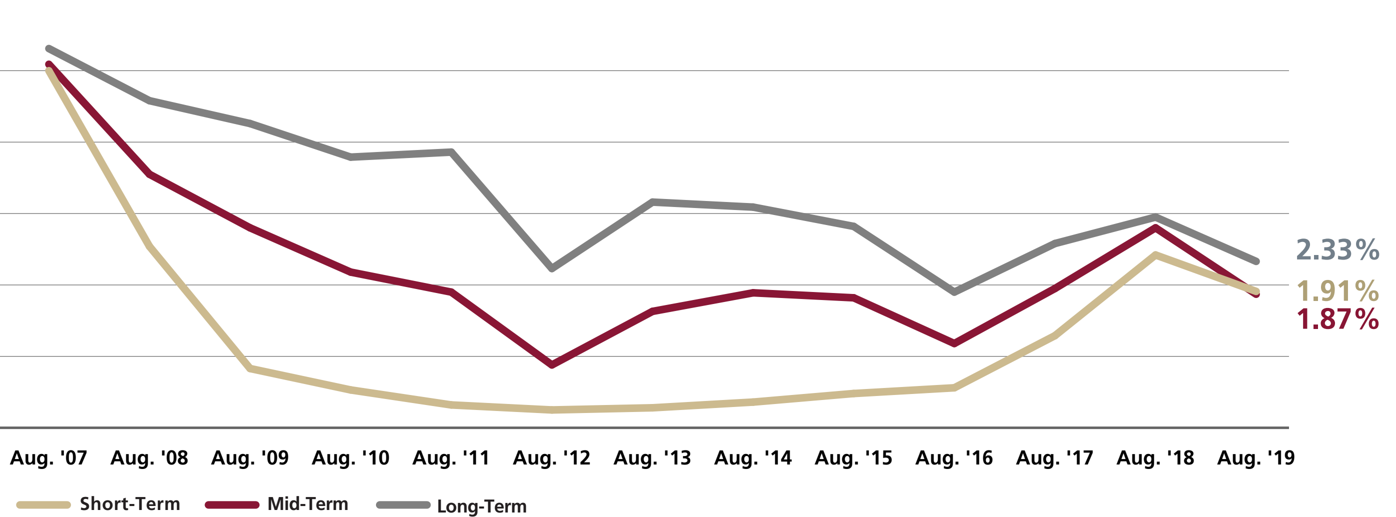
IRS Private Letter Ruling 201928007, July 12, 2019

Facts: At the time of Decedent's death, Decedent's revocable grantor Trust held Shares (Percentage) of the Company, a closely held corporation in Decedent's state of domicile comprising six separate operating units. The operations of the business units are reported on a consolidated corporate income tax return in the name of Company. Decedent's Estate requests from IRS a ruling that the activities of four of the operating units are sufficient to constitute the "carrying on of a trade or business" such that an interest in that operating unit will qualify as an interest in a "closely-held business" for purposes of IRC §6166(a)(1). IRC §6166 provides generally for the extension of time for payment of Federal estate tax where the estate consists largely of an interest in a closely-held, family business. Company was owned by Trust at the time of Decedent's death but were included in Decedent's taxable estate under IRC §§2037 and 2038 due to being owned by a trust that was revocable by Decedent at the time of his death.

Holding: The IRS was able to provide the requested rulings. (In fact, four separate rulings were requested, each dealing with a specific business unit of Company.) IRC § 6166(a)(1) provides generally that if the value of an interest in a "closely-held business" that is included in determining the gross estate of a decedent exceeds 35 percent of the adjusted gross estate, the estate may elect to pay all or part of its Federal estate tax liability in two to ten equal installments. Under IRC §6166(a)(2), the maximum amount of tax that may be deferred is the pro rata portion of estate tax attributable to the closely-held business. If an estate elects deferral under IRC §6166(a)(1), the estate has up to five years from the estate tax due date to make the first installment payment. According to IRC §6166(b)(1) and the regulations thereunder, an "interest in a closely held business" is defined, in relevant part, as stock in a corporation carrying on a trade or business if 20% or more of the value of voting stock of the corporation is included in the gross estate, or the corporation has 45 or fewer shareholders. IRS looks to a non-exclusive list of factors to determine whether real property interests are interests in a closely held business for purposes of section 6166: the amount of time the corporation's employees devoted to the trade or business; whether an office was maintained from which the activities of the corporation were conducted and whether the corporation maintained regular business hours for that purpose; the extent to which the corporation's employees were actively involved in finding new tenants and negotiating and executing leases; the extent to which the corporation's employees provided services beyond the mere furnishing of leased premises; the extent to which the corporation's employees personally arranged for, performed, or supervised repairs and the maintenance of property (whether or not performed by independent contractors); and the extent to which the corporation's employees handled tenant repair requests and complaints. Although this list deals with real estate interests, IRS uses it to evaluate other manners of interests to determine whether such interests are an active trade or business. In the case of each of the rulings requested, IRS found that the business unit was actively involved in maintaining and conducting business and that the employees of the business unit were affirmatively involved in those activities. Thus, each of the business units owned by Trust at Decedent's death examined for these rulings constituted an "interest in a closely-held business" for purposes of IRC §6166(a)(1).

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





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