John Hancock INSURANCE

ADVANCED MARKETS

# Central Intelligence

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## Interesting CI Updates

U.S. v. Garrity, 2019 WL 1004584 (D.Conn. Feb. 28, 2019):
We first reported this case in our April 2019 edition of John Hancock Central Intelligence. Taxpayer was held liable for $936,691 in penalties for failure to report a foreign account (FBAR) under 31 USC §5314. Taxpayer argued unsuccessfully that despite a 2004 amendment to the statute, penalties remain capped at $100,000. Taxpayer has filed an appeal in this case. We will continue to follow this case and report any significant developments.

H.R. 1994 (The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019, March 28, 2019):
We just reported last month on this piece of legislation introduced in the US House of Representatives. The bill would make sweeping changes to the laws governing qualified plans and other retirement vehicles, including increasing the required beginning date for distributions from such plans to 72, among very many others. The bill passed the House with a vote of 417-3. A slightly different version of the bill has already been introduced in the Senate, but the bills enjoy broad bipartisan support. We will let you know of any progress.

## District Court Finds Taxpayer Owner of Real Property Facially Owned by Nominee and Federal Tax Liens Attach to the Property

*Saepoff v. North Cascade Trustee Services, Inc., et al.,* 123 AFTR 2d 2019-1616, (DC WA), April 19, 2019

**Facts:** Taxpayer and her Husband are domiciliaries of Washington State. In November 2006, Taxpayer acquired residential real estate ("Property") and two loans secured by Property in the amounts of $490,000 and $122,500. In September 2010, Taxpayer transferred Property via quitclaim deed to a nominee trust. Taxpayer was the sole

beneficiary of this trust, and Taxpayer had the power to direct the trustee's actions with respect to trust property. Taxpayer received no consideration in exchange for the transfer. The trustee of the trust later testified that it was his understanding that Taxpayer had transferred Property to the trust because "she was trying to shelter her assets from debtors." Less than three weeks later, the trustee transferred Property back to Taxpayer. In January 2011, IRS recorded a Notice of Federal Tax Lien against Taxpayer. In November 2012, Taxpayer again transferred Property to a nominee trust of which Husband was Trustee, again for no consideration. Taxpayer and Husband lived together at Property, as their primary residence. During all relevant times, Taxpayer managed Property as her own and made all payments on Property, such as utility bills and property taxes. In October 2014, IRS recorded a Notice of Federal Tax Lien with King County registrar of deeds against Property for Taxpayer's unpaid federal income tax assessments for the taxable years 2009 to 2012. Subsequently, the lenders of the loans filed an action in foreclosure against Property to recover their interests in default under the loans. IRS filed an action seeking a determination that its liens from the taxable years 2009 to 2012 are valid, attach to Property, and have priority over any interest that Trust or lenders have in the Property. IRS moves for summary judgment.

**Holding:** As a threshold matter, the Court enunciates the provisions of IRC §§6321 and 6322: "If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount ... shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person." The lien attaches at the time the assessment is made and continues until the liability for the amount so assessed "is satisfied or becomes unenforceable by reason of lapse of time." The Court looks initially to state law to determine the taxpayer's ownership interest in the property Citing Washington case law, the Court notes that IRC §6321 applies "not only [to] the property and rights to property owned by the delinquent taxpayer, but also [to] property held by a third party if it is determined that the third party is holding the property as a nominee or alter ego of the delinquent taxpayer." Whether a person holds property as a nominee for a taxpayer is determined by the degree to which the taxpayer exercises control over an entity and its assets. District courts in Washington consider the following factors: (1) whether the nominee paid no or inadequate consideration; (2) whether the property was placed in the name of the nominee in anticipation of litigation or liabilities; (3) whether there is a close relationship between the transferor and the nominee; (4) whether the parties to the transfer failed to record the conveyance; (5) whether the transferor retained possession; and (6) whether the transferor continues to enjoy the benefits of the transferred property. (The factors to be considered in determining whether an entity is an alter-ego of a taxpayer are similar to the nominee factors.) Considering these factors, the Court noted that Taxpayer received no consideration for her transfer to Trust, that she continued to live at Property with Trustee/Husband, that she continued to treat Property as her own, accepting all financial responsibilities for Property. Finally, the Court found significant that Taxpayer did not even bother to file a response to IRS action. As a result, the Court held that Taxpayer continued to be the owner of Property despite the artificial transfer and that the liens of IRS attached to Property at the time the tax was assessed, and that IRS interest in Property is superior to any interest by Trustee or the lenders.

## Bankruptcy Court Grants Claim of Exemption for Rollover Contribution to IRA Immediately Before Petition is Filed

*In re: Jones,* 123 AFTR 2d 2019-1507, (Bktcy Ct IL), April 15, 2019

**Facts:** Taxpayer, an Illinois domiciliary, found himself in deep financial straits. On April 16, 2018, Taxpayer withdrew $50,000 from an individual retirement account ("IRA"). Taxpayer deposited $49,000 of the funds into his personal checking account at Bank on April 23, 2018, and retained $1,000 to purchase lottery tickets. From time to time, Taxpayer withdrew funds from this checking account to purchase more lottery tickets. The lottery ticket purchases were made on specific dates and for considered amounts as part of Taxpayer's "strategy" to win money and pay his debts, thereby avoiding the necessity of filing bankruptcy. Ultimately, to his surprise, Taxpayer lost money. On June 14, 2018, Taxpayer purchased a $20,000 cashier's check from Bank. The check was made payable to Taxpayer's IRA and was deposited into the IRA on June 15, 2018. Taxpayer incurred tax liabilities exceeding $9,000 with IRS and

the Illinois Department of Revenue for income taxes and penalties resulting from the withdrawal of money from his IRA. On October 22, 2018, Taxpayer filed a petition for bankruptcy under chapter 7 of the Bankruptcy Code and listed his IRA on schedule A/B of the petition in the amount of $40,000. Taxpayer claimed a $40,000 exemption in the IRA under 735 ILCS § 5/12-1006. Bankruptcy Trustee objected and moved that the Court deny Taxpayer's claim of exemption due to Taxpayer availing himself to the free use of the IRA proceeds in the months leading up to the bankruptcy petition.

**Holding:** Trustee objects to Taxpayer's exemption to the extent of $20,000, the sum contributed by Taxpayer to his IRA on June 15, 2018. Trustee agrees that had the entirety of the funds remained in the IRA, they would have been exempt on the petition date. However, Trustee argues that the funds lost their exempt status once Taxpayer withdrew them from his IRA. Taxpayer counters that the funds were reinvested into the same IRA within the 60-day rollover time frame allowed by the IRS regulations, and that the funds were in a protected retirement account on the date of filing bankruptcy. The Court looks to state law to determine the existence and nature of a taxpayer's right, and in this case, Taxpayer relies upon 735 ILCS § 5/12-1006(a), which provides in pertinent part:

> A debtor's interest in or right, whether vested or not, to the assets held in or to receive pensions, annuities, benefits, distributions, refunds of contributions, or other payments under a retirement plan is exempt from judgment, attachment, execution, distress for rent, and seizure for the satisfaction of debts if the plan (i) is intended in good faith to qualify as a retirement plan under applicable provisions of the Internal Revenue Code ... or (ii) is a public employee pension plan....

Under the same statute, a "retirement plan" includes an individual retirement annuity or individual retirement account. Trustee argues that this statute only protects "assets held in … a retirement plan" and thus the assets were reachable by Taxpayer's creditors in bankruptcy as soon as they were withdrawn from the plan. The Court, however, rejected Trustee's arguments on two independent bases. First, at the time that Taxpayer filed his petition in bankruptcy, he had already deposited the $20,000 into his IRA. No action by a creditor was filed to reach the $20,000 before it was deposited and thus protected by an exemption. Second, IRAs are governed by the provisions of, among other statutes, IRC §408. According to the provisions of §408(d)(1), amounts distributed from an IRA are included in the payee's gross income. Under §408(d)(3), however, distributions are excluded from gross income if the entire amount is subsequently paid into an eligible retirement plan not later than the 60th day after the date on which the payee receives the distribution. (Such distributions and repayments are known as "rollover contributions.") Partial rollover contributions are also permitted under §408(d)(3)(D). Regulations under §408 permit the pay-back to be made from any property, and not necessarily the same funds withdrawn from the IRA. The Court notes that the 60-day rollover period would be of no value if the same funds, untouched, were required to be repaid to the IRA. Finally, the Court observes that Trustee made no allegations of fraudulent conveyance as to the re-contribution of the funds at a time when Taxpayer was almost certainly already insolvent. For that reason, the Court offers no determinations as to what effect, if any, such an allegation might yield.

## Appeals Court Upholds 40% Gross Valuation Misstatement Penalty

*Roth v. Commissioner.,* 123 AFTR 2d 2019-1676, (CA10), April 29, 2019

**Facts:** Taxpayers, a married couple, were at all relevant times domiciliaries of Colorado. In 2007, Taxpayers contributed a conservation Easement to Land Trust, a §501(c)(3) entity. Easement encumbered a 40-acre parcel of land that Taxpayers owned in Colorado, among other ways, by restricting the right to mine gravel from the underlying property. On their 2007 federal income tax return, Taxpayers claimed a charitable income tax deduction in the amount of $970,000 for the contribution of Easement to Land Trust. Because they did not have sufficient income in 2007 against which to apply this deduction, Taxpayers applied the unused portion against their 2008 income. IRS audited Taxpayers' returns for 2007-2009 and, in the process of that audit, secured an independent appraisal that determined the value of Easement to be worthless; the parties later settled on a stipulated value of $40,000. The Auditor issued a set of discrepancy adjustments of Taxpayers' taxes for the years in audit, including a "gross valuation misstatement" penalty under IRC§6662(h). This statute allows a penalty of 40% of the unpaid taxes where a valuation misstatement is 200%

or more than the actual value. Taxpayers filed a protest of the 40% penalty and requested administrative review. The reviewing officer produced a memorandum concluding that "all issues including [Auditor's proposed] penalties should be fully sustained for the government" with respect to Easement. However, due to a clerical error, the penalties in the reviewing officer's memo were calculated at 20% under §6662(a) instead of 40% under §6662(h). In 2012, Taxpayers filed an appeal with the Tax Court, which ruled in favor of IRS and reiterated Taxpayers' liability for the 40% penalty under §6662(h). Taxpayers appeal this determination to the Court of Appeals for the 10th Circuit. (This case also deals with unrelated issues surrounding repayment of proceeds from the sale of tax credits attributable to another conservation easement contribution in 2006.)

**Holding:** Taxpayers do not contest that the value of Easement is anything other than $40,000 or that they grossly misstated the value of Easement on their 2007 and 2008 federal income tax returns. On appeal, Taxpayers' central challenge is whether the IRS complied with the "written-approval" requirement under IRC §6751(b) before attempting to impose a gross valuation misstatement penalty. IRC §6751 requires IRS to obtain written, supervisory approval for its "initial determination" of a penalty assessment. Taxpayers do not dispute that IRS obtained written, supervisory approval at every step, nor do they dispute that a 40% penalty could apply under §6662(h) to their gross misstatement of Easement's value. Rather, Taxpayers argue that the notice of deficiency produced by the IRS after the reviewing officer's review is the agency's "initial determination" of the penalty under §6751(b). Because that notice included only a 20% penalty under §6662(a), even if a clerical error, §6751(b) now prevents IRS from attempting to impose anything other than the 20% penalty it "initially determined." I.R.C §6751(b)(1) provides that "no penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate." The Court first examines the definitions of "assessment," "determination," "penalty," and "deficiency." Finding the language ambiguous, the Court then turns to the legislative history of the statute, which reveals that the legislature intended the statute to require two things of the IRS: first, the agency must explain any penalty to be assessed and that penalty's computation in a notice to the taxpayer; and second, the agency must secure written, supervisory approval for its initial determination of "such assessment," Requiring IRS employees to obtain supervisory approval for penalties under §6751(b) (and to include computations of those penalties in a notice to the taxpayer) could conceivably "prevent the IRS from improperly using penalties ... to coerce settlements." Applying this interpretation to the present case, the Court sees no reason why the original assessment of the penalty under §6662(h) by Auditor, approved in writing by her supervisor, would not satisfy the requirements of the statute. The Court proceeds on to state that even the written approval of the reviewing officer's report, containing the clerical error, would not constrain IRS from imposing the higher, correct penalty in the fullness of review.

## Appeals Court Denies Motion to Dismiss, Will Hear Case on Fiduciary Duty of Custodian of §529 Plan, UTMA Accounts

*Maxwell R. Alberhasky v. George Rodney Alberhasky and Grayson H. Alberhasky,* No. 18-0927, (Court of Appeals, Iowa), May 15, 2019

**Facts:** In 1999, Father divorced his wife, the mother of two sons, Son1 and Son2. (After the divorce, Son1 chose to live with his mother, while Son2 chose to live with Father.) In 2000, Grandmother (Father's mother) created a revocable Trust for her grandchildren, including Sons, as part of her estate planning. Grandmother named herself as her Trustee, and designated Father and Aunt as successor trustees upon her death, incapacity, or resignation; Father and Aunt assumed the role of co-trustees in 2009. In 2010, Trust enrolled in 529 Plan, naming Son1 as beneficiary, and deposited $65,000 of Trust assets in Plan by check annotated "FBO Son1." Trust set up identical 529 accounts for her other grandchildren. Father also acts as custodian of various other asset owned by Son1 under UTMA transfers from Grandmother and others. Grandmother died in 2011. In 2012, in his capacity as Trustee of Trust, Father changed the beneficiary on the 529 Plan set up for Son1 to be for the benefit of Son2 (who already has his own 529 plan). In December 2013, Son1 sued Father in Iowa District Court, seeking three remedies: (1)

an accounting of the UTMA assets held for Son1; (2) a voiding of the transaction transferring the beneficiary designation of the 529 account from Son1 to Son2; and (3) damages stemming from Father's alleged breach of fiduciary duties. In February 2014, Father moved to dismiss Son1's suit for failure to state a claim upon which relief can be granted. Father argued 529 Plan was not subject to the Iowa Trust Code (Iowa Code chapter 633A) and Son1 lacked standing to challenge any change in beneficiary designation of 529 Plan because plan owners are authorized to change beneficiaries as they see fit. Father also asserted the UTMA assets were not governed by state law trust code. The District Court granted Father's motion to dismiss, and Son1 appeals.

**Holding:** Son1 argues the district court wrongly dismissed his petition. He contends the petition was not required to identify a specific legal theory but could go forward if its factual allegations gave Father "fair notice" of the events giving rise to the claim. The Court finds that case law supports his contention a motion to dismiss should only be granted if the petition on its face shows no right of recovery under any set of facts. Under notice pleading, almost every case survives a motion to dismiss. Iowa's notice-pleading rules encourage courts to determine controversies on their merits. Under the state's rules of civil procedure, a pleading meets the notice requirement if it contains "a short and plain statement of the claim showing that the pleader is entitled to relief and a demand for judgment for the type of relief sought." The Court finds that Son1's allegation as to the 529 Plan establishes a claim and that a genuine issue exists as to whether such plans create a fiduciary relationship. (The Court all but ruled that trust-owned 529 plans do, in fact, enjoy a fiduciary duty protection.) The Court also suggested that the district court's analysis was incomplete as it did not consider whether such plans might be governed by both the 529 plan statutes and by Iowa's trust code. The Court further finds that Son1's allegations as to Father's management of his UTMA property survive the motion to dismiss. The district court simply stated that the trust code specifically excludes custodial relationships. However, Son1 does not state that Father's fiduciary duty is imposed by the state trust code, simply that such a duty exists. To determine whether a custodian owes a fiduciary duty to his or her principal cannot be determined without a hearing, and thus, dismissal is premature. Thus, the Court reversed the dismissal of the district court and remanded the case for further proceedings consistent with this opinion.

## IRS Rules Modified Trust Should Not Result In §2042 Inclusion of Life Insurance Death Benefit in Trustee/Insured's Estate

IRS Private Letter Ruling 201919002, May 10, 2019

**Facts:** Grantor created an irrevocable Trust for the benefit of Child and Child's descendants. Child is designated Trustee of Trust and if Child dies or is otherwise unable to serve, Child's spouse is named as successor trustee. Grantor died and is survived by Child. Child has not made, and represents that Child will not make any contributions to Trust. Trust is authorized to purchase life insurance on the life of any person in which the beneficiaries of Trust have an insurable interest, and ownership of any such policies acquired by Trust vests in Trustee. Trust provisions specifically state that Trustee is vested with all rights, powers, options, elections, privileges, and incidents of ownership in all insurance policies owned by Trust. Trustee may use all or any part of Trust principal or income to pay premium on any policy it owns, except that premiums on a policy insuring the life Grantor may come only from principal. During Child's lifetime, Trustee may distribute principal or income as Trustee may determine to be appropriate to provide for the health, support, maintenance and education of Child and Child's descendants. At Child's death, Child shall have a testamentary special power of appointment over the remaining assets of Trust limited to the class consisting of Child's descendants. To the extent Child does not exercise Child's testamentary special power of appointment, then Trustee shall divide any remaining assets into sub-trusts for Child's descendants, *per stirpes.* Trust specifically provides that Grantor does not intend that Trustee have any power over trust property that, if held by Trustee in a fiduciary capacity, would result in inclusion of trust assets in the estate of the Trustee for federal estate tax purposes. For this purpose, Trust appoints a "Special Co-Trustee" to manage any asset that would risk such inclusion (with specific reference to IRC §2042, which governs inclusion in a decedent's taxable estate of proceeds of life insurance of which decedent held any incident of ownership at the time of death). Child,

as Trustee, proposes to purchase survivorship life insurance insuring the joint lives of Child and Child's spouse. Although a Special Co-Trustee would have sole authority to manage any such policy, Trustee is concerned that Child's testamentary special power of appointment of Trust assets, including death benefit, might cause estate inclusion under IRC §2042. For this reason, Trustee petitioned the appropriate Court to reform Trust to remove Child's testamentary power of appointment over the life insurance insuring Child's life or its proceeds, and the Court approved this modification. The modification further provided that premiums on any life insurance policy insuring the life of a trustee may be paid only from principal and not income. Finally, the modification also provides for a separate "Insurance Trustee" in whom will vest ownership of any policy risking inclusion, and who will have sole authority to take action with such policy. Trustee requests from IRS a ruling that with these modifications Child will not possess any incidents of ownership over any life insurance policy on Child's life acquired by Trust and that the proceeds of any policy on Child's life will not be includible in Child's gross estate under IRC §2042(2).

**Holding:** IRS was able to provide Trustee with the requested ruling, assuming that Child is not serving as Insurance Trustee at the time of Child's death, or Trust is modified such that Child regains fiduciary powers over life insurance on Child's life. IRC §2042(2) provides, in pertinent part, that the value of the gross estate includes the value of all property to the extent of the amount receivable as insurance under policies on the life of the decedent by beneficiaries, with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person. IRS Reg. §20.2042-1(c)(2) provides that the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term refers to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy. Also, IRS Reg. §20.2042-1(c)(4) provides, in pertinent part, that a decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust. IRS found that the modifications to Trust eliminated Trustee's powers with respect to any life insurance policy on Child's life and granted transferred those powers to Insurance Trustee. Insurance Trustee has complete authority to surrender policies, borrow on them, or utilize the proceeds for the benefit of the beneficiary if necessary for the health, support or maintenance of the beneficiary. Accordingly, Trustee is precluded from exercising any power normally conferred on the owner of a policy. Furthermore, the modifications to Trust restrict Child's testamentary special power of appointment. IRS ruled that the result of these modifications is that, with assumptions, Child will not possess any incidents of ownership over any life insurance policy on Child's life acquired by Trust and that the proceeds of any policy on Child's life will not be includible in Child's gross estate under IRC §2042(2).

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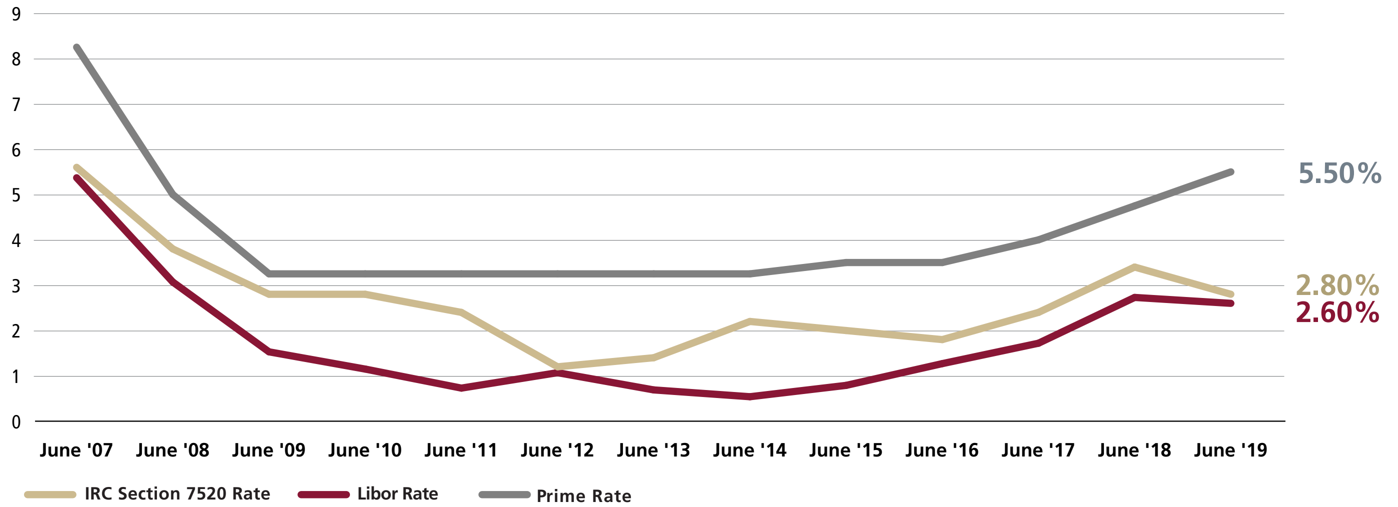
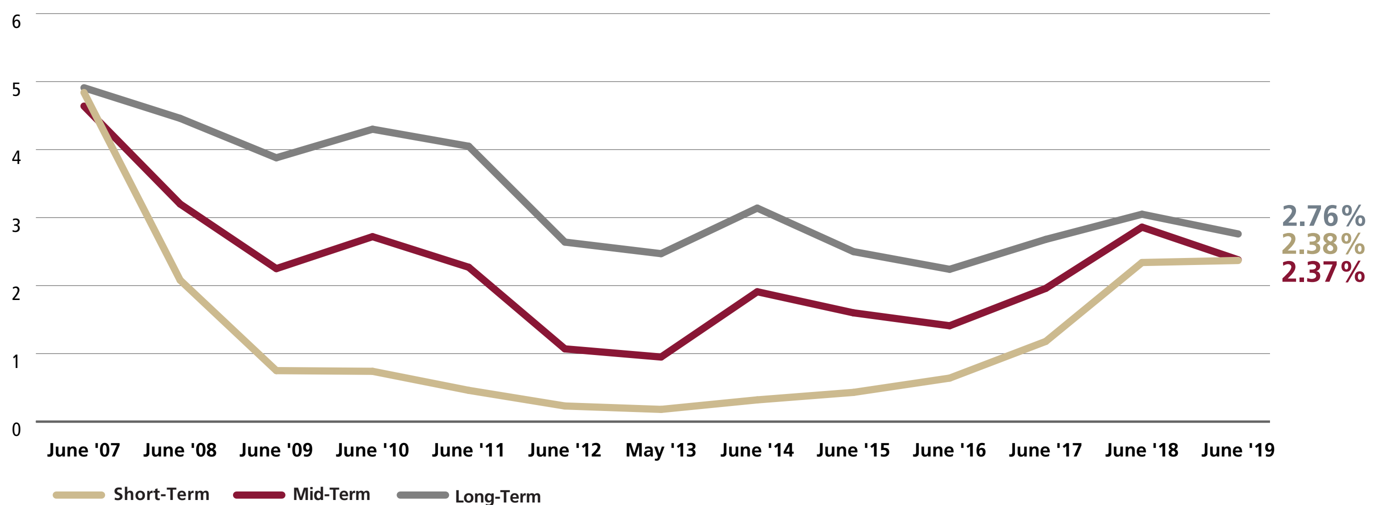
### 7520, LIBOR, AND PRIME RATES




### APPLICABLE FEDERAL RATES

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