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Taxability of life insurance proceeds

Brothers Michael and Thomas Connelly were the sole shareholders of a corporation. The corporation obtained life insurance on each brother so that if one died, the corporation would have ready cash to redeem his shares without impairing the company operations. A buy-sell agreement was in place, giving each brother the right to buy the other's shares at death, and the corporation would redeem the shares if the survivor declined to purchase. Although the agreement included a mechanism for valuing the shares, it was never used.

Michael died first, and the company received $3.5 million of life insurance proceeds. The corporation redeemed the shares for $3 million in an amicable agreement, and Michael's interest in the business was valued at the same $3 million on the federal estate tax return. A $300,000 estate tax was timely paid, likely out of the remaining $500,000 of proceeds..

Upon audit, the IRS disagreed with the valuation of the company. The $3.5 million must be added to the value of the company, as it was a company asset. That brought the total value of the company to $6.86 million. Michael had owned 77.18% of the company, so the estate tax value of his interest came to about $5.3 million. That meant another $1 million in estate taxes were due. Where that money was to come from was not a concern of the IRS.

In Court, the estate argued that the value of the company was controlled by the shareholder's agreement, and although the insurance proceeds were a corporate asset they were offset by the obligation on the company to proceed with the redemption. The arguments were unavailing, first in the District Court and then in the Eighth Circuit Court of Appeals. Given that the appraisals called for by the shareholder's agreement were never done, the agreement provides no point of reference, and it was not actually used in any event. The $3 million figure was simply agreed upon by the heirs and the estate executor some time after the death, it was not the value on the date of death. The claim of an offsetting liability is not logical, the Court explained:

"Thomas. If we accept the estate's view and look to Crown's value exclusive of the life insurance proceeds intended for redemption, then upon Michael's death, each share was worth $7,720 before

redemption. After redemption, Michael's interest is extinguished, but Thomas still has 114.1 shares giving him full control of Crown's $3.86 million value. Those shares are now worth about $33,800 each. Overnight and without any material change to the company, Thomas's shares would have quadrupled in value. This view of the world contradicts the estate's position that the proceeds were offset dollar-by-dollar by a "liability." A true offset would leave the value of Thomas's shares undisturbed."

—Thomas Connelly v. United States, No. 21-3683 (8th Cir. 2023)

COMMENT: Writing for Leimberg Information Services analyzing this case, Paul Hood concludes that it is the right result on these facts. "Unfortunately, some of the broad language and economic analysis of the decision goes beyond this to potentially threaten very legitimate and rational agreements that are assiduously followed" [LISI Business Entities Newsletter #275 (June 20, 2023)].

Put the IRS on notice

A long-standing axiom in estate planning is that when a taxable gift is made, the gift should be promptly reported to the IRS, even if no gift tax is due because of the available lifetime credits. The reason is that the filing of the gift tax return starts the statute of limitations running. Absent fraud, the IRS can't challenge the value of the gift after three years.

The importance of this rule was illustrated in a recent Tax Court case with highly unusual facts. Taxpayer funded a life insurance policy in 2006, and assigned ownership of the policy to other family members in 2007. In 2012 Taxpayer entered into the IRS voluntary offshore disclosure program, to restate his tax obligations from 2004 to 2009. Included in his submission was a gift tax return for 2006, for the purchase of the insurance policy. However, the IRS decided in 2016 that there was no gift in 2006, the gift happened in 2007. The Taxpayer disagreed, and withdrew from the program. The IRS issued a gift tax deficiency of $4.4 million for the 2007 gift in 2019.

Too late, the Tax Court ruled. The gift tax statute of limitations runs from the time that the IRS is put on notice of the transfer, even if the transfer is not completed until a later year. In this case, the IRS became aware of the transfer when Taxpayer submitted his forms for the voluntary disclosure program in 2013, so the statute of limitations (including an extension) expired in 2017.

—Ronald Schlapfer v. Comm'r, T.C. Memo 2023-65

SECURE 2.0 Technical Corrections coming

In May, four prominent Congressmen (two Democrats, two Republicans, both Houses) sent Treasury a letter warning them that technical corrections are in the works to better reflect Congressional intent. Specifically:

- The tax credit for employer plan contributions in Section 102 should be in addition to, not limited by, the credit for starting a plan;
- an ambiguity regarding the increase in RMD age to 75 needs clarification;
- contributions to Roth accounts in SIMPLE IRA and SEP plan are not to be taken into account for determining the Roth IRA contribution limit; and
- catch-up contribution rules were not intended to be modified for the rank and file. Under the new law, an individual who earned more than $145,000 the previous year would be required to make a catch-up contribution in a Roth account. What if the plan didn't provide for Roth accounts at all? Would that effectively mean that no one could make a catch-up contribution?

COMMENT: Tax observers have identified several more areas of SECURE 2.0 in need of a fix. Because the Technical Corrections bill is a tax bill, the time frame for passage is uncertain, and there is a possibility other tax amendments could be included.

Guess who's coming to dinner

In 2018, Loch David Crane, a California resident, died without having made a will. His reasons for not taking care of this important financial chore are unknown, but perhaps it was because he had no surviving spouse, children, siblings,

or grandparents. Under California law, that meant his heirs were the descendants of his grandparents. The only such descendant from the paternal grandparents was Shannon Wehsener, a cousin.

Shannon was named the administrator of the Crane estate. On January 8, 2020, she filed her report and petition for distribution of the estate with the probate court. On February 21, 2020, Judy Scherber filed an objection, claiming that she also was an heir.

Mr. Crane's mother had an adopted brother, Charles Bloodgood. Judy's mother had abandoned her as an infant. When she was two years old, Judy's father asked Charles and his wife to babysit her—then never returned to pick her up. Charles and his wife raised Judy as their own daughter, but they never formally adopted her. When the family moved to Indiana, Charles said he was Judy's father when she was enrolled in school. In his will, Charles called Judy his daughter.

In his entire life Mr. Crane never met either Judy or Charles, as neither of them had been to California. Judy only learned about her potential inheritance when she was contacted by a company that locates missing heirs for a share of their inheritances.

The legal question is whether Judy is a descendant of Crane's grandparents. Had the adoption formalities been attended to, the answer would be yes in all jurisdictions. But under Indiana law, where Judy lives, the answer is no.

California has a more expansive, less formal rule, under which Charles is presumed to be Judy's "natural parent" unless clear and convincing evidence to the contrary is presented. No such evidence was offered, and Judy's attorneys persuaded the California courts that the California rule should apply. Judy gets half of the estate.

—Wehsener v. Jernigan, 302 Cal. Rptr. 3d 916

COMMENT: The Court's decision does not reveal how large the Crane estate was—but it was at least large enough to support four years of legal proceedings.

Nothing is immune from seizure

Omar Firestone was the executor of the estate of Ghaida Firestone. On January 17, 2012, he was notified that the estate tax return had been selected for audit. A recomputed estate tax of over $1.8 million was communicated to Omar by the IRS on April 16, 2013.

Omar owned a valuable cello, crafted in 1816. On May 17, 2013, a month after getting the bad news about the additional estate tax due, Omar created "The Firestone Irrevocable Cello Trust." He was the sole trustee. Ostensibly, ownership passed from him personally to him as trustee.

The estate stipulated to the additional estate tax liabilities in 2014, but Omar never paid them. By 2021 the tax debt had grown to over $2.5 million.

The IRS brought an action to foreclose on certain real property and to seize the cello to begin paying down the tax debt. Omar claimed he owned only a life estate in the cello now, it was no longer his property. Oddly, the trust did not name any beneficiary other than Omar, although he produced an unsworn e-mail from a rare instrument seller claiming to have the remainder interest.

The District Court was unpersuaded. Taking the trust at face value, Omar had both equitable and legal interests in the cello, and so is properly regarded as the real owner. The IRS may take it. In a footnote, the Court observed that it need not reach the issues of whether the Trust is merely Mr. Firestone's nominee or alter ego, was created for unlawful purposes, or was self-settled in order to avoid creditors.

—United States v. Omar G. Firestone et al., 2:22-CV-01201-TL (W.D. Wash. Mar. 28, 2023)

At the IRS, whistleblowers come in two categories

The first is the IRS employee who sees a problem in the agency. The two IRS employees who went to Congress with their concerns about how the tax investigation of Hunter Biden was handled are examples of this sort. In a July 7 internal memorandum, IRS Commissioner Daniel Werfel provided guidance confirming that whistleblowing is encouraged. "I want it to be clear that we will always encourage a 'see something, say something' philosophy," he wrote. Concerns are normally raised through the chain of command, he wrote, but when that is not appropriate, the alternatives include

- Treasury Inspector General for Tax Administration (TIGTA)
- Relevant Oversight Committees of the U.S.Congress
- U.S. Office of Special Counsel (OSC); and/or
- U.S. Department of Justice Office of Inspector General

The other category of whistleblower is those in the general public who provide tips to the IRS, and who in turn may collect a portion of the increased taxes collected. It was thought that with the increased funding of the IRS last year, this area would grow smartly, but so far that has not been the case.

In fiscal 2022, the IRS Whistleblower Office paid $37.8 million in cash awards on $172.7 million in taxes collected, from 132 cases. Although that is a bit more than the $36.1 million paid the year before as rewards, it was a drop from the 179 cases in the earlier period. In fiscal 2018—the high-water mark for the program—the IRS made 217 award payments to whistleblowers totaling $312 million and collected a total of $1.44 billion for the government.

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