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INCOME TAX AND ESTATE TAX UPDATE

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NEWS UPDATES

Supreme Court Cases

The Supreme Court's 2023-24 term has ended, and three important cases which will have significant impact on federal taxes and businesses were decided.

Moore v. United States

The first opinion is in Moore v. United States. In this case the Supreme Court upheld a one-time tax on foreign earnings which assessed a mandatory one-time tax of up to 15.5% on previously untaxed offshore accumulated earnings of many U.S.-owned foreign corporations. The tax was due from U.S. owners based on their ownership of the foreign corporation, regardless of whether they received a distribution of earnings from the firm. A couple who owned shares of an Indian corporation, and were charged this tax, argued before the Supreme Court that the tax is assessed on unrealized earnings and is unconstitutional. The high court disagreed and ruled that the tax was valid.

Taxing undistributed income of foreign firms held by U.S. taxpayers is proper. Per the Court, the tax taxes realized income…namely, income realized by the corporation in prior years. The tax attributes a foreign firm's realized income to its shareholders, and subsequently taxes the shareholders on their share of that attributed income. Because of this, the Court didn't need to address whether unrealized income is taxable.

Significance of the Decision

It's important to note that the Court intentionally kept its decision narrow. The opinion signed onto by the majority of the justices says that the decision doesn't address the taxation of unrealized income, a wealth tax or net worth tax, or income taxes on appreciation in the value of assets (e.g., a mark-to-market tax).

A wealth tax is usually defined as an annual tax levied on the net worth, or total assets net of all debts, of an individual or household above an exemption threshold. Net worth is made up of financial assets — such as bank accounts, bonds, stocks, and mutual funds — as well as non-financial assets — such as real estate, luxury goods, and family heirlooms. Most proposals suggest levying a wealth tax as an addition to existing forms of taxation, not as a substitute.

Though this case didn't answer whether the 16th Amendment requires realization, at least four justices said that income must be realized to be constitutionally taxed leaving the fate of a national wealth tax, which some in Congress have proposed, doubtful, but not clearly dead. Under the view of the four justices, such a tax would have to be apportioned among the states based on population.

Loper Bright v. Raimond

The second case involves judicial deference given to government regulations. In Loper Bright v. Raimondo, the Court overruled the Chevron doctrine, which was derived from a 40-year-old high court case that said when a federal statute is ambiguous, a reasonable interpretation by the agency writing the regs will be upheld. In overruling Chevron, the Court stated:

> *"The Administrative Procedure Act requires courts to exercise their independent judgment in deciding whether an agency has acted within its statutory authority, and courts may not defer to an agency interpretation of the law simply because a statute is ambiguous; Chevron is overruled."*

The nullification of Chevron means that "much of the day-to-day regulatory framework for tax will be put on hold and litigated. In the longer term, Congress will need to be incredibly specific in the statutes it passes. This will be difficult in the current political environment, as getting anything done in Congress is a chore."

Significance of the Decision

The decision will strip federal agencies of some of their power to write regs. Going forward, judges will have more flexibility to determine how to review the rules. What will this mean for the Dept. of Treasury and IRS on tax regulations? It will take time to fully see the implications, but here are initial thoughts: Controversial tax regs will be the most vulnerable to judicial challenge - rules on partnership basis-shifting transactions between related parties, syndicated easement donations, and clean-energy tax breaks, just to name a few. And it could impact IRS's and Treasury's rulemaking going forward. For instance, it will be harder for IRS to fill in the blanks on newly enacted legislation that Congress didn't want to address or couldn't address when passing the law. IRS will still write tax regs, but there is lots more it will now need to consider.

The *Loper Bright* ruling gives taxpayers an opportunity to challenge these regulations on an even playing field. This could allow taxpayers to obtain the tax benefits that Congress originally intended, without the additional statutory interference imposed by the Treasury and IRS. This represents a significant shift in the balance of power in tax law interpretation and application.

Estate of Connelly

The Supreme Court curbs an estate tax planning angle for closely held firms: Earmarking life insurance proceeds to redeem a deceased owner's stock. Two brothers who owned a corporation entered into a stock purchase agreement that contractually required the firm to acquire all the shares of the first brother to die. The firm bought life insurance to make sure it had enough cash to acquire the stock. Upon the death of one of the brothers, the company used the life insurance proceeds to purchase the decedent's shares for $3 million. For estate tax purposes, the executor valued the decedent's shares at $3 million, treating the firm's contractual obligation to redeem the decedent's shares as a liability that offset the life insurance proceeds committed to funding the redemption. But that was incorrect, the high court decides. When accounting for the life insurance proceeds received, the estate tax valuation of the decedent's redeemed shares is closer to $5.3 million (Est. of Connelly).

Significance of the Decision

A stock purchase or buy-sell agreement, like the agreement in the Connelly case, can generally either take the form of a “cross-purchase” agreement or a “redemption agreement.”

A cross-purchase agreement is an agreement solely among the entity’s owners, i.e., the shareholders, partners, or members. The entity itself is not directly involved in the purchase rights or obligations. The funding of the obligation under this type of agreement must occur at the owner level. In many cases, the owners will own life insurance on each other to fund the buy-out obligation in case one of the owners dies.

Example: A and B are the sole shareholders of XYZ, Inc. They entered into a cross-purchase agreement. Under the terms of the agreement, A and B agree that neither will transfer his stock in XYZ without first offering it to the other shareholder. A takes out a life insurance policy on B in the amount of the purchase obligation, B does the same on A’s life. If, for example, B dies, the agreement provides that A will purchase B’s stock at an agreed-upon price. The obligation is funded with the life insurance A purchased on B’s life.

A redemption agreement is like a cross-purchase agreement with the difference being that the purchase obligations fall on the entity rather than the owners.

Example: Same facts as in the Example in C.2., above. In the event either A or B dies, the corporation has the obligation to purchase the deceased shareholder’s stock. The corporation purchase life insurance of both A and B to fund the purchase obligation.

In Connelly, the stock purchase agreement was in the form of a stock redemption agreement. The corporation had acquired life insurance on the lives of the two brothers to make sure it had enough cash to acquire the stock. The Supreme Court held that the life insurance received on the death of an owner increased the value of the corporation for estate tax purposes. The Connelly decision makes redemption agreements the less attractive option as compared to cross purchase agreements for this reason. If the brothers in the Connelly case had adopted a cross-purchase agreement, the life insurance funding the purchase obligation would have been held outside the corporation and would not have been included as a corporate asset in the valuing the corporation for estate tax purposes.

More on Employee Retention Credit Refund Claims

IRS will slowly work on its logjam of employee retention credit refund claims. The emphasis is on slowly. This COVID-19-related payroll tax break for firms was designed to help eligible businesses whose operations were fully or partly halted, or whose gross receipts fell significantly, during the height of the pandemic. Employers had been swamping IRS with Form 941-X filings seeking refunds for prior-year employment taxes that they paid and any excess refundable ERCs. By the end of May 2024, IRS had more than 1.3 million unprocessed ERC claims. Per IRS, a significant number of the filings were improper, with some due to fraud.

The agency halted its processing of ERC refund claims in Sept. 2023, citing the need for a detailed review. IRS has completed that review and has more bad news for filers. Most ERC claims that IRS has reviewed have the potential for errors. IRS says that 10% to 20% of filings are clearly erroneous and between 60% and 70% show an unacceptable level of risk of error. Only 10% to 20% are zero-risk or low-risk. IRS will begin to process refund claims in this third group, provided the taxpayer filed the 941-X before Sept. 14,

2023. Later-filed claims will continue to be subject to the agency's moratorium on processing until the agency announces otherwise. Meanwhile, many legitimate ERTC filers are stuck waiting for their refunds with no recourse. Although IRS will have to pay interest when it eventually doles out the delayed refunds, that won't help businesses that need the money now.

Rescheduling and Recreational Marijuana: Possible Step Toward National Legalization?

On May 16, 2024, the Department of Justice ("DOJ") issued its Notice of Proposed Rulemaking related to the transfer of marijuana from schedule I of the Controlled Substances Act ("CSA") to schedule III ("NPRM"), consistent with the recommendation provided by the Department of Health and Human Services ("HHS") in August 2023. The CSA requires that rescheduling must be accomplished through a formal rulemaking process and public comment starting 60 days from the date of publication in the Federal Register.

Pursuant to the HHS Recommendation and the corresponding NPRM, the basis for rescheduling marijuana is based on the view that marijuana has a currently accepted medical use and lower propensity for abuse potential and physical or psychological dependence. While many believe rescheduling is a positive step forward for marijuana, the recreational marijuana markets may see only one true benefit from rescheduling.

Specifically, rescheduling is expected to eliminate the bar on claiming a federal deduction for marijuana business expenses under Code Sec. 280E for both recreational and medicinal marijuana enterprises because, by its plain terms, the Code Sec. 280E bar only applies to trafficking in Schedule I and II controlled substances. Code Sec. 280E prevents marijuana businesses from claiming tax credits and deductions for ordinary business expenses, including salaries, rent, utilities, travel and property expenses.

Yet, it is unclear what reclassification could entail or how it would affect recreational/adult-use marijuana enterprises. For example, the DOJ's NPRM states, within its summary, that "if marijuana is transferred into schedule III, the manufacture, distribution, dispensing, and possession of marijuana would remain subject to the applicable prohibitions of the CSA." Thus, at this point it still unknown how the recreational market may be affected, outside of the benefits of Code Sec. 280E no longer being applicable to marijuana.

At this time it is by no means clear that reclassification would cure all regulatory ills in the multi-billion dollar industry, which is permitted under state law to sell marijuana for medicinal use in 38 states and the District of Columbia, and 24 states plus the District of Columbia have legalized recreational, or adult-use, marijuana products.

Further, insofar as commerce in marijuana is concerned, reclassification to Schedule III would constitute only an acknowledgment that marijuana "has a currently accepted medical use" and that its abuse "may lead to moderate or low physical dependence or high psychological dependence." How that acknowledgment is codified into federal law could have enormous implications for the marijuana industry.

For instance, would marijuana be a prescription drug requiring manufacturers and distributors to be registered and, if so, would enterprises engaged in the sale of recreational marijuana products remain barred from accessing the federal bankruptcy system due to perceived violation of the CSA?

What changes will marijuana companies see as to bank access if they are engaged in the recreational market outside of Drug Enforcement Administration (DEA) registration for schedule III substances, or will the Attorney General not require registration under a determination that the requirement for registration is inconsistent with the public interest? 21 U.S.C. § 823.

Further, what will be the effect on existing state medical marijuana laws? As of now, these questions have no clear answers.

Ultimately, much remains to be determined, and there are presently more questions than answers about the implications of marijuana rescheduling. But many current industry players agree that rescheduling to a schedule III substance will in fact be a positive action related to the immense ramifications related to Code Sec. 280E, providing the same tax relief non-marijuana businesses enjoy today.

Additionally, the state-by-state legalization of medical marijuana seems to have been a catalyst for the widespread state legalization of recreational marijuana. A summary of the history since the 1970 enactment of the CSA, which criminalized any use of marijuana nationwide, is instructive for consideration of the potential ramifications of the federal government's current, apparent openness to federal regulation of the use and sale of medical marijuana.

Current landscape and future prospects

If all that rescheduling accomplishes for recreational marijuana is the elimination of the Code Sec. 280E bar on claiming a federal deduction for business expenses, further regulatory actions will be needed to truly remove the industry's major regulatory impediments — namely the lack of access to the banking system and to the federal bankruptcy system, as merely two examples in a very complicated industry.

This means that pending congressional bills like the Cannabis Administration and Opportunity Act, the Marijuana Opportunity Reinvestment and Expungement Act, and the States Reform Act — all of which would de-schedule marijuana from the CSA, making marijuana legal — ultimately could prove more vital to the industry than reclassification of marijuana to a Schedule III drug under the CSA.

This is due to the fact it is unknown if the DEA would still see manufacturing and sales of marijuana for recreational use as illegal and a violation of the CSA due to lack of registrations required for Schedule III substances.

Reminder: Marijuana Businesses Still Subject to Section 280E (07/03/2024):

In a News Release, the IRS has reminded taxpayers that, until a final federal rule is published, marijuana remains a Schedule I controlled substance and marijuana businesses remain subject to Code Sec. 280E. The IRS issued this reminder because some taxpayers are claiming refunds based on prohibited deductions. The IRS is taking steps to address these invalid claims. (IR 2024-177, 6/28/2024)

US Treasury Finalizes New Crypto Tax Reporting Rules

The US Treasury Department finalized a rule on Friday requiring cryptocurrency brokers, including exchanges and payment processors, to report new information on users' sales and exchanges of digital assets to the Internal Revenue Service. (TD 10000)

The new requirements aim to crack down on crypto users who may be failing to pay their taxes, and stem from the $1 trillion bipartisan 2021 Infrastructure Investment and Jobs Act. At the time the bill was passed, it was estimated that the new rules could bring in close to $28 billion over a decade.

The rule, which would be phased in starting next year for the 2026 tax filing season, align the tax requirements for cryptocurrencies with existing tax reporting requirements for brokers for other financial instruments, such as bonds and stocks, Treasury said.

The final rule was modified from Treasury's original proposal in order to limit some burdens on brokers and to phase in the new requirements in stages, Treasury officials said. It also includes a $10,000 threshold for reporting on transactions involving stablecoins, a type of crypto token typically pegged to an asset like the US dollar.

The cryptocurrency industry had waged a comment letter campaign after Treasury proposed the rule last year, arguing that the scope of the proposal's definition of a broker was too broad and that the requirements violated the privacy of crypto owners.

Treasury said it reviewed more than 44,000 comments on the proposal. It also said it anticipates issuing additional rules later this year to establish tax reporting requirements for non-custodial brokers, including decentralized crypto exchanges.

In a release, Treasury emphasized that crypto owners "have always owed tax on the sale or exchange of digital assets" and that the new rule "simply created reporting requirements... to help taxpayers file accurate returns and pay taxes owed under current law."

The rule introduces a new tax reporting form called Form 1099-DA, meant to help taxpayers determine if they owe taxes, and would help crypto users avoid having to make complicated calculations to determine their gains, according to the Treasury Department.

Brokers would need to send the forms to both the IRS and digital asset holders to assist with their tax preparation.

The IRS currently requires crypto users to report many digital asset activities on their tax returns, regardless of whether the transactions resulted in a gain. Users are required to make that calculation themselves, and the platforms on which digital assets trade do not give the IRS that information.