Current Federal Tax Developments

Week of June 23, 2019

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ACCOUNTING
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KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF JUNE 23, 2019
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Published in 2019 by Kaplan Financial Education.

Printed in the United States of America.

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Kaplan Financial Education

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SECTION: STATE TAX
MERELY HAVING AN IN-STATE INCOME BENEFICIARY INSUFFICENT TO ALLOW A STATE TO TAX ALL TRUST INCOME

Citation: North Carolina Department of Revenue v. The Kimberly Rice Kaestner 1992 Family Trust, United States Supreme Court, Case No. 18-457, 6/21/19

The U.S. Supreme Court appears to be making June 21 its annual tax opinion day. Or, at least, they've issued the major tax opinion of the term on June 21 for the past two years. While last year's issue related to sales taxes (*Wayfair*), this year the issue is whether a state can tax a trust solely based on the trust having a resident current income beneficiary, even if that beneficiary has no right to force a current distribution of such income, no such distribution is made, and there' s no guarantee the beneficiary will ever receive such a distribution.

A unanimous Supreme Court decided that the answer is no, a state cannot impose its tax in that situation, in the case of *North Carolina Department of Revenue v. The Kimberly Rice Kaestner 1992 Family Trust*, United States Supreme Court, Case No. 18-457.[1] Justice Sotomayor wrote the main opinion on behalf of the Court.

The Court was to decide if the North Carolina Supreme Court had correctly ruled that the imposition of this tax violated the Due Process Clause of the Fourteenth Amendment to the U.S. Constitution. The opinion explains that, in the context of state taxation, two tests must be met by the state to not run afoul of the Due Process clause:

- There must be a definite link between the state and the item it seeks to tax and
- The income attributed to the state for tax purposes must be rationally related to values connected with the taxing state.[2]

With regard to the first test that the Court decides this case upon, the opinion provides the following discussion of how that test is applied:

> *To determine whether a State has the requisite "minimum connection" with the object of its tax, this Court borrows from the familiar test of International Shoe Co. v. Washington, 326 U. S. 310 (1945). Quill, 504 U. S., at 307. A State has the power to impose a tax only when the taxed entity has "certain minimum contacts" with the State such that the tax "does not offend 'traditional notions of fair play and substantial justice.'" International Shoe Co., 326 U. S., at 316; see Quill, 504 U. S., at 308. The "minimum contacts" inquiry is "flexible" and focuses on the reasonableness of the government's action. Quill, 504 U. S., at*

[1] https://www.supremecourt.gov/opinions/18pdf/18-457_2034.pdf, Retrieved June 21, 2019

[2] *Ibid*, pp. 5-6

> *307. Ultimately, only those who derive "benefits and protection" from associating with a State should have obligations to the State in question. International Shoe, 326 U. S., at 319.*

The opinion notes that the Supreme Court has found that such a minimum connection has existed in the trust context in the following situations:

- Income is distributed to an in-state beneficiary;
- The tax is based on the in-state residence of the trustee of the trust; and
- The state is the site of trust administration (though the opinion in this case states the prior opinions "suggest" this result)[3]

None of those situations applied to the Kaestner Trust. No distributions were made to Kimberly Kaestner or her children (the beneficiaries who lived in North Carolina) during the years in question, the trustee resided in Connecticut, the records of the trust were kept in New York, the custodians of the trust assets were located in Massachusetts, the trust had no property in North Carolina and the settlor of the trust did not reside in North Carolina. Rather, North Carolina claimed the right to tax all undistributed income of the trust based solely on the residency of Kimberly Kaestner, the trust's potential income beneficiary who received no distributions in the years in question.

The Court wastes no time stating the ultimate holding it will make, immediately telling the reader:

> *We hold that the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain ever to receive it. In limiting our holding to the specific facts presented, we do not imply approval or disapproval of trust taxes that are premised on the residence of beneficiaries whose relationship to trust assets differs from that of the beneficiaries here.*[4]

The opinion notes that in previous opinions where the question of a beneficiary's status and a state's ability to impose a tax has arisen, the Court focused on "extent of the instate beneficiary's right to control, possess, enjoy, or receive trust assets."[5]

The opinion notes that the same question regarding power and control have arisen when the Court has decided this issue based upon the residence of settlors and trustees. The opinion states:

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[3] *Ibid*, p. 6

[4] *Ibid*, p. 7

[5] *Ibid*

> *In Curry, for instance, the Court upheld a Tennessee trust tax because the settlor was a Tennessee resident who retained "power to dispose of" the property, which amounted to "a potential source of wealth which was property in her hands." 307 U. S., at 370. That practical control over the trust assets obliged the settlor "to contribute to the support of the government whose protection she enjoyed." Id., at 371; see also Graves v. Elliott, 307 U. S. 383, 387 (1939) (a settlor's "right to revoke [a] trust and to demand the transmission to her of the intangibles . . . was a potential source of wealth" subject to tax by her State of residence).*
>
> *A focus on ownership and rights to trust assets also featured in the Court's ruling that a trustee's in-state residence can provide the basis for a State to tax trust assets. In Greenough, the Court explained that the relationship between trust assets and a trustee is akin to the "close relationship between" other types of intangible property and the owners of such property. 331 U. S., at 493.*
>
> *The trustee is "the owner of [a] legal interest in" the trust property, and in that capacity he can incur obligations, become personally liable for contracts for the trust, or have specific performance ordered against him. Id., at 494. At the same time, the trustee can turn to his home State for "benefit and protection through its law," id., at 496, for instance, by resorting to the State's courts to resolve issues related to trust administration or to enforce trust claims, id., at 495. A State therefore may tax a resident trustee on his interest in a share of trust assets. Id., at 498.*

For beneficiaries, the opinion holds:

> *When a tax is premised on the instate residence of a beneficiary, the Constitution requires that the resident have some degree of possession, control, or enjoyment of the trust property or a right to receive that property before the State can tax the asset. Cf. Safe Deposit, 280 U. S., at 91–92.8 Otherwise, the State's relationship to the object of its tax is too attenuated to create the "minimum connection" that the Constitution requires. See Quill, 504 U. S., at 306.*[6]

In this fact pattern, the Court concludes it's clear the beneficiaries do not have sufficient rights with regard to trust property to allow the state to impose its tax on trust income.

The Court refused to accept North Carolina's view that a trust and its constituents are "inextricably intertwined" so that if, say, the fact that trustee residence would support taxation, the same must be true for the residency of the beneficiary.[7] The opinion finds that the rights of beneficiaries vary too widely to allow the Court to accept the position that North Carolina's view should be adopted as an absolute rule.

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[6] *Ibid*, p. 10

[7] *Ibid*, p. 14

The Court also found that overturning North Carolina's law would not serve to undermine a large number of state taxation schemes trusts. The opinion notes that North Carolina is part of a very small minority states that claim the right to tax all income of a trust based on a resident beneficiary who received no distributions.[8]

Finally, the Court did not accept the state's view that not allowing it to tax the trust's income would inevitably lead to gaming of state tax systems. The Court found that it was far from clear that would happen. And even if that were the case, "mere speculation about negative consequences cannot conjure the 'minimum connection' missing between North Carolina and the object of its tax."[9]

The Court specifically notes that this opinion does consider the validity of a state tax regime that considers the residency of a beneficiary as one factor in determining the taxation of trust of trust income. One such state that has this sort of test is California.[10]

Justice Alito, joined by Chief Justice Roberts and Justice Gorsuch, wrote a concurring opinion to emphasize that this opinion is based on North Carolina's "tenuous connection" to the trust and merely applies existing precedent to that narrow issue. The opinion, in the view of the three who joined in this opinion, does not open up any prior opinion for reconsideration.

So what does this opinion add to our knowledge of the conditions under which a state can tax the income of a trust? Not much, actually. It seems possible, under the ruling, that trusts other than those with the unique characteristics of the Kaestner Trust might still find themselves subject to tax on all income of the trust by North Carolina based on the residence of a beneficiary so long as that person has sufficient rights to control, possess, enjoy, or receive assets of the trust.

All we really know is Kimberly Kaestner and her children have been found, under these facts, to not possess such rights. And, therefore, North Carolina cannot impose its tax on this trust's income at this time. What other situations create similarly tenuous conditions that bar a state's ability to tax will have to await future cases and decisions.

The opinion does recite other situations that do justify a state taxing all trust income, including simply have a trustee who resides in the trust (a test the state of Arizona uses to determine if it will claim the right to tax all of a trust's undistributed income).

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[8] *Ibid*, p. 15

[9] *Ibid*, p. 16

[10] *Ibid*, pp. 15-16

SECTION: 1341
INDIVIDUAL'S REIMBURSEMENT OF HER SHARE OF REPAID WAGES OF HER EX-SPOUSE DUE TO LAWSUIT SETTLEMENT QUALIFIES FOR CLAIM OF RIGHT TREATMENT

Citation: Mihelick v. Commissioner, Case No. 17-14975, CA 11, 6/18/19

An individual who paid half of an amount previously included in income by her ex-spouse on a joint return was allowed a claim of right deduction under IRC §1341 for her payment in the case of *Mihelick v. Commissioner*, Case No. 17-14975, CA 11.[11]

Claim of right issues are the sort of thing CPAs run into infrequently, but almost everyone seems to hit at least one or two during a career in tax. The claim of right rule, found at IRC §1341(a), provides the following:

> *(a) General rule If—*
>
> > *(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;*
> >
> > *(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and*
> >
> > *(3) the amount of such deduction exceeds $3,000,*
> >
> > *then the tax imposed by this chapter for the taxable year shall be the lesser of the following:*
> >
> > *(4) the tax for the taxable year computed with such deduction; or*
> >
> > *(5) an amount equal to—*
> >
> > > *(A) the tax for the taxable year computed without such deduction, minus*
> > >
> > > *(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).*

[11] http://media.ca11.uscourts.gov/opinions/pub/files/201714975.pdf, retrieved June 21, 2019

> *For purposes of paragraph (5)(B), the corresponding provisions of the Internal Revenue Code of 1939 shall be chapter 1 of such code (other than subchapter E, relating to self-employment income) and subchapter E of chapter 2 of such code.*

Ms. Mihelick had been married to Michael Bluso. She filed for divorce in 2004 and as that proceeded her soon to be ex-husband's sister filed a suit against Ms. Mihelick's soon to be ex-husband. The opinion describes the facts as follows:

> *From 1999 to 2004, the couple lived in Ohio and worked at Gotham Staple Company, a closely held Ohio corporation owned by Bluso's family. Mihelick worked for the company, planning events, caring for and maintaining the homes of Bluso's parents, and handling administrative tasks. Bluso was the chief executive officer of Gotham at the time, and he eventually became majority shareholder as well. Both Mihelick and Bluso earned income for their roles at Gotham, and the couple filed joint tax returns that included Bluso's income during those years. The couple likewise paid taxes on the taxable income they earned from Gotham during that time.*
>
> *In September 2004, Mihelick filed for divorce. While the divorce was pending, Pamela Barnes — one of Bluso's sisters, who was a minority shareholder at Gotham — sued Bluso, Gotham, and others. Among other things, Barnes claimed that Bluso had breached his fiduciary duties by excessively compensating himself at Gotham's expense.*
>
> *Mihelick was not a party to the litigation, but Bluso wanted Mihelick to share any resulting liability from Barnes's lawsuit. To Bluso, Mihelick had also reaped the benefits of his compensation, so she should share the burdens of his compensation as well.*
>
> *At first, Mihelick opposed the idea of sharing liability for the Barnes litigation — she wanted the separation agreement to provide that she was "not liable for anything that Pam Barnes comes up with." But when Bluso threatened to have a judge decide Mihelick's responsibility, Mihelick relented and agreed to share liability for the Barnes lawsuit.*
>
> *After some back and forth between the parties about how to divide the liability, they agreed to Article 5 of their separation agreement, which provided that any liability from the Barnes litigation would be considered a marital liability for which Bluso and Mihelick would be jointly and severally liable. Specifically, the section clarified that the liability "arose all or in part from the acquisition of marital assets," and that since the marital assets had been equally divided, the liability "shall be deemed to be a marital liability," too.*[12]

Eventually Mr. Bluso settled the dispute with his sister for $600,000, which he paid. He then sought reimbursement from Ms. Mihelik for half of those funds. While she initially resisted paying it, eventually, after her attorney told her it was required under the divorce agreement, she paid Mr. Bluso $300,000.

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[12] *Ibid*, pp. 4-6

Mr. Bluso claimed a tax benefit on $300,000 of the payment under the claim of right doctrine of §1341, and the IRS granted him that relief.[13] Mr. Bluso testified he did not claim the entire $600,000 he paid, as he did not feel it was right to do so, since Ms. Mihelick was liable for the other $300,000.[14]

But when Ms. Mihelick attempted to get relief for her $300,000 payment under the same provision, the IRS balked at granting that relief. The question of whether she can get relief under §1341 depends on three factors, all of which the IRS claims are resolved against her:

The taxpayer must have appeared to have had an unrestricted right to the income (meaning the taxpayer reasonably believed she had such a right);

- The taxpayer must show she actually did not have an unrestricted right to the income; and
- The taxpayer must be eligible to deduct the payment under another provision of the IRC.[15]

The IRS first argued that the taxpayers did not have appear to have an unrestricted right to the income since, the government argued, Mr. Bluso knowingly misappropriated money from the Company. The opinion noted that if an individual knowingly steals income, there would be no reasonable belief that the person had an unrestricted right to the income, thus failing the first test.[16] But the opinion noted:

> *But here, the record lacks any proof that Bluso knowingly misappropriated income, since his settlement agreement with Barnes expressly disclaimed any wrongdoing. Since we must take the facts in the light most favorable to Mihelick, the government's contention that Bluso did not believe he had an unrestricted right to his income necessarily fails.*

The IRS also argued that Ms. Mihelick had no right to the income, since the salary was her husband's salary. But the opinion first notes that's what relevant is not if she had a right to the income, but whether she *believed* she had an unrestricted right to such income. The opinion notes that §1341 only applies when it turns out the taxpayer did not have such a right—so §1341 would never apply if the taxpayer had to *actually* have an unrestricted right to the cash. Rather, the taxpayer must simply reasonably believe she had such a right.[17]

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[13] *Ibid*, p. 6

[14] *Ibid*, p. 5

[15] *Ibid*, p. 8

[16] *Ibid*, p. 9

[17] *Ibid*, p. 10

As well, the opinion, relying on Ohio property law, found that Ms. Mihelick did have a right to this income even though it was salary issued to her then husband. The opinion notes:

> *Although Ohio is not a community property state, it does treat income from labor — as opposed to passive income — as marital property, and "[e]ach spouse shall be considered to have contributed equally to the production and acquisition of marital property." Ohio Rev. Code § 3105.171. Marital property is to be divided equally upon divorce, unless doing so would be inequitable. Id. So it appears that under Ohio law, Bluso's income was marital property, and Mihelick presumptively had an equal right to it.*[18]

The panel also found that the second prong of the test was met—she did not actually have an unrestricted right to the funds. If a taxpayer merely gives the money back voluntary (that is, not under any compulsion), that would not meet the requirement to show she did not have an unrestricted right to funds.

The panel notes that the mere fact that the payment arose from a settlement rather then a final judgment does not make this into a voluntary payment of funds rather than a showing that the couple did not have an unrestricted right to the funds. Citing the Tax Court's reasoning in *Barrett v. Commissioner*, 96 TC 713 (1991), the panel noted that a good faith, arm's length settlement of a lawsuit will qualify to show the unrestricted right did not exist.[19]

That is true both of the settlement with Mr. Bluso's sister to pay back the full $600,000 and Ms. Mihelick's agreement to reimburse Mr. Bluso for half of that payment.[20]

The final test is whether Ms. Mihelick would have the right to a claim a deduction for the amount she paid under some provision of the IRC so she obtains the right to elect to use the credit under §1341 in lieu of that deduction. The panel found that the payment would qualify for a deduction under IRC §165(c)(1) on its own.[21] IRC §165 provides in part:

> *§165 Losses*
>
> *(a) General rule*
>
> *There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.*
>
> …

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[18] *Ibid*, p. 11

[19] *Ibid,* p. 15-18

[20] *Ibid,* p. 18

[21] *Ibid*, p. 20

(c) Limitation on losses of individuals In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

The panel found this situation like the situation the Tax Court addressed in the case of *Butler v. Commissioner*, 17 TC 675 (1951) where a corporate officer was sued for a claimed breach of fiduciary duty as an officer of the corporation and was granted a deduction for a payment made personally to settle the suit.[22]

Applying that reasoning to the dispute that gave rise to Ms. Mihelick's payment, the decision notes:

As CEO and majority shareholder, Bluso carried out the trade or business of serving as a fiduciary and employee of Gotham. Barnes's lawsuit alleged that Bluso breached his fiduciary duty by misappropriating funds from Gotham as he was acting as CEO. The two sides then settled the lawsuit. So the settlement payment was made "in settlement of a suit for breach of trust or mismanagement of funds by a fiduciary, where the threatened litigation is bona fide" and "arises . . . out of the business of the taxpayer." Butler, 17 T.C. at 679. And, like the case in Butler, there is no public policy issue with allowing the deduction because Bluso may well be innocent, since his settlement disclaimed wrongdoing. Thus, as was the case with the settlement amount in Butler, the $600,000 settlement here was deductible as a loss incurred in Bluso's business as a fiduciary.

Since Mihelick was presumed to have contributed equally to the production and acquisition of the income from Gotham, she also was presumed to have contributed equally to the ensuing $600,000 liability. And the couple affirmed that presumption through their actions, as Mihelick did pay for her share of that liability. Because she paid for half the liability that she helped create, and because that liability was deductible under § 165(c)(1), Mihelick can take a deduction for her payment under § 165(c)(1).[23]

The panel concludes that Ms. Mihelick has the right to claim the benefits of IRC §1341. Thus, she is allowed to either claim a deduction for the $300,000 paid as a miscellaneous itemized deduction on Schedule A for the year of repayment, or a credit against her tax for the year of repayment equal to the extra tax paid on the prior joint income tax return related to the $300,000 she paid to her ex-husband during the year. Which path she goes down depends on which path results in the lower tax for the year of repayment.

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[22] *Ibid*, p. 20-21

[23] *Ibid*, p. 22

SECTION: 1361
REGULATIONS ISSUED FOR ESBTS WITH NRA POTENTIAL CURRENT BENEFICIARY SUBJECT TO GRANTOR TRUST RULES

Citation: Reg. TD 9868, 6/13/19

The IRS has moved to plug a potential loophole created when Congress changed the law in the Tax Cuts and Jobs Act (TCJA) to allow an electing small business trust (ESBT) to have a nonresident alien (NRA) potential current beneficiary (PCB). In the proposed regulations REG-117062-18,[24] which drew no comments, the IRS provides that if such an NRA would be treated as the owner of trust corpus under the grantor trust rules for such a trust, the grantor will not be treated as the owner of the S corporation portion of the ESBT.

Less than two months later, the regulations were issued unchanged as final regulations (TD 9868)[25].

In the preamble to the proposed regulations, the IRS pointed out that the committee reports related to the TCJA had stated that allowing NRAs to be PCBs of ESBTs did not pose a risk that the S corporation income would not be subject to U.S. tax, since tax is imposed on the trust and not the beneficiary for S corporation income when shares are held by an ESBT.

However, previously the IRS had taken the position that the grantor trust rules overrode the ESBT rules. So if a trust elected ESBT status that was fully or partially a grantor trust, the deemed owner under the grantor trust rules would be treated as the owner of some or all of the S corporation shares and subject to tax on such income. Now that an NRA can be a PCB of a electing small business trust, it is possible under a number of scenarios that the S corporation income could escape U.S. taxation if that treatment were permitted to continue.

To prevent this from happening, the IRS has added the following to Reg. §1.641(c)-1(b). In Reg. §1.641(c)-1(b)(1)(ii) the IRS provides that, in such a case, "the items of income, deduction, and credit from that grantor portion must be reallocated from the grantor portion to the S portion … of the ESBT." In that case, the trust would pay tax directly on the income from the S corporation.

Example 6 is added at Reg. §1.641(c)-1(l)(6) to illustrate the application of this provision:

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[24] https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-07919.pdf?utm_campaign=pi%20subscription%20mailing%20list&utm_source=federalregister.gov&utm_medium=email, retrieved April 19, 2019

[25] https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-12639.pdf, retrieved June 14, 2019

> *Example 6: NRA as potential current beneficiary. Domestic Trust (DT) has a valid ESBT election in effect. DT owns S corporation stock. The S corporation owns U.S. and foreign assets. The foreign assets produce foreign source income. B, an NRA, is the grantor and the only trust beneficiary and potential current beneficiary of DT. B is not a resident of a country with which the United States has an income tax treaty. Under section 677(a), B is treated as the owner of DT because, under the trust documents, income and corpus may be distributed only to B during B's lifetime. Paragraph (b)(2)(ii) of this section requires that the S corporation income of the ESBT that otherwise would have been allocated to B under the grantor trust rules must be reallocated from B's grantor portion to the S portion of DT. In this example, the S portion of DT is treated as including the grantor portion of the ESBT, and thus all of DT's income from the S corporation is taxable to DT.*

The regulations apply to all ESBTs after December 31, 2017.