Quarterly Tax Updates: Timely Takeaways on IRS Audits, Art, Aircraft & Estate Planning

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In our latest Tax Quarterly Newsletter, we're covering a number of key tax planning topics, including:

The Accidental Art Collector: Income and Estate Tax Considerations

Use of Private Aircraft: Has the IRS Become Your Co-Pilot

What's Up at the IRS

Odds and Ends

The Far Side

What's Up at the IRS

Disclosure of Tax Information

It is always comforting to know that you may be exposed to a "Virtual Peeping Tom." Recently, the IRS sent thousands of letters to taxpayers notifying them that an IRS contractor, Charles Littlejohn, reviewed and/or disclosed their tax return or tax return information. While the IRS has no specific knowledge that Littlejohn disclosed any information outside of *Pro Publica* and *The New York Times*, it could not unequivocally state that taxpayer information has not been disclosed to others. Tax information of notable people, including President Trump, Ken Griffin, and Kelcy Warren was disclosed. Griffin sued the IRS and the Treasury Department and received an apology. Warren also sued Booz Allen, Littlejohn's employer. Littlejohn plead guilty to one count of unauthorized tax information disclosure and was sentenced to five years in prison. If you believe that your tax information has been unlawfully disclosed, you should contact the IRS at: https://www.irs.gov/newsroom/irs-communication-on-data-disclosure

Tax Refunds

Many taxpayers have filed their income tax returns and are awaiting refunds. The IRS has notified taxpayers:

"When the IRS processes your tax return and approves your refund, you can see your actual personalized refund date. Refund information for the most current tax year you filed will generally be available within 24 hours after we acknowledge receipt of your e-filed return. If you filed a paper return, please allow 4 weeks before checking the status."

For more information, see the IRS website: https://www.irs.gov/refunds/about-wheres-my-refund.

Will There Be Fewer IRS Audits and More Settlements?

President Biden's “Inflation Reduction Act” increased funding for the IRS by more than $80 billion. The $80 billion funding was across the four major IRS budget accounts: 57% ($46 billion) was allocated to enforcement; 32% ($25 billion) to operations support; 6% ($5 billion) to business systems modernization; and 4% ($3 billion) for taxpayer services. The remaining 1% ($0.7 billion) was provided to the Treasury Inspector General for Tax Administration, other offices in the Treasury, and the United States Tax Court. Beyond those broad allocations, Congress did not mandate how the funding would be used. President Trump and Treasury Secretary Scott Bessent reduced the IRS headcount, firing 7% of the IRS employees and freezing hiring. The reduction and freeze have resulted in the IRS having to prioritize cases that it will audit and increasing its settlement of cases being audited. One well-known tax lawyer stated that he received a call from an IRS Appeals officer offering to settle a case on taxpayer-friendly terms. Others have reported that prospective audits have been closed before they were opened. Secretary Bessent has stated, “We are doing a big review. I have three priorities for the IRS: collections, privacy, and customer service. We'll see what level is needed to prioritize all those.” Notably missing from Secretary Bessent's statement is *enforcement*, and notably included is *customer service*. This is a shift from the Inflation Reduction Act. Critics have argued that fewer audits encourage tax cheating. Proponents counter that the IRS will target fewer smaller taxpayers.

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Odds and Ends

Scams and Frauds

Romance

In a prior writing, “Pig Butchering” was discussed in detail. In short, Pig Butchering concerns the use of international online romantic scams to induce foolish taxpayers to invest money in purported crypto currency schemes promising large returns. Romance is often the bait used to swindle investors. Unfortunately, Pig Butchering is only the tip of the iceberg. Recently, the *Wall Street Journal* featured an article on “How to Avoid Online Romance Scams.” The article noted that people over 60 reported $357 million in losses from “Romance Fraud” to the Internet Crime Complaint Center in 2023. California had the highest rate of romance scams, while Vermont had the lowest, and Wyoming had the second lowest. Romance scammers are paid in various forms, including gift cards, but median losses from cryptocurrency payments are the highest.

Pre-IPO

The Securities and Exchange Commission (SEC) recently warned of investing in “Pre-IPO” shares of companies. The SEC stated:

"Pre-IPO" investing involves buying a stake in a company before the company makes its initial public offering of securities, also known as “going public.”

Many stock promoters entice potential investors by promising an opportunity to make high returns by investing in a startup enterprise at the ground level.
However, investing at the pre-IPO stage can involve significant risk for investors, including the risk that one could lose one's entire investment. The early-stage company may never be successful, and the share price of the stock may never appreciate in value. In addition, the company may never go public, a market for the company's shares may never develop, and investors may be unable to resell their shares.

Further, pre-IPO offerings are not registered with the SEC. Unregistered securities offerings are prohibited under federal securities laws unless an exemption from registration is available, and many potential registration exemptions do not permit companies relying on them to broadly offer their securities to the general public. As such, many pre-IPO offerings targeted at the general public may even be illegal.

Taxpayers Flee Washington State

Until recently, Washington had a state sales tax, but did not have an income tax. In 2023, Washington began collecting a "capital gains" tax of 7% on gains over $270,000. Jeff Bezos, former CEO of Amazon, moved from Washington to Florida, which does not have any personal income tax and subsequently sold $4 billion in Amazon stock, saving nearly $290 million in Capital Gains taxes. It was recently reported that Bezos plans to sell another $5 billion in Amazon stock, and being a Florida resident, will have no state income tax liability. Bezos' state tax savings should surpass the $290 million in Washington state taxes that he avoided in 2023. Washingtonians now fear that a first in the nation "Wealth Tax" may be enacted. The threat of new Wealth Tax has caused Washington residents to leave the state to seek friendlier tax jurisdictions

Nevada and Texas have also been beneficiaries of the ultra-rich exodus from Washington. Nevada and Texas have no Capital Gains or Estate Tax. Prior to the enactment of its Capital Gains tax regime, Washington witnessed a strong influx of investor money. However, the prospect of paying Capital Gains tax on the sale of a successful business has caused entrepreneurs to think twice before considering relocating to Washington. Fueling this migration, Nevada has established a venture capital fund to support investment in startups that have shown potential to grow. The absence of taxes on Capital Gains in Nevada is a strong incentive for entrepreneurs to start and expand their businesses in Nevada.

ESG Loses and Wins In a Texas Court

In a closely watched court decision, *Spence v. American Airlines*, a Federal Judge held that American Airlines and its Benefits Committee had mismanaged the Company's 401(k) plan by allowing BlackRock to support Environmental, Social, and Governance (ESG) agendas over financial returns. This marked the first time that a Federal Judge has ruled that a retirement committee had breached the ERISA fiduciary duty of loyalty. The Judge ruled that fiduciaries must prioritize financial performance over ESG considerations. The ruling also called into practice the custom of delegating proxy voting authority to an ERISA plan's external managers. However, while the Court found that American Airlines had breached its Duty of Loyalty, it had not breached its Duty of Prudence. In his written opinion, a Texas Federal District Court Judge stated:

"The Court concludes that the facts compellingly demonstrated that Defendants breached their fiduciary duty by failing to loyally act solely in the retirement plan's best financial interests by allowing their corporate interests, as well as BlackRock's ESG interests, to influence management of the plan. However, the facts do not compel the same result for the duty of prudence. Defendants acted according to prevailing industry practices, even if leaders in the fiduciary industry contrived to set the standard. This is fatal to Plaintiff's breach of prudence claim. Accordingly, Plaintiff prevails on the merits of his breach of loyalty claim but not on the breach of prudence claim."

As of this writing, American Airlines has not indicated if it will appeal the Court's decision. If the damages are minimal, American Airlines may forego an appeal. However, if the damages are significant, an appeal is likely absent a settlement. It is certain that the decision has caused plan sponsors to reconsider the authority they give to their external managers.

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The Far Side

You don't have to be a lawyer to know the importance of reading the "fine print" in a written document or contract. This time-worn warning was highlighted in a recent case, *Herrington v. Virginia*. Here are the facts:

1. Herrington was criminally charged with failing to file his 2009 Virginia income tax return. According to the charges, Herrington had $16,736 of *unemployment income* and $9,543 of *rental income*.

2. Herrington decided to represent himself.

3. The jury was instructed that for 2009, Virginia residents with incomes greater than $11,250 were required to file a tax return. Herrington did not object to this instruction.
4. Herrington was convicted of failing to file his 2009 return.
5. At his sentencing, Herrington objected to the jury instruction because it did not distinguish between “income” and “adjusted gross income.”
6. Herrington requested that the court appoint a counsel to assist Herrington with filing posttrial motions.
7. The trial court denied Herrington's motions.
8. Herrington was appointed Appellate counsel who argued that Herrington had received an excessive sentence. This effort failed.
9. Herrington then filed a writ of habeas corpus with the Virginia Supreme Court, which dismissed the writ.
10. Herrington filed a writ of habeas corpus with the U.S. District Court. The District Court dismissed the writ.
11. The case was appealed to the United States Court of Appeals for the Fourth Circuit. The Fourth Circuit vacated the lower-court decision because the Virginia Supreme Court had not considered Herrington's ineffective assistance of counsel claim.
12. The U.S. District Court on remand rejected Herrington's claim.
13. Herrington, again, appealed the case to the United States Court of Appeals for the Fourth Circuit, which found that his appeal counsel was ineffective and reversed and remanded the district court's decision with instructions to issue a writ of habeas corpus unless Herrington was afforded a new state court appeal. The appellate court then granted Herrington a new direct appeal on the jury instruction issue.

How Did This Saga End?

Eventually, it was determined that Herrington could not have been found guilty of failing to file a Virginia tax return for 2009 because the unemployment income of $16,736 did not qualify as *taxable income* for Virginia purposes. Thus, Herrington's income for 2009 fell below the threshold of $11,250 to file a 2009 return. It is an amazing case. Through the trial and appeals, it was never argued that Herrington could not have been found guilty of the crime he was charged with because he never committed a crime. The upshot of the case is clear; always read the fine print.

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