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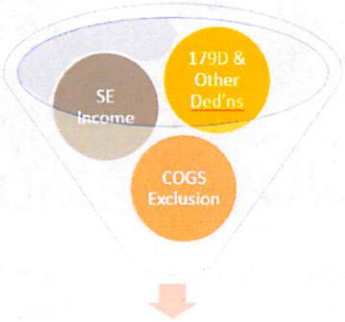
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Federal Tax Update 2024 Developments

Edward K. Zollars, CPA (Arizona)

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Table of Contents

Federal Disaster Tax Relief Act of 2023 Provisions....3
VETT Act Signed Into Law....4
Details of the VETT Act.... 4
IRC §501(c)(19) Requirements.... 4
Employer Reporting Improvement Act (HR 3801) Signed Into Law.... 5
Fifth Circuit Merits Panel Stay on Injunction Against Enforcement of the CTA Vacated After Case Transferred to Merits Panel, BOI Enforcement Back on Hold.... 6
Background.... 7
Reasons for Vacating the Stay.... 7
Additional Points to Consider.... 8
Where Things Stand Now.... 9
Supreme Court Overturns Chevron Deference to Agency Interpretations of Statutes....15
Majority Opinion - The Binding Holding.... 16
The Minority's Objections.... 17
Arguments Against the Majority's Interpretation of the APA and Historical Context....17
Arguments Against the Majority's Disregard for Stare Decisis....18
Arguments Against the Majority's Reasoning on Chevron's Unworkability.... 18
Practical Concerns....19
Additional Points of Criticism....19
Facts of the Case.... 20
Background of Denham Capital Management, LP....20
Partners' Roles and Responsibilities.... 21
Denham's Operations and Revenue.... 22
Denham's Financial and Tax Reporting....22
IRS Adjustments....24
The Court's Analysis and Decision.... 24
Core Issue: Determining Net Earnings from Self-Employment (NESE) and the Limited Partner Exception.... 24
Jurisdiction and the Partnership Item Determination....24
The Functional Analysis Test and the "Limited Partner, as Such".... 25
Application of Functional Analysis Test....25
Rejection of Petitioner's Arguments....26
Conclusion....26
Why Did the Decision Not Rely Simply on the State Law Definition of a Limited Partner?.... 27
The Core Issue: The Limited Partner Exception and Self-Employment Tax.... 27
Why Not Just State Law?.... 27

The Functional Analysis Test: A Deeper Dive..... 28
Precedent for Functional Analysis..... 29
The Court's Conclusion in Denham Capital Management..... 29
Implications for Tax Professionals..... 29
Required Minimum Distribution Final Regulations..... 30
Account Inherited from a Decedent Who Died After 2019 and Had Attained His/Her Required Beginning Date..... 30
Important Considerations:..... 31
Eligible Designated Beneficiaries..... 31
Rules for Eligible Designated Beneficiaries:..... 32
Special Cases..... 33
Surviving Spouse Eligible Designated Beneficiary..... 33
Definition of Surviving Spouse..... 33
Treatment as an Eligible Designated Beneficiary..... 34
Distribution Rules..... 34
Special Rules..... 35
Trusts..... 35
Examples..... 35
Minor Child Eligible Designated Beneficiary..... 36
Definition of a Minor Child..... 36
Treatment as an Eligible Designated Beneficiary..... 36
Distribution Rules..... 36
Special Rules..... 37
Trusts..... 37
Example..... 37
Disabled Eligible Designated Beneficiaries..... 37
Definition of Disability..... 37
Treatment as an Eligible Designated Beneficiary..... 38
Distribution Rules..... 39
Special Rules..... 39
Trusts..... 39
Examples..... 40
Chronically Ill Individual Eligible Designated Beneficiary..... 40
Definition of Chronically Ill..... 40
Treatment as an Eligible Designated Beneficiary..... 41
Distribution Rules..... 41
Special Rules..... 42
Trusts..... 42
No More than Ten Years Younger Eligible Designated Beneficiary..... 43

Definition 43
Treatment as an Eligible Designated Beneficiary 43
Distribution Rules 43
Multiple Beneficiaries 43
Trusts as Beneficiaries 44
See-Through Trusts and Required Minimum Distributions 44
Definition of a See-Through Trust 44
Identifying Trust Beneficiaries 45
Disregarded Beneficiaries 45
Documentation Requirements 45
Special Rules for Applicable Multi-Beneficiary Trusts 46
RMD Calculations 46
Provisions Related to Corrections of RMD Errors 47
Excise Tax on Insufficient Distributions 47
Reduced Excise Tax with Corrective Distribution 47
Corrective Distribution Rules 47
Waiver of Excise Tax 48
Automatic Waiver 48
Disregard of Certain Distributions 48
Other Considerations 48

Federal Disaster Tax Relief Act of 2023 Provisions

Federal Disaster Tax Relief Act of 2023 (HR 5863), signed into law December 12, 2024

The Federal Disaster Tax Relief Act of 2023 provides the following forms of relief:

- **Extends rules for treatment of certain disaster-related personal casualty losses** by applying section 301 of the Taxpayer Certainty and Disaster Tax Relief Act of 2020 using the new act's name in place of the old.
- **Excludes from gross income any amount received by an individual as a qualified wildfire relief payment**. A qualified wildfire relief payment is defined as compensation for losses, expenses, or damages (including additional living expenses, lost wages, personal injury, death, or emotional distress) resulting from a qualified wildfire disaster, to the extent these losses are not covered by insurance or other means. A qualified wildfire disaster is a federally declared disaster after December 31, 2014, resulting from a forest or range fire.
    - This exclusion only applies to payments received in tax years beginning after December 31, 2019, and before January 1, 2026.
    - The Act does not allow a deduction or credit for expenditures to the extent they are covered by the excluded payment, nor does it allow an increase in the basis or adjusted basis of any property as a result of the excluded payment.

- **Treats East Palestine train derailment payments as qualified disaster relief payments** for purposes of section 139(b) of the Internal Revenue Code of 1986. These payments include compensation for loss, damages, expenses, loss in real property value, closing costs, or inconvenience resulting from the East Palestine train derailment.

VETT Act Signed Into Law

VSO Equal Tax Treatment (VETT) Act (H.R. 1432), signed into law December 12, 2024

Details of the VETT Act

The VETT Act, also known as the VSO Equal Tax Treatment Act, modifies the Internal Revenue Code of 1986 by adding a new category of organization to which charitable contributions can be made. Specifically, it amends section 170(c) to include federally chartered corporations described in section 501(c)(19) as eligible recipients of deductible charitable contributions.

Here's a more detailed breakdown of the changes:

- **Section 170(c) Amendment**: The VETT Act amends section 170(c) of the Internal Revenue Code of 1986 by inserting a new paragraph after paragraph (5). The new paragraph, (6), reads: "An organization described in section 501(c)(19) that is a federally chartered corporation".
- **Section 170(b)(1)(A) Amendment**: The VETT Act also amends section 170(b)(1)(A) of the Internal Revenue Code of 1986. This section deals with percentage limitations for charitable deductions. The amendment adds a new clause after clause (ix) stating: "an organization described in section 501(c)(19) that is a federally chartered corporation". This means that **contributions to these organizations are subject to the same percentage limitations as other qualifying charities.**
- **Effective Date**: These changes apply to taxable years that begin after the enactment date of the VETT Act which was December 12, 2024.

In effect, the VETT Act expands the list of organizations to which individuals can make tax-deductible charitable contributions. Previously, section 501(c)(19) organizations, which are posts or organizations of past or present members of the Armed Forces, were not explicitly included under section 170(c) as eligible to receive deductible charitable contributions.

IRC §501(c)(19) Requirements

To be a tax-exempt organization under section 501(c)(19) of the Internal Revenue Code, an organization must meet specific criteria related to its purpose, membership, and earnings. These organizations are posts or organizations of past or present members of the Armed Forces of the

United States, or auxiliary units or societies of, or a trust or foundation for, any such post or organization.

Here are the detailed requirements for a 501(c)(19) organization, based on the sources:

- **Organization and Location**: The organization must be organized in the United States or any of its possessions.
- **Membership**:
    - At least 75% of the members must be past or present members of the Armed Forces of the United States.
    - Substantially all of the other members must be individuals who are cadets or are spouses, widows, widowers, ancestors, or lineal descendants of past or present members of the Armed Forces of the United States or of cadets.
- **Net Earnings**: No part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

In summary, a 501(c)(19) organization must be a group associated with the U.S. Armed Forces, with a high percentage of its members being veterans or current service members, and it must operate without any private benefit from its net earnings. The VETT Act expands the list of organizations to which individuals can make tax-deductible charitable contributions by including these 501(c)(19) organizations that are federally chartered corporations.

Employer Reporting Improvement Act (HR 3801) Signed Into Law

Employer Reporting Improvement Act (HR 3801), December 23, 2024

The "Employer Reporting Improvement Act" (H.R. 3801) makes several amendments to the Internal Revenue Code of 1986, primarily concerning employer reporting requirements related to health insurance coverage. Here's a breakdown of the key provisions and their effective dates:

- **TIN Reporting Flexibility**: This provision allows the Secretary of the Treasury to permit the substitution of an individual's full name and date of birth for their Taxpayer Identification Number (TIN) on returns if the reporting entity is unable to collect the TIN, codifying an existing practice.[1] This applies to returns with a due date **after December 31, 2024**.

- **Electronic Statements**: This provision states that individuals are considered to have consented to receive health coverage statements electronically if they have previously consented to electronic delivery with their employer, unless they revoke consent in writing.[2]

[1] IRC §6055(b)(1)
[2] IRC §6056(c)

This applies to statements with a due date **after December 31, 2024**. This provision affects statements required under both sections 6055 and 6056 of the code.

- **Time for Response**: The Act requires the Secretary to allow applicable large employers at least **90 days** to respond to a proposed assessment of the employer shared responsibility payment before taking further action.[3] This provision is effective for assessments proposed in taxable years beginning **after the date of the enactment of this Act (December 23, 2024)**.

- **Statute of Limitations on Penalty Assessment**: This provision establishes a **6-year statute of limitations** for assessing penalties related to the employer shared responsibility payment, beginning from the due date of the return under section 6056 or the date the return was filed, if later.[4] This applies to returns that are due **after December 31, 2024**.

The purpose of the Act is to streamline health care reporting requirements, protect dependent privacy, and offer employers more flexibility and time to respond to potential penalties. It addresses issues that arose from the Affordable Care Act (ACA) which required employers to annually report health insurance coverage data to the IRS. This data is used to determine if an employee's health coverage offer is affordable, and incorrect reporting or failure to offer affordable coverage can lead to financial penalties for the employer. The Act aims to reduce burdens on employers, provide more certainty, and ensure fairness in the penalty assessment process.

Fifth Circuit Merits Panel Stay on Injunction Against Enforcement of the CTA Vacated After Case Transferred to Merits Panel, BOI Enforcement Back on Hold

Order Vacating Portion of Stay Order Issued on December 23, 2024, Texas Top Cop Shop, Inc. v. Garland, Case No. 24-40792, December 26, 2024

On December 26, 2024, an order was issued vacating a previous stay that had been granted regarding the enforcement of the Corporate Transparency Act (CTA) and its corresponding Reporting Rule.[5] The stay had been granted by a motions panel of the Fifth Circuit Court of Appeals on December 23, 2024, but was vacated by the merits panel of the same court. The order vacating

[3] IRC §4980H(d)
[4] IRC §6501(n)
[5] Order Vacating Portion of Stay Order Issued on December 23, 2024, *Texas Top Cop Shop, Inc. v. Garland*, Case No. 24-40792, December 26, 2024, https://www.ca5.uscourts.gov/opinions/unpub/24/24-40792..pdf

the stay was made to "preserve the constitutional status quo while the merits panel considers the parties' weighty substantive arguments".[6]

Here's a breakdown of the situation:

Background

- The district court had issued a preliminary injunction on December 3, 2024, enjoining the enforcement of the CTA and its Reporting Rule, finding them likely unconstitutional.
- The government appealed this decision, and a motions panel of the Fifth Circuit granted the government's emergency motion for a stay of the preliminary injunction on December 23, 2024. This stay effectively reinstated the January 1, 2025, reporting deadline for businesses.
- The merits panel of the Fifth Circuit was then assigned the appeal, which was expedited.

Reasons for Vacating the Stay

The December 26 order from the merits panel vacated the stay to preserve the "constitutional status quo" while the court deliberates on the merits of the case.[7] This decision indicates a concern that allowing the stay to remain in place would have consequences that might be difficult to reverse if the court ultimately found the CTA to be unconstitutional. This approach is consistent with the purpose of a preliminary injunction, which is to "maintain the status quo pending litigation".

The court's decision to vacate the stay also suggests that it considered the following:

- **Constitutional Concerns**: The district court had deemed the CTA likely unconstitutional, and the merits panel acknowledged that the case involves "weighty substantive arguments" related to the constitutionality of the CTA and Reporting Rule. By vacating the stay, the court essentially acknowledges that the businesses and other parties challenging the law could be subject to unconstitutional burdens if the reporting requirement were to go into effect.
- **Preservation of Rights:** The court's decision to vacate the stay can also be seen as a move to protect the rights of the plaintiffs, as compliance with the CTA would force them to disclose private information that they contend is protected by the First and Fourth Amendments.
- **Balancing Equities**: The court weighed the potential harm to the government if the stay was vacated against the harm that plaintiffs would face if the stay remained in effect. The panel noted that the harm of compliance for businesses was minimal, with FinCEN estimating it would take a typical company 90 minutes to file a report. However, the court's decision to vacate the stay indicates it was also concerned about the possibility of forcing

[6] Order Vacating Portion of Stay Order Issued on December 23, 2024, *Texas Top Cop Shop, Inc. v. Garland*, Case No. 24-40792, December 26, 2024

[7] Order Vacating Portion of Stay Order Issued on December 23, 2024, *Texas Top Cop Shop, Inc. v. Garland*, Case No. 24-40792, December 26, 2024

businesses to comply with a law that might ultimately be found unconstitutional, which would constitute an irreparable injury.

- **Procedural Concerns:** The district court issued a nationwide injunction against the CTA, despite the fact that other courts had tailored relief to the parties before them or denied relief altogether. The merits panel may be considering whether the district court's issuance of a nationwide injunction was appropriate.
- **No prejudice to the government**: The court may have taken into consideration that the government's stated need to enforce the CTA had been undermined by the fact that the CTA was enacted in 2021, yet the compliance deadline was set by FinCEN, not Congress, and that FinCEN had chosen to delay the compliance deadline for over three years.

Additional Points to Consider

- The December 23 order from the motions panel had granted the government's emergency motion for a stay pending appeal, indicating that the panel found the government had met the requirements for a stay under *Nken v. Holder*. The criteria for this included showing a strong likelihood of success on the merits, irreparable harm absent a stay, minimal harm to other parties if the stay was granted and that public interest favored the stay.[8]
- Judge Haynes dissented in part from the December 23 order, arguing that the stay should not apply to the plaintiffs or members of the National Federation of Independent Business (NFIB). She agreed that a national injunction was not appropriate.[9]
- The plaintiffs filed an emergency petition for rehearing en banc, arguing that the panel decision to grant a stay conflicted with Supreme Court precedent, improperly weighed the equities in favor of the government and ignored harms to the plaintiffs.[10]
- The plaintiffs also argued that forcing compliance with the CTA could moot their First and Fourth Amendment claims by compelling the disclosures that form the basis of these claims.[11]
- The plaintiffs further asserted that the panel decision would harm millions of entities subject to the CTA by reinstating the compliance deadline with only days to comply.[12]

In conclusion, the December 26 order vacating the stay was not a decision on the merits of the case, but a step taken to ensure the court had time to consider the complex arguments involved without creating a situation that might be difficult to reverse. It aimed to preserve the "constitutional status quo" by preventing the enforcement of the CTA while the court deliberates on the legal issues.

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[8] Order, Texas Top Cop Shop, Inc. v. Garland, CA5 Case No. 24-40792, Document 140-2, December 23, 2024, https://storage.courtlistener.com/recap/gov.uscourts.ca5.222187/gov.uscourts.ca5.222187.140.2.pdf
[9] Order, Texas Top Cop Shop, Inc. v. Garland, CA5 Case No. 24-40792, Document 140-2, December 23, 2024
[10] Plaintiffs-Appellees' Emergency Petition for Rehearing En Banc - Texas Top Cop Shop, Inc., CA5, December 24, 2024, https://www.currentfederaltaxdevelopments.com/s/govuscourtsca52221871430.pdf
[11] Plaintiffs-Appellees' Emergency Petition for Rehearing En Banc - Texas Top Cop Shop, Inc., CA5, December 24, 2024
[12] Plaintiffs-Appellees' Emergency Petition for Rehearing En Banc - Texas Top Cop Shop, Inc., CA5, December 24, 2024

Where Things Stand Now

The beneficial ownership information reporting deadline is currently on hold, pending a decision by the merits panel, which is expected early in 2025. This decision will determine the merits of the original appeal by the Government against the District Court's injunction.

If the panel decides to lift the stay (or at least its national applicability), the January 13, 2025 deadline would likely apply, unless FinCEN issues another relief ruling to push it back. It is also possible that the Department of Justice may seek emergency relief from the U.S. Supreme Court in the interim to restore the original injunction that removed the bar on enforcement and reinstated the upcoming deadlines.

FinCEN continues to allow affected entities to voluntarily file their reports, even though deadlines and enforcement are currently on hold. Entities that prefer not to track the rapid changes in this case may consider filing the report to avoid having to devote significant time to following the court proceedings.

Written with the assistance of NotebookLM in analyzing the most recent order.

Supreme Court Finds Obligation to Redeem Shares Cannot Be Considered in Valuing Corporation for Estate Tax Purposes

Connelly v. United States, US Supreme Court, Docket 23-146, June 6, 2024

In the case of *Connelly v. United States,* US Supreme Court, Docket 23-146, June 6, 2024[13], the U.S. Supreme Court resolved inconsistent holdings in lower courts. In a unanimous opinion the Court, authored by Justice Thomas, found that although life insurance proceeds received by the corporation that were intended to be used to redeem a deceased majority shareholder had to be included in valuing the corporation as of the date the shareholder died, the estate could not use the obligation to redeem those shares to reduce the value of the corporation when valuing the interest.

The opinion begins by outlining the basic facts and the fundamental issue to be decided in this case:

> Michael and Thomas Connelly owned a building supply corporation. The brothers entered into an agreement to ensure that the company would stay in the family if either brother died. Under that agreement, the corporation could be required to redeem (i.e., purchase) the deceased brother's shares. To fund the possible share redemption, the corporation obtained life insurance on each brother. After Michael died, a narrow dispute arose over how to value his shares for calculating the estate tax. The central question is whether the corporation's

[13] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/insurance-proceeds-included-estate-tax-value-supreme-court-holds/7k9cn

> obligation to redeem Michael's shares was a liability that decreased the value of those shares.[14]

The opinion notes that a decedent's estate would include interests in any close held corporation he/she might have owned an interest in at his/her death. These interests have various unique features:

> A decedent's taxable estate includes his shares in a closely held corporation. 26 U.S.C. §2031(b). Closely held corporations ordinarily have only a few shareholders (often within the same family) and, unlike public corporations, those shareholders typically participate in the corporation's day-to-day management. 3 J. Cox & T. Hazen, *Law of Corporations* §14.1 (3d ed. 2010) (Cox & Hazen). Given this close working relationship, shareholders sometimes enter into an agreement to restrict the transfer of shares to outside investors. 3 id., §14.9. One such arrangement involves "giving the corporation or the other shareholders the right to purchase the shares of a holder on his death." *Ibid.* A related arrangement, called a share redemption agreement, contractually requires a corporation to repurchase a deceased shareholder's shares. Although such an agreement may delineate how to set a price for the shares, it is ordinarily not dispositive for valuing the decedent's shares for the estate tax. See 26 U.S.C. §2703. As a general rule, the fair market value of the corporation determines the value of the shares, and one must therefore consider "the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors," "including proceeds of life insurance policies payable to . . . the company." 26 CFR §20.2031-2(f)(2).[15]

In this case, the corporation's shares were held by two brothers who entered into just such a redemption agreement with the corporation that took effect upon either of their deaths.

> Brothers Michael and Thomas Connelly were the sole shareholders in Crown C Supply, a small but successful building supply corporation in St. Louis, Missouri. Michael owned 77.18% of Crown's outstanding shares (385.9 out of 500 shares), and Thomas owned the remaining 22.82% (114. 1 shares). The brothers entered into an agreement with Crown to ensure a smooth transition of ownership and keep Crown in the family in the event one of the brothers died. The agreement provided that if either Michael or Thomas died, the surviving brother would have the option to purchase the deceased brother's shares. And, if the surviving brother declined to do so, then Crown itself would be contractually required to redeem the shares. With an exception not relevant here, the agreement specified that the redemption price for each share would be based upon an outside appraisal of Crown's fair market value. App. 12-14. To ensure that Crown would have enough money to redeem the shares if required, Crown obtained $3.5 million in life insurance on each brother.[16]

But when Micheal died, Thomas and Michael's son did not exactly follow this agreement:

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[14] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024
[15] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024
[16] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024

> When Michael died in 2013, Thomas opted not to purchase Michael's shares. As a result, Crown was obligated under the agreement to redeem Michael's shares. Rather than secure an outside appraisal of the company's fair market value (as the agreement contemplated), Michael's son and Thomas agreed in an "amicable and expeditious manner" that the value of Michael's shares was $3 million. *Id.*, at 25-26. Crown then used $3 million of the life-insurance proceeds to redeem Michael's shares, leaving Thomas as Crown's sole shareholder.[17]

Thomas was also the executor of Michael's estate, so he had prepared a filed an estate tax return as described below:

> As the executor of Michael's estate, Thomas then filed a federal tax return for the estate. The return reported the value of Michael's shares as $3 million, in accordance with the agreement between Michael's son and Thomas. The Internal Revenue Service (IRS) audited the return. During the audit, Thomas obtained a valuation from an accounting firm. The firm's analyst took as given the holding in *Estate of Blount v. Commissioner*, 428 F. 3d 1338 (CA11 2005), which concluded that insurance proceeds should be "deduct[ed] . . . from the value" of a corporation when they are "offset by an obligation to pay those proceeds to the estate in a stock buyout." *Id.*, at 1345. The analyst thus excluded the $3 million in insurance proceeds used to redeem Michael's shares, and determined that Crown's fair market value at Michael's death was $3.86 million. Because Michael held a 77.18% ownership interest, the analyst calculated the value of Michael's shares as approximately $3 million ($3.86 million x 0.7718).[18]

The Eleventh Circuit had, in the *Estate of Blount* cited above, approved considering the obligation to redeem the shares as a liability of the corporation that was appropriate to consider as largely offsetting the life insurance proceeds the corporation received. But the IRS did not agree with the Eleventh Circuit holding, nor the estate's use of that holding to reduce the value of the shares redeemed:

> The IRS took a different view, insisting that Crown's redemption obligation did not offset the life-insurance proceeds. The IRS counted the $3 million in life-insurance proceeds excluded by the analyst and assessed Crown's total value as $6.86 million ($3.86 million + $3 million). And, the IRS thus calculated the value of Michael's shares as $5.3 million ($6.86 million x 0.7718). Based on this higher valuation, the IRS determined that the estate owed an additional $889,914 in taxes.[19]

The estate paid the tax and then sued for a refund. But the lower courts did not agree with the Eleventh Circuit's analysis and ruled that the estate was not entitled to a refund.

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[17] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024
[18] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024
[19] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024

> The estate paid the deficiency and Thomas, acting as executor, sued the United States for a refund. As relevant, Thomas argued that the $3 million in life-insurance proceeds used to redeem Michael's shares should not be counted when calculating the value of those shares. The District Court granted summary judgment to the Government, concluding that Michael's estate was not entitled to a refund. *Connelly v. Department of Treasury, IRS*, 2021 WL 4281288, *17 (ED Mo., Sept. 21, 2021). The court held that the $3 million in life-insurance proceeds must be counted to accurately value Michael's shares. It explained that, under customary valuation principles, Crown's obligation to redeem Michael's shares was not a liability that reduced the corporation's fair market value. Id., at *14. The court therefore held that Crown's redemption obligation did not offset the life-insurance proceeds. Id., at *15-*17. The Court of Appeals affirmed on the same basis. *Connelly v. Department of Treasury*, IRS, 70 F. 4th 412 (CA8 2023).[20]

As there was now a clear split of opinion between the holding of the Eleventh Circuit in *Blount* and the Eight Circuit in *Connelly*, the Supreme Court decided to hear the estate's appeal of the *Connelly* holding.

The opinion notes that both parties agree that the life insurance proceeds increased the corporation's value, but the question was whether a partially offsetting liability was also in place:

> The dispute in this case is narrow. All agree that, when calculating the federal estate tax, the value of a decedent's shares in a closely held corporation must reflect the corporation's fair market value. And, all agree that life-insurance proceeds payable to a corporation are an asset that increases the corporation's fair market value. The only question is whether Crown's contractual obligation to redeem Michael's shares at fair market value offsets the value of life-insurance proceeds committed to funding that redemption.[21]

The opinion goes on to outline both parties' position on the issue of whether or not the obligation to redeem the shares should be considered in valuing the shares:

> Thomas argues that a contractual obligation to redeem shares is a liability that offsets the value of life-insurance proceeds used to fulfill that obligation. Brief for Petitioner 17. He accordingly contends that anyone purchasing "a subset of the corporation's shares would treat the two as canceling each other out." *Ibid*. By contrast, the Government argues that Crown's obligation to pay for Michael's shares did not reduce the value of those shares. It contends that "no real-world buyer or seller would have viewed the redemption obligation as an offsetting liability." Brief for United States 15.[22]

[20] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024
[21] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024
[22] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024

The Court quickly states that in its view the answer is that redemption is irrelevant in determining the fair value of the interest.

> An obligation to redeem shares at fair market value does not offset the value of life-insurance proceeds set aside for the redemption because a share redemption at fair market value does not affect any shareholder's economic interest.[23]

Justice Thomas offers an example to explain this holding:

> A simple example proves the point. Consider a corporation with one asset — $10 million in cash — and two shareholders, A and B, who own 80 and 20 shares respectively. Each individual share is worth $100,000 ($10 million ÷ 100 shares). So, A's shares are worth $8 million (80 shares x $100,000) and B's shares are worth $2 million (20 shares x $100,000). To redeem B's shares at fair market value, the corporation would thus have to pay B $2 million. After the redemption, A would be the sole shareholder in a corporation worth $8 million and with 80 outstanding shares. A's shares would still be worth $100,000 each ($8 million ÷ 80 shares). Economically, the redemption would have no impact on either shareholder. The value of the shareholders' interests after the redemption — A's 80 shares and B's $2 million in cash — would be equal to the value of their respective interests in the corporation before the redemption. Thus, a corporation's contractual obligation to redeem shares at fair market value does not reduce the value of those shares in and of itself.[24]

Thus, Justice Thomas goes on to note, the theoretically willing buyer would not take the redemption into consideration when buying the decedent's shares.

> Because a fair-market-value redemption has no effect on any shareholder's economic interest, no willing buyer purchasing Michael's shares would have treated Crown's obligation to redeem Michael's shares at fair market value as a factor that reduced the value of those shares. At the time of Michael's death, Crown was worth $6.86 million — $3 million in life-insurance proceeds earmarked for the redemption plus $3.86 million in other assets and income-generating potential. Anyone purchasing Michael's shares would acquire a 77.18% stake in a company worth $6.86 million, along with Crown's obligation to redeem those shares at fair market value. A buyer would therefore pay up to $5.3 million for Michael's shares ($6.86 million x 0.7718) — i.e., the value the buyer could expect to receive in exchange for Michael's shares when Crown redeemed them at fair market value. We thus conclude that Crown's promise to redeem Michael's shares at fair market value did not reduce the value of those shares.[25]

The Court then outlines the estate's argument against this position, which relies upon the holding in *Blount*:

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[23] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024
[24] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024
[25] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024

> Thomas resists this straightforward conclusion. He suggests that Crown's redemption obligation "would make it impossible" for a hypothetical buyer seeking to purchase 77.18% of Crown "to capture the full value of the insurance proceeds." Brief for Petitioner 26. That is so, according to Thomas, because the insurance proceeds would leave the company as soon as they arrived to complete the redemption. He argues that the "buyer would thus not consider proceeds that would be used for redemption as net assets." Ibid. In other words, Thomas views the relevant inquiry as what a buyer would pay for shares that make up the same percentage of the less-valuable corporation that exists after the redemption. See *Estate of Blount v. Commissioner*, 87 TCM 1303 (2004), ¶2004-116 RIA Memo TC, *aff'd in part and rev'd in part*, 428 F. 3d 1338 (CA11 2005); see also A. Chodorow, *Valuing Corporations for Estate Tax Purposes*, 3 Hastings Bus. L. J. 1, 25 (2006) ("Any valuation that takes the redemption obligation into account effectively values the corporation on a 'post-redemption' basis, i.e., after the decedent's shares have been redeemed").[26]

But the Justices' opinion holds that the proper time to value the corporation is before the redemption takes place:

> But, for calculating the estate tax, the whole point is to assess how much Michael's shares were worth at the time that he died — before Crown spent $3 million on the redemption payment. See 26 U.S.C. §2033 (defining the gross estate to "include the value of all property to the extent of the interest therein of the decedent at the time of his death"); 26 CFR §20.2031-1(b) (the "value of every item of property includible in a decedent's gross estate . . . is its fair market value at the time of the decedent's death" (emphasis added)). A hypothetical buyer would thus treat the life-insurance proceeds that would be used to redeem Michael's shares as a net asset.[27]

The opinion goes on to consider an issue that took up quite a bit of time in the oral arguments before the Court, that the estates' position ignores the fact that while Michael's son received cash equal to what the estate claimed was the value of his father's shares, at the same time Thomas managed to go from holding a minority interest in the company to now holding 100% of the shares of a company still worth what the estate claimed it was worth at his brother's passing.

> Moreover, Thomas's argument that the redemption obligation was a liability cannot be reconciled with the basic mechanics of a stock redemption. As the District Court explained, when a shareholder redeems his shares he "is essentially 'cashing out' his shares of ownership in the company and its assets." 2021 WL 4281288, *16. That transaction necessarily reduces a corporation's total value. And, because there are fewer outstanding shares after the redemption, the remaining shareholders are left with a larger proportional ownership interest in the less-valuable corporation. Thomas's understanding, however, would turn this ordinary process upside down. In Thomas's view, Crown's redemption of Michael's shares left Thomas with a larger ownership stake in a company with the same value as before

[26] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024
[27] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024

> the redemption. Thomas argues that Crown was worth only $3.86 million before the redemption, and thus that Michael's shares were worth approximately $3 million ($3.86 million x 0.7718). But, he also argues that Crown was worth $3.86 million after Michael's shares were redeemed. See Reply Brief 6. That cannot be right: A corporation that pays out $3 million to redeem shares should be worth less than before the redemption. See Cox & Hazen §21.2. Thomas's argument thus cannot be reconciled with an elementary understanding of a stock redemption.[28]

Finally, the Court did not consider the estate's argument that this decision would make estate planning for closely held corporations much more difficult, noting that the entire issue could have been avoided with a cross-purchase structure, although the Court concedes that a cross-purchase agreement adds certain non-estate tax issues to the transaction.

> Finally, Thomas asserts that affirming the decision below will make succession planning more difficult for closely held corporations. He reasons that if life-insurance proceeds earmarked for a share redemption are a net asset for estate-tax purposes, then "Crown would have needed an insurance policy worth far more than $3 million in order to redeem Michael's shares at fair market value." Brief for Petitioner 33. True enough, but that is simply a consequence of how the Connelly brothers chose to structure their agreement. There were other options. For example, the brothers could have used a cross-purchase agreement — an arrangement in which shareholders agree to purchase each other's shares at death and purchase life-insurance policies on each other to fund the agreement. See S. Pratt, *Valuing a Business 821*. (6th ed. 2022). A cross-purchase agreement would have allowed Thomas to purchase Michael's shares and keep Crown in the family, while avoiding the risk that the insurance proceeds would increase the value of Michael's shares. The proceeds would have gone directly to Thomas — not to Crown. But, every arrangement has its own drawbacks. A cross-purchase agreement would have required each brother to pay the premiums for the insurance policy on the other brother, creating a risk that one of them would be unable to do so. And, it would have had its own tax consequences. By opting to have Crown purchase the life-insurance policies and pay the premiums, the Connelly brothers guaranteed that the policies would remain in force and that the insurance proceeds would be available to fund the redemption. As we have explained, however, this arrangement also meant that Crown would receive the proceeds and thereby increase the value of Michael's shares. Thomas' concerns about the implications of how he and Michael structured their agreement are therefore misplaced.[29]

Supreme Court Overturns Chevron Deference to Agency Interpretations of Statutes

[28] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024
[29] *Connelly v. United States*, US Supreme Court, Docket 23-146, June 6, 2024

Loper Bright Enterprises v. Raimondo, USSC Case Nos. 22-451 and 22-1219, June 27, 2024

The US Supreme Court overturned the doctrine of *Chevron* deference to agency interpretations of the law in certain circumstances in the case of *Loper Bright Enterprises v. Raimondo*.

Majority Opinion - The Binding Holding

The Supreme Court's majority opinion in *Loper Bright Enterprises v. Raimondo* held that the *Chevron* doctrine should be overruled. The *Chevron* doctrine, established in *Chevron U. S. A. Inc. v. Natural Resources Defense Council, Inc.*, previously required courts to defer to a federal agency's interpretation of a statute when the statute was ambiguous. The Court vacated the judgments of the D.C. and First Circuits, which had relied on *Chevron* in their rulings. The cases were remanded for further proceedings consistent with the Supreme Court's opinion, which requires the lower courts to interpret the relevant statutes themselves without deference to the agencies.

The majority's reasoning for overruling *Chevron* was multifaceted, touching on the nature of the judicial role, the separation of powers, and the text of the Administrative Procedure Act (APA), as well as practical considerations about how the *Chevron* doctrine has functioned in the courts.

The majority argued that the *Chevron* doctrine is inconsistent with the APA. The APA requires courts to "decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action". The Court argued that the APA makes it clear that agency interpretations of statutes are not entitled to deference. The majority asserted that the APA was intended to codify the traditional understanding that it is the role of the courts to interpret the law. The majority cited the legislative history of the APA, in which congressional reports stated that questions of law were for the courts to decide. It also cited various legal scholars and commentators from that time who believed the APA required courts to exercise independent judgment on questions of law. According to the majority, the APA does not prescribe a deferential standard for answering questions of law, nor does it prescribe a de novo standard, but rather leaves the standard up to the courts to determine.

The majority emphasized the traditional role of the judiciary in interpreting the law as a key reason for rejecting *Chevron*. Citing *Marbury v. Madison*, the Court stated that it is emphatically the province and duty of the judicial department to say what the law is. The majority noted that from the Nation's founding, the interpretation of laws has been considered a judicial function. The Court acknowledged that the views of the Executive Branch could be informative and persuasive, but they could not control the judiciary's independent judgment. According to the majority, the judicial role is to interpret the act of Congress in order to ascertain the rights of the parties.

The majority argued that *Chevron* represented a departure from the traditional approach of courts independently examining statutes to determine their meaning. Before *Chevron*, the Court stated that judicial review involved the court independently interpreting the statute. The Court pointed to cases

like *Skidmore v. Swift & Co.* as examples of how courts before *Chevron* would consider agency interpretations, giving them weight based on their persuasiveness but not deferring to them simply because they were the agency's views. They argued that the judicial role was to "interpret the act of Congress". The court also noted that while the views of the Executive Branch could be afforded "great weight," they did not have the power to control the judiciary.

The majority criticized several aspects of the *Chevron* doctrine itself, arguing that it is unworkable and has resulted in inconsistent applications. The Court stated that the test for ambiguity under *Chevron* is difficult to apply consistently, with some judges seeing ambiguity in statutes frequently while others rarely do. The Court also pointed out the difficulty of applying *Chevron*'s two-step framework. The Court also noted that the *Chevron* decision did not mention the APA and was decided by a bare quorum of six justices. In addition, they argue that the *Chevron* framework is arbitrary in practice.

The majority rejected the argument that statutory interpretation amounts to policymaking suitable for political actors rather than courts. The Court stated that the Framers crafted the Constitution to ensure that federal judges could exercise judgment free from the influence of the political branches and that courts interpret statutes based on traditional tools of statutory construction, not individual policy preferences.

In summary, the majority in *Loper Bright* overruled *Chevron* based on their interpretation of the APA, the traditional role of the judiciary, and what they viewed as flaws and inconsistencies in the *Chevron* doctrine. The Court's decision marks a significant shift in administrative law, moving away from judicial deference to agency interpretations and placing greater emphasis on the judiciary's role in statutory interpretation.

The Minority's Objections

The dissenting opinion in *Loper Bright Enterprises v. Raimondo* criticized the majority's decision to overturn the *Chevron* doctrine on several grounds, arguing that it was not supported by the Administrative Procedure Act (APA), misrepresented the history of judicial review, and disregarded principles of stare decisis.

Arguments Against the Majority's Interpretation of the APA and Historical Context

- **Misinterpretation of Section 706 of the APA**: The dissent argues that the majority misinterprets Section 706 of the APA, which outlines the scope of judicial review of agency action. The majority contends that this section mandates that courts decide all relevant questions of law and does not allow for deference to agency interpretations of statutes. The dissent counters that Section 706 does not explicitly forbid deference, and its language is compatible with the *Chevron* doctrine. It points out that the APA requires deferential review for agency fact-finding and policy-making, and it would be odd if it did not allow it for

statutory interpretation as well. The dissent also notes that the legislative history of the APA does not support the majority's view that the APA disallows deference.

- **Misrepresentation of Pre-APA Law**: The dissenting Justices argue that the majority inaccurately portrays the state of judicial review before the APA's enactment. The majority suggests that courts consistently exercised independent judgment on questions of law, but the dissent points to a trend towards greater deference to agencies in the New Deal era. The dissent cites cases such as *Gray v. Powell* and *NLRB v. Hearst Publications, Inc.*, which, the dissent argues, demonstrate that courts were already practicing a form of deference to agencies when interpreting statutes. According to the dissent, the APA was intended to reflect the existing law, which included some degree of deference to agency interpretations.
- **Ignoring Scholarly Consensus**: The dissent notes that many respected administrative law scholars of the time understood Section 706 as allowing deference, citing Professors Louis Jaffe and Kenneth Culp Davis as examples. Additionally, the dissent claims that, in the years following the APA's enactment, the Supreme Court did not indicate that the APA rejected deference to agency interpretations of law.

Arguments Against the Majority's Disregard for Stare Decisis

- **Entrenched Precedent**: The dissent emphasizes that *Chevron* is an entrenched precedent that warrants strong protection under the doctrine of stare decisis. This doctrine dictates that courts should adhere to established precedent unless there is a strong reason to depart. The dissent argues that the majority has not provided a sufficient justification for overturning *Chevron*, particularly given how long the doctrine has been in effect, and how many actors have relied on it.
- **Congressional Acceptance of Chevron**: The dissent notes that Congress has had numerous opportunities to overrule *Chevron* but has not done so, indicating tacit approval of the doctrine. According to the dissent, Congress has essentially delegated interpretive authority to agencies by not legislating to overturn the *Chevron* precedent, and that the majority opinion disregards Congress's decision to do so.
- **Undermining Judicial Humility**: The dissenting opinion argues that overturning *Chevron* contradicts the principle of judicial humility, which suggests that courts should acknowledge their limitations and recognize the expertise of other branches of government. The dissent argues the majority opinion shows judicial hubris by taking on the role of "administrative czar" and asserting that courts have special competence in areas that require scientific, technical, and policy expertise. The dissent states that the majority's decision represents a power grab and a disregard for the separation of powers.

Arguments Against the Majority's Reasoning on Chevron's Unworkability

- **Ambiguity is Common**: The dissent argues that the majority's claim that *Chevron* is unworkable because ambiguity can be hard to identify is misguided, as the legal system has long dealt with varying interpretations of ambiguity in various contexts. It cites contract law

and other areas of law where ambiguity triggers specific interpretive approaches. The dissent argues that such ambiguity is inherent in statutes, and that it is the agency's role to resolve such ambiguities based on policy considerations.

- **Exceptions are not Difficult**: The dissent rejects the majority's argument that *Chevron's* exceptions are difficult to apply, asserting that the exceptions fit with the doctrine's rationale and generally require a simple, check-the-box analysis.
- **Skidmore Deference is Similar**: The dissent points out that the majority's prescribed alternative of *Skidmore* deference will create similar difficulties, as it will require courts to determine what "respect" is due to an agency's interpretation.

Practical Concerns

- **Disruption to the Legal System**: The dissent warns that overturning *Chevron* will create a massive shock to the legal system, casting doubt on settled interpretations of statutes and threatening the reliance interests of many parties. According to the dissent, overturning the *Chevron* doctrine will raise new doubts about agency constructions of statutes and will be far more disruptive than the majority acknowledges.

Additional Points of Criticism

- **Judicial Overreach**: The dissent argues that the majority is improperly giving itself the power to make policy decisions that should be left to agencies, which are accountable to the public.
- **Pre-determined Outcome**: The dissent suggests that the majority has been working toward overruling *Chevron* for some time, and that their criticisms of the doctrine have been developed in pursuit of that goal.

In summary, the dissenting opinion in *Loper Bright* argues that the majority's decision to overrule *Chevron* is based on a flawed interpretation of the APA, a misrepresentation of historical judicial practice, a disregard for stare decisis, and an exaggerated view of the difficulties associated with applying the *Chevron* doctrine. The dissenters believe that the majority is improperly seizing power that belongs to agencies and Congress and is creating unnecessary disruption in the legal system.

Tax Court Again Finds That a Functional Test Must be Applied to State Law Limited Partners for the Exclusion from Self-Employment Income Under IRC §1402(a)(13)

Denham Capital Management LP et al. v. Commissioner, TC Memo 2024-114, December 23, 2024

The Tax Court's decision in *Denham Capital Management LP v. Commissioner* addresses whether a state law limited partner's distributive share of partnership income is subject to self-employment tax. The court concluded that the partners were not "limited partners, as such" under section 1402(a)(13), and their distributive shares were included in the partnership's net earnings from self-employment (NESE). This conclusion is consistent with the court's prior ruling in *Soroban Capital Partners LP v. Commissioner*, 161 T.C. 310 (2023), which held that a partner's status as a limited partner for purposes of the limited partner exception is determined by a functional analysis of their roles and responsibilities, not solely on their state law designation

Facts of the Case

In *Denham Capital Management LP v. Commissioner*, T.C. Memo. 2024-114, the Tax Court addressed whether certain partners in a state law limited partnership, Denham Capital Management, LP (Denham), qualified for the limited partner exception under section 1402(a)(13), which would exclude their distributive share of partnership income from net earnings from self-employment (NESE). The case is significant because it applies the functional analysis test established in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), and reinforced in *Soroban Capital Partners LP v. Commissioner*, 161 T.C. 310 (2023), to a state law limited partnership, determining that the partners' roles and responsibilities, rather than their state law designation, dictate their status for self-employment tax purposes.

Background of Denham Capital Management, LP

Denham was organized as a limited partnership under Delaware law, with its principal place of business in Massachusetts. The partnership provided investment advisory and management services to affiliated private equity funds that invested in the energy sector, specifically oil and gas, mining, and power. Denham's services included furnishing investment advice, negotiating investment terms, monitoring investments, and handling day-to-day fund administration. The partnership's general partner, Denham Capital Management GP LLC, a Delaware limited liability company, was also the tax matters partner.

During the tax years in question, 2016 and 2017, Denham had five limited partners in addition to the general partner: Stuart Porter, Scott Mackin, Carl Tricoli, Riaz Siddiqi, and Jordan Marye. These partners functioned similarly to employees, subject to the same general policies and procedures as Denham employees. Despite being designated as limited partners under state law, the court

examined their actual roles within the partnership to determine their status for self-employment tax purposes.

The Fifth Amended and Restated Limited Partnership Agreement (LPA), effective May 1, 2014, governed the obligations and authority of Denham's partners for the years in issue. Under the LPA, the general partner had "unlimited liability" for Denham's debts, while the limited partners enjoyed limited liability, only being held personally liable to the extent of their capital contributions. All management authority was vested exclusively in the general partner, but the limited partners had authority to the extent it was delegated to them by the general partner. For example, three of the limited partners and several key employees were authorized to execute any agreement or document on the general partner's behalf. The LPA also required each partner, except for Mr. Porter, to devote substantially all of his or her business time and attention to the affairs of Denham and its affiliates.

The founding partners were Messrs. Porter, Siddiqi, and Tricoli. Mr. Porter made an initial capital contribution of approximately $8 million in 2007 in exchange for his limited partner interest. The other partners received their limited partner interests through grants of profits interests at various times. No other capital contributions were made to Denham by any of the partners, though Messrs. Porter and Siddiqi testified that the other partners paid Mr. Porter directly for their interests, however, no such written agreements were provided as evidence. The partners had the authority to remove partners by consensus.

Partners' Roles and Responsibilities

The partners held various roles and responsibilities, which were not explicitly outlined in the LPA. Mr. Porter oversaw Denham's investment strategy, managed the risk group, and spent time meeting with lower level employees. Denham carried total life insurance coverage on Mr. Porter of $90 million in 2016 and $30 million in 2017. Messrs. Tricoli, Mackin, and Marye each held the title of managing partner and led deal teams within their respective sectors, with Messrs. Tricoli and Mackin also holding the title of co-president. Mr. Siddiqi served as managing partner and led the portfolio services group.

The partners' role with Denham was so fundamental to the firm's operation that investors had the right to withdraw their investments early if one or more of the partners died, became disabled, or could no longer devote substantially all business time to the funds. Although each fund's "key person" provision referred to Mr. Porter, all five partners were considered a key person by at least one of the funds. The partners also served on various committees, including management, valuation, and investment committees. The management committee, which included Messrs. Porter, Tricoli, and Mackin, discussed issues such as budgeting, employee hirings or departures, and expansion. Excluding Mr. Porter, the partners frequently served on the boards of directors of the portfolio companies, but they were not compensated for this.

The partners actively engaged in fostering and attracting investor relationships, traveling to meet with potential and current investors for fundraising purposes, with travel reimbursements provided by Denham.

Denham's Operations and Revenue

Denham managed five active funds in 2016 and seven in 2017, with $7.5 billion and $8.3 billion of assets under management, respectively. Each fund was a separate limited partnership entity with another limited partnership as its general partner. The partners and employees of Denham were the partners of the limited partnerships that served as the funds' general partners. The funds' investors were primarily institutional, and they had no decision-making authority.

Denham generated revenue from management fees paid by each fund in exchange for its advisory services. The management fees typically ranged from 0.75% to 1.75% of capital committed by investors. Denham generated $69,903,232 and $61,280,194 in total revenue for 2016 and 2017, respectively, derived solely from its investment management services.

Denham's investment process included deal teams, investment committees, and valuation committees. Deal teams generated investment proposals, which were presented to the investment committees. The investment committees, which included Messrs. Porter, Tricoli, and Siddiqi for every fund, as well as Mr. Mackin for the commingled commodity funds and Mr. Marye for the oil and gas fund, met weekly to vote on potential new investments and significant decisions. All voting members of the investment committee were required to unanimously approve an investment recommendation, meaning a single partner could effectively reject a proposal. The valuation committees reviewed and approved valuation recommendations, and all five partners served on the valuation committees during the years in issue. As with investment committees, the valuation committee required a unanimous vote to approve a recommendation.

Denham's Private Placement Memorandums (PPMs) represented to investors that "[t]he overall direction of the firm is guided by its partners," and the partners' experience was influential to investors.

Denham's Financial and Tax Reporting

Denham worked with PricewaterhouseCoopers, LLP (PwC) to audit its financial statements and prepare its Forms 1065. PwC's audit report described the partners as "active limited partners," a term provided by Denham.

Denham Capital Management GP LLC (the general partners) did not make any guaranteed payments or distributions to the partners in 2016 or 2017. In each of those years, Denham (the limited partnership) made guaranteed payments and capital distributions to the partners and the general partner. The guaranteed payments were intended to represent the partners' salaries, and included the value of typical employment benefits. The distributions to the partners were tied to

their distributive shares of Denham's income and calculated on the basis of their profits interests. There was no guaranteed minimum for the partners' distributive shares for the year, and they varied as they were tied to the profits of the firm.

When computing the partners' NESE for the years in issue, Denham included their guaranteed payments but excluded their distributive shares of ordinary business income. The following table shows the amounts reported on Denham's returns for 2016 and 2017:

	Ordinary Income	**Guaranteed Payments**	**NESE**	**Distributions**
2016				
General Partner	$33,813	—	$33,633	$39,574
Stuart Porter	10,027,043	$427,178	427,178	8,723,326
Scott Mackin	3,990,985	241,565	241,565	3,030,423
Carl Tricoli	6,931,842	350,820	350,820	5,656,821
Riaz Siddiqi	2,456,321	382,820	382,820	2,083,944
Jordan Marye	4,068,995	342,516	342,516	2,424,961
2017				
General Partner	$28,088	—	$28,268	$24,705
Stuart Porter	6,554,420	$382,959	382,959	7,091,483
Scott Mackin	2,662,994	179,704	179,704	2,919,166
Carl Tricoli	6,890,616	389,633	389,633	7,316,065

	Ordinary Income	Guaranteed Payments	NESE	Distributions
Riaz Siddiqi	1,412,031	47,175	47,175	1,434,193
Jordan Marye	5,398,806	367,809	367,809	5,331,920

Denham reported total NESE of $1,778,532 and $1,395,001 for 2016 and 2017, respectively.

IRS Adjustments

On March 27, 2023, the IRS issued Notices of Final Partnership Administrative Adjustment (FPAA) for the years in issue, increasing Denham's NESE to $29,253,718 and $24,314,415 for 2016 and 2017, respectively. These adjustments were based on the IRS's position that the partners' distributive shares of ordinary business income were not excludable from NESE under the limited partner exception of section 1402(a)(13). In other words, the IRS determined that the partners did not qualify for the limited partner exception and their distributive shares should be included in the partnership's NESE. The IRS included the partners' distributive share of the ordinary income in NESE. The court noted that Denham reported $547 less of total NESE than the sum of the NESE reported on the partners' Schedules K-1 for 2017. However, the court noted that this error did not affect the resolution of the case.

The Court's Analysis and Decision

The Tax Court's analysis of the applicable law and authorities, as well as how they applied to these facts are summarized below.

Core Issue: Determining Net Earnings from Self-Employment (NESE) and the Limited Partner Exception

At the heart of the case is the determination of Denham's Net Earnings from Self-Employment (NESE). The IRS issued Notices of Final Partnership Administrative Adjustment (FPAA) that increased Denham's NESE for 2016 and 2017. The court had to determine (1) whether adjustments to a partnership's NESE are partnership items subject to determination at the partnership level, and (2) whether the income of five of Denham's partners could be excluded from NESE under the limited partner exception provided by section 1402(a)(13) of the Internal Revenue Code.

Jurisdiction and the Partnership Item Determination

The court first addressed whether it had the jurisdiction to determine if a partner qualified for the limited partner exception, which was challenged by the petitioner. The court relied on its prior holding in *Soroban Capital Partners LP v. Commissioner*, 161 T.C. 310 (2023), where it determined that it

did have jurisdiction to decide a state law limited partner's status when determining the applicability of the limited partner exception in partnership-level proceedings.

The court rejected the petitioner's argument that *Soroban* failed to consider whether the item affected the entire partnership, noting that it adheres to the doctrine of *stare decisis* and would only revisit prior decisions when presented with special justification, which it found was not present. The court concluded that the determination of the applicability of the limited partner exception is a partnership item over which it has jurisdiction.

The Functional Analysis Test and the "Limited Partner, as Such"

The court then turned to the critical question of whether the five partners qualified as "limited partners, as such" under section 1402(a)(13). This section excludes from NESE a limited partner's distributive share of partnership income, except for guaranteed payments for services. The court clarified that this section is an exception to NESE, which is construed narrowly to achieve the congressional intent of ensuring that the maximum number of individuals are covered under the Social Security framework. The Court applied a functional analysis to determine whether the partners were limited partners, as such, which the court initially adopted in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011).

The functional analysis test, as described in *Renkemeyer*, examines whether a partner's role is akin to that of a passive investor or an active participant in the business. The court noted that Congress intended for section 1402(a)(13) to apply to passive investors, not partners actively engaged in the partnership's business. The court stated that the legislative history indicates that the intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations would not receive credits toward Social Security coverage.

The court rejected the petitioner's argument that the functional analysis test should be based on whether the partners maintained their limited liability status under state law or the Revised Uniform Limited Partnership Act. It emphasized that having limited liability under state law was not sufficient for a partner to be considered a limited partner for purposes of section 1402(a)(13). In *Renkemeyer*, the court had already concluded that a limited partner interest was similar to that of a passive investor. The court highlighted that federal law, not state law, determines the classification of individuals and organizations for federal tax purposes. The court cited Treas. Reg. § 301.7701-1(a) and *Kraatz & Craig Surveying Inc. v. Commissioner*, 134 T.C. 167, 180 (2010), in support of this point.

Application of Functional Analysis Test

The Court in *Denham Capital Management* looked at the source of Denham's income, the partners' roles in generating the income, and the relationship between their distributive shares and any capital contributions. The court found that Denham's income was generated from fees charged for its investment advisory services and that the partners' time, skills, and judgment were essential to

providing these services. It contrasted the large distributive shares the partners received with the relatively small amount of capital they contributed (most partners contributing no capital). The court cited *Renkemeyer* in noting that a small investment compared to the income generated is insufficient to classify the distributive share as a return on investment.

The Court noted that all the partners, except Mr. Porter, were required to "devote substantially all of their business time" to Denham. It emphasized the partners' participation in the management of the firm through their service on various committees. The Court found that the partners' expertise was a draw for fund investors, and their decisions directly affected the operation of the business. It also noted the partners' control over personnel decisions, which further supported the conclusion that they were active participants in the firm.

Rejection of Petitioner's Arguments

The court specifically rejected the argument that the partners were acting in their capacity as members of the general partner, stating that their work was focused on benefiting and being compensated by Denham, the limited partnership, not the general partner. The court also rejected the argument that a passive investor standard would render the guaranteed payment carveout meaningless because partners could receive guaranteed payments, and still be passive investors in other areas. The court emphasized that it must make a comprehensive inquiry and decide whether, based on all facts and circumstances, the partners were "generally akin" to passive investors.

Conclusion

The court concluded that the partners were not "limited partners, as such" under section 1402(a)(13) and that their distributive shares could not be excluded from Denham's NESE. The Court found that the partners' relationships with Denham were more akin to those of employees or self-employed individuals than passive investors. The court's decision was based on the weight of the evidence, which demonstrated the partners' active and integral roles in the business, rejecting the petitioner's argument that compliance with state partnership law was sufficient to qualify the partners as limited partners. The court stated that because the partners were not limited partners, as such, the distributive shares of income are subject to self employment tax under the Internal Revenue Code.

Why Did the Decision Not Rely Simply on the State Law Definition of a Limited Partner?

Why did the Tax Court emphasize the term "limited partner, as such" and apply a functional test instead of relying solely on state law definitions of what is a limited partner? Why is "as such" such a big deal? The reasons are outlined below.

The Core Issue: The Limited Partner Exception and Self-Employment Tax

The crux of the matter lies in Section 1402(a)(13) of the Internal Revenue Code, which provides an exception to the general rule that a partner's distributive share of partnership income is subject to self-employment tax. Specifically, it states that a "limited partner, as such" may exclude their distributive share of income or loss, except for guaranteed payments for services rendered, from net earnings from self-employment (NESE). The critical phrase here is "limited partner, as such." The court's analysis in *Denham Capital Management LP v. Commissioner*, T.C. Memo. 2024-114, hinges on how this phrase is interpreted.

Why Not Just State Law?

The petitioner in *Denham Capital Management* argued that if a partner is designated as a "limited partner" under state law, that should be sufficient to qualify them for the exception under section 1402(a)(13). The Tax Court rejected this argument, emphasizing that federal tax law defines these terms, not state law. The court's reasoning is deeply rooted in legal precedent and the intent of the tax code:

1. **Federal Law Governs Tax Classification**: The court explicitly stated that federal law, not state law, dictates how individuals and organizations are classified for federal tax purposes. This principle is supported by Treasury Regulation § 301.7701-1(a). The court also cited *Kraatz & Craig Surveying Inc. v. Commissioner*, 134 T.C. 167, 180 (2010), and *Estate of Steffke v. Commissioner*, 538 F.2d 730, 732 (7th Cir. 1976), which state that the meaning and legal status of terms under federal tax law need not be identical to their state law counterparts.
2. **"Limited Partner, As Such" is Not a Simple Label**: The court reasoned that the phrase "limited partner, as such," implies more than just having a state law designation. The court held that Congress intended section 1402(a)(13) to apply to partners that are passive investors. The court interpreted this to mean the exception was meant for individuals who are primarily passive investors, not those who are actively engaged in the business, regardless of their state law classification.
3. **Preventing Tax Avoidance**: The court's interpretation of section 1402(a)(13) is designed to prevent individuals from using state law labels to avoid self-employment tax. If the exception applied merely because of a state law designation, it would be easy for partners who function as active participants in a business to avoid paying self-employment taxes simply by calling themselves "limited partners".

4. **The Legislative Intent of Section 1402(a)(13)**: The court noted the legislative history of section 1402(a)(13) which states that "the intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage". The court concluded that Congress did not intend to exclude partners who performed services for a partnership in their capacity as partners from liability for self-employment taxes.

The Functional Analysis Test: A Deeper Dive

The court's response to the petitioner's argument is the application of a "functional analysis test." This test, which the court first articulated in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), doesn't just look at a partner's title but at their actual role and activities within the partnership. The key aspects of the functional analysis are:

1. **Passive Investor vs. Active Participant**: The fundamental question the court seeks to answer is whether the partner is functioning more like a passive investor or an active participant in the business. Passive investors, in the traditional sense, put up capital and do not actively engage in the management or day-to-day operations of the business.
2. **Source of Income**: The court scrutinizes how the partnership generates income. In *Denham Capital Management*, the income was generated from management fees earned through the active management of investments, not through passive returns on capital. This indicated that the partners' efforts were integral to the partnership's income generation.
3. **Partner's Role in Generating Income**: The court analyzes the partner's involvement in the activities that generate income. The court found that the partners' time, skills, and judgment were essential to providing the investment services from which the partnership earned its fees.
4. **Capital Contribution vs. Distributive Share**: A crucial element of the analysis is comparing the partner's capital contributions to their distributive share of partnership income. In *Denham Capital Management*, most partners made no capital contributions, yet received large distributive shares, which were disproportionate to any investment risk. The court, citing *Renkemeyer*, held that where a partner's investment is small compared to the income, the income is not considered a return on investment.
5. **Management and Decision-Making**: The court examines the extent of the partner's participation in the management and decision-making processes of the partnership. In *Denham Capital Management*, the partners were deeply involved in strategic decisions through their participation in management, valuation, and investment committees.
6. **Time Commitment**: The court considers the time the partner dedicates to the partnership. The *Denham Capital Management* partnership agreement required all partners (except one) to devote substantially all their business time to the partnership, which the court took as an indicator of active involvement.

Precedent for Functional Analysis

The Tax Court has consistently applied the functional analysis test in prior cases:

- ***Soroban Capital Partners LP v. Commissioner*, 161 T.C. 310 (2023)**: The court stated that a functional analysis test should be used to determine the roles and responsibilities of partners to determine their status for tax purposes.
- ***Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011)**: The court established the functional analysis test, focusing on whether a partner's role is akin to that of a passive investor or an active participant in the business.
- ***Castigliola v. Commissioner,* T.C. Memo. 2017-62**: The court used the *Renkemeyer* analysis to conclude that the members of a professional limited liability company were not limited partners because they were involved in the management of the business.
- ***Hardy v. Commissioner,* T.C. Memo. 2017-16**: The court found that a surgeon was a limited partner because they had no management responsibilities and their share of income was based on the fees paid for the use of the surgery center.

These cases reinforce the idea that the "limited partner, as such" designation requires more than just a state law label; it requires an examination of the partner's actual function and role within the partnership.

The Court's Conclusion in Denham Capital Management

In *Denham Capital Management*, the court found that the partners were not "limited partners, as such" because they were actively involved in the core business operations, their income was directly related to their efforts and expertise, and their role was integral to the business. The court emphasized the fact that the partners' roles were so fundamental to the firm's operation that investors had the right to withdraw their investments early if one or more of the Partners died, became disabled, or could no longer devote substantially all business time to the funds. The court concluded that the partners' relationships with Denham were more akin to those of employees or self-employed individuals rather than passive investors.

Implications for Tax Professionals

For CPAs, this case underscores that, in the view of the Tax Court, simply labeling a partner as a "limited partner" under state law is insufficient to exclude their distributive share from self-employment tax. The tax implications are determined by a functional analysis of the partner's role and responsibilities. Tax professionals should carefully evaluate the activities, income sources, and management roles of partners to accurately determine their status for federal tax purposes.

In summary, the Tax Court emphasized "limited partner, as such" because this phrase is not merely a state law designation, but a federal tax concept that requires an evaluation of a partner's economic relationship to their partnership. The functional analysis test, as detailed above, is used to make this

determination. This analysis is necessary to achieve the intent of Section 1402(a)(13) to benefit passive investors and prevent tax avoidance.

Required Minimum Distribution Final Regulations

TD 10001, July 19, 2024

Account Inherited from a Decedent Who Died After 2019 and Had Attained His/Her Required Beginning Date

When an employee dies after their required beginning date, distributions to the beneficiary must satisfy section 401(a)(9)(B)(i), which requires that distributions be made at least as rapidly as under the method the employee was using, as well as section 401(a)(9)(B)(ii), which generally requires that the employee's entire interest be distributed within 10 years.[30]

Here's a breakdown of the relevant provisions:

- **Required Minimum Distributions (RMDs):** For calendar years after the year of the employee's death, the applicable denominator for calculating the required minimum distribution is generally the remaining life expectancy of the designated beneficiary. The RMD is calculated by dividing the prior year's account balance by the applicable denominator. This calculation must be done annually until the account is fully distributed. A required minimum distribution is due for the calendar year of the beneficiary's death and must be distributed to any successor beneficiary.[31]
- **10-Year Rule:** Unless the beneficiary is an eligible designated beneficiary taking life expectancy payments, the employee's entire interest must be distributed by the end of the calendar year that includes the tenth anniversary of the employee's death.[32] If the designated beneficiary is an eligible designated beneficiary, the 10-year rule applies upon the death of that eligible designated beneficiary.
- **Eligible Designated Beneficiary:** An eligible designated beneficiary can take distributions over their life expectancy. An eligible designated beneficiary is defined as:
    - The surviving spouse of the employee.
    - A child of the employee who has not reached the age of majority (age 21).
    - An individual who is disabled.
    - An individual who is chronically ill.
    - An individual not more than 10 years younger than the employee.
- **Multiple Beneficiaries:** If there are multiple beneficiaries, the life expectancy of the oldest beneficiary is used to determine the applicable denominator. However, if the employee's

[30] TD 10001, Preamble to Final Regulations, July 19, 2024
[31] Treasury Regulation § 1.401(a)(9)–5(d)(1)(i)
[32] Treasury Regulation § 1.401(a)(9)–5(d)(1)(i)

beneficiary is a multi-beneficiary trust, then only the disabled and chronically ill beneficiaries of the trust are taken into account in determining the oldest designated beneficiary. If any of the beneficiaries are minor children, the 10-year rule is applied based on when the oldest child reaches the age of majority, plus 10 years.

- **Annual Distributions:** Even if the 10-year rule applies, annual distributions must continue to be taken for up to 10 years following the death of the employee, and a full distribution of the remaining account balance must be made by the end of the 10th year. This requirement also applies if an eligible designated beneficiary who was taking life expectancy payments dies, or if a minor child beneficiary reaches the age of majority. The requirement for annual distributions does not apply if the beneficiary is an eligible designated beneficiary and takes life expectancy payments.
- **Effective Date of SECURE Act:** The rules introduced by the SECURE Act generally apply to distributions for employees who die after December 31, 2019. However, for collectively bargained plans, these rules may apply to distributions for employees who die in calendar years beginning after December 31, 2021, or if earlier, the date when the last collective bargaining agreement terminates.

Important Considerations:

- **Documentation:** If the beneficiary is disabled or chronically ill, documentation must be provided to the plan administrator by October 31 of the year following the employee's death.
- **Transition Relief:** The Treasury Department and the IRS have provided transition relief for the requirement to take annual distributions. Under this relief, a plan will not fail to be qualified for failing to make a required distribution in 2021, 2022, 2023, or 2024, and the taxpayer will not be assessed an excise tax for failing to do so. This applies to beneficiaries of employees who died in 2020, 2021, 2022, or 2023, and after the employee's required beginning date, provided that the beneficiary was not an eligible designated beneficiary taking life expectancy payments.
- **Separate Accounts:** If a plan has separate accounts for each beneficiary, the rules may be applied separately to each account, but only for calendar years after the death of the employee. This does not apply for the calendar year of the employee's death. If a trust is divided immediately into separate trusts for each beneficiary upon the death of the employee, the rules can be applied separately for each of those trusts.

These regulations are applicable for determining required minimum distributions for calendar years beginning on or after January 1, 2025.

Eligible Designated Beneficiaries

An **eligible designated beneficiary** is a designated beneficiary who, as of the date of the employee's death, is one of the following:

- The surviving spouse of the employee.
- A child of the employee who has not reached the age of majority. The definition of child includes a stepchild, an adopted child, and an eligible foster child.
- Disabled. Disability is defined using the standard of whether an individual is unable to engage in substantial gainful activity. For beneficiaries under 18, disability is defined as a medically determinable physical or mental impairment that results in marked and severe functional limitations, and that can be expected to result in death or to be of long-continued and indefinite duration. A safe harbor for determining disability exists if, as of the employee's death, the Commissioner of Social Security has determined the individual is disabled.
- Chronically ill. A chronically ill individual is defined in section 7702B(c)(2), subject to certain exceptions.
- An individual not more than 10 years younger than the employee. This is determined based on the dates of birth of the employee and the beneficiary.

Rules for Eligible Designated Beneficiaries:

- **Life Expectancy Payouts:** An eligible designated beneficiary of an employee who dies before their required beginning date can elect to receive distributions over their life expectancy. This option is not available to non-eligible designated beneficiaries.
- **Annual Distributions:** If an eligible designated beneficiary is taking life expectancy payments, annual distributions must continue until the employee's interest is fully distributed. A required minimum distribution is due for the calendar year of the eligible designated beneficiary's death, and that amount must be distributed during that calendar year to any beneficiary of the deceased eligible designated beneficiary.
- **10-Year Rule Exception:** If a beneficiary is an eligible designated beneficiary, the 10-year rule for full distribution applies upon the death of that eligible designated beneficiary, meaning the remaining interest must be distributed by the end of the tenth calendar year following the calendar year in which the eligible designated beneficiary died.
- **Multiple Beneficiaries**: If an employee has multiple beneficiaries, and one is a minor child, the employee is treated as having an eligible designated beneficiary even if other beneficiaries are not eligible. In this case the 10-year rule is applied ten years after the youngest of the minor children reaches the age of majority.
- **Documentation Requirements**: If a beneficiary is disabled or chronically ill, documentation of the disability or chronic illness must be provided to the plan administrator no later than October 31 of the calendar year following the calendar year of the employee's death. If the designated beneficiary is chronically ill, the documentation must include a certification by a licensed health care practitioner. A transition rule for the documentation deadline exists for employees who died in 2020, 2021, 2022, or 2023; in those cases, the documentation does not need to be furnished until October 31, 2025.
- **Applicable Multi-Beneficiary Trusts**: If a trust is an applicable multi-beneficiary trust, then only the disabled and chronically ill beneficiaries of the trust are taken into account in

determining the oldest designated beneficiary. If no beneficiary other than a disabled or chronically ill eligible designated beneficiary has any right to the employee's interest in the plan until the death of all of those disabled or chronically ill eligible designated beneficiaries, then payments can be made over the life expectancy of the eligible designated beneficiary and the non-disabled or chronically ill beneficiaries are treated as beneficiaries of the disabled or chronically ill beneficiary.

- **Plan Provisions**: A plan may provide that only a surviving spouse may elect between the 10-year rule and life expectancy payments, or that a particular distribution method will apply to certain categories of eligible designated beneficiaries. If a plan allows an election between the 10-year rule and the life expectancy rule, then the plan must specify a default that would apply when no election is made, but only if the default is different than the default in the regulations.
- **Spouse as Eligible Designated Beneficiary:** If the employee's designated beneficiary is their surviving spouse, and the surviving spouse dies before distributions to the spouse have begun, then the determination of whether a person is a beneficiary of the surviving spouse is made using the rules that apply to an employee. A designated beneficiary of the employee's surviving spouse is an eligible designated beneficiary if they would have been an eligible designated beneficiary if the rules were applied by substituting the surviving spouse for the employee.

Special Cases

- If a designated beneficiary is an eligible designated beneficiary because they are a minor child, they will continue to be treated as an eligible designated beneficiary after reaching the age of majority only if documentation requirements are met.
- If a surviving spouse is also disabled or chronically ill, they will be treated as disabled or chronically ill for purposes of the applicable multi-beneficiary trust rules only if the documentation requirements are met.

These regulations are applicable for determining required minimum distributions for calendar years beginning on or after January 1, 2025.

Surviving Spouse Eligible Designated Beneficiary

When an employee designates a surviving spouse as an eligible designated beneficiary, specific rules apply regarding required minimum distributions.

Definition of Surviving Spouse

- For purposes of satisfying the requirements of section 401(a)(9), an individual is the spouse or surviving spouse of an employee if the marriage of the employee and individual is

recognized for Federal tax purposes. The spouse is determined as of the date of death of the employee.

- A former spouse who is an alternate payee under a qualified domestic relations order (QDRO) is also treated as a spouse.

Treatment as an Eligible Designated Beneficiary

- A surviving spouse is considered an eligible designated beneficiary.
- As an eligible designated beneficiary, the surviving spouse can use the life expectancy rule for distributions.
- If the surviving spouse is also disabled or chronically ill, they can remain an eligible designated beneficiary even after remarriage, provided documentation requirements are met. The documentation of disability or chronic illness must be provided to the plan administrator no later than October 31 of the calendar year following the calendar year of the employee's death.
- If the surviving spouse is the sole beneficiary of the employee, then the applicable denominator during the spouse's lifetime is the spouse's life expectancy, which reflects an annual recalculation.
- The surviving spouse can elect to be treated as the employee for purposes of required minimum distributions.

Distribution Rules

- If the employee dies before the required beginning date, the surviving spouse can delay the commencement of distributions until the end of the calendar year in which the employee would have attained the applicable age.
- If the surviving spouse is the sole beneficiary, distributions can be delayed until the end of the calendar year in which the employee would have reached the applicable age.
- If the surviving spouse dies before distributions have commenced, the rules are applied as if the surviving spouse were the employee. For this purpose, the date of death of the surviving spouse is substituted for the date of death of the employee.
- If the surviving spouse remarries but dies before distributions have begun, the delayed commencement rule is not available to the surviving spouse of the deceased employee's surviving spouse.
- If the surviving spouse dies after distributions have commenced, the distributions to the spouse's beneficiary are calculated using the spouse's age in the year of their death, reduced by one for each subsequent year.
- If the employee dies on or after their required beginning date, distributions to the employee's beneficiary for calendar years after the calendar year in which the employee died must satisfy section 401(a)(9)(B)(i) as well as section 401(a)(9)(B)(ii).

- If the surviving spouse is the sole beneficiary, the applicable denominator during the spouse's lifetime is the spouse's life expectancy, which is recalculated annually.

Special Rules

- A surviving spouse can elect to treat a deceased spouse's IRA as their own.
- If the surviving spouse is subject to the 10-year rule, a special rule applies to prevent an undue delay in commencement of distributions that results from the expansion of the 5-year rule into a 10-year rule.
- The surviving spouse can roll over a distribution to their own IRA.
- The surviving spouse can elect to treat the IRA as their own, subject to certain conditions.
- If a surviving spouse rolls over a distribution to a qualified plan, the amount rolled over is treated as the spouse's own interest under the receiving plan, and not the interest of the decedent under the distributing plan.
- A plan administrator may assume that a surviving spouse will only roll over the eligible portion of a distribution to an eligible retirement plan under which they are not treated as the beneficiary of the employee.
- In the case of a joint and survivor annuity, if the employee and spouse divorce after the annuity starting date, the former spouse is still treated as an eligible designated beneficiary.

Trusts

- If a trust is named as a beneficiary, special rules apply to determine if the trust beneficiaries are eligible designated beneficiaries.
- If a see-through trust is named as a beneficiary, and the surviving spouse could receive amounts in the trust that are not contingent on another beneficiary's death, the surviving spouse is treated as a beneficiary.
- The documentation requirements for a see-through trust do not have to be provided to an IRA custodian.

Examples

- If the employee names the surviving spouse as the sole beneficiary, the surviving spouse may elect to be treated as the employee.
- If the employee's spouse is the sole beneficiary and dies before distributions begin, then the rules are applied as if the surviving spouse was the employee.

These rules allow a surviving spouse flexibility in managing retirement distributions while complying with the required minimum distribution regulations.

Minor Child Eligible Designated Beneficiary

When an employee designates a minor child as an eligible designated beneficiary, specific rules apply regarding required minimum distributions.

Definition of a Minor Child

- A child is defined consistently with section 152(f)(1), which includes a stepchild, an adopted child, and an eligible foster child.
- A child reaches the age of majority on their 21st birthday.

Treatment as an Eligible Designated Beneficiary

- A child of the employee who has not reached the age of majority is considered an eligible designated beneficiary.
- If a child is an eligible designated beneficiary, they may initially use the life expectancy rule for distributions.
- If a child who is an eligible designated beneficiary is also disabled or chronically ill, they can remain an eligible designated beneficiary even after reaching the age of majority, provided documentation requirements are met.
- **The documentation of disability or chronic illness must be provided to the plan administrator no later than October 31 of the calendar year following the calendar year of the employee's death**.
- If the documentation is not timely provided, the child will cease to be an eligible designated beneficiary upon reaching the age of majority.

Distribution Rules

- **The treatment of a child as an eligible designated beneficiary ends when the child attains the age of majority**.
- If the child is an eligible designated beneficiary due to being a minor, and not due to disability or chronic illness, any remaining interest must be distributed within 10 years of that date.
- **If the employee has multiple beneficiaries, and one of them is a minor child, the 10-year rule applies 10 years after the youngest of the minor children reaches the age of majority**. This means that the distribution does not have to be completed 10 years after the oldest minor child reaches the age of majority, but rather 10 years after the youngest does.
- Annual distributions, based on the life expectancy rule, must continue until the child reaches the age of majority.
- If the child is taking life expectancy payments, these annual distributions must continue for up to 10 years after the child attains the age of majority.

Special Rules

- If payments are made to a child and then become payable to the surviving spouse upon the child reaching the age of majority, those payments are treated as if they were made to the surviving spouse.
- When determining the applicable denominator for distributions, the age of the child is not taken into consideration for the Minimum Distribution Incidental Benefit (MDIB) requirement if payments will be made to a surviving spouse after the child reaches the age of majority.
- A plan can provide that only a surviving spouse can elect between the 10-year rule and life expectancy payments, which may affect minor children who are also beneficiaries.

Trusts

- If a trust is named as a beneficiary, special rules apply to determine if the trust beneficiaries are eligible designated beneficiaries.
- If a trust is a see-through trust, a minor child who is a beneficiary of the trust is treated as if they could receive amounts in the trust, regardless of whether the payments are made directly to them or to a custodial account for their benefit.
- If a see-through trust requires a full distribution to a beneficiary by the later of the year after the employee's death, or the tenth anniversary of the beneficiary reaching the age of majority, any other beneficiaries are disregarded.

Example

- If an employee dies in 2022 and designates their child, who will reach the age of majority in 2024, as the sole beneficiary, the child is considered an eligible designated beneficiary.
- If the child is disabled, and the documentation requirements are met, the child remains an eligible designated beneficiary even after reaching the age of majority and can continue to take life expectancy payments.
- If the child is not disabled, then the remaining interest must be distributed by the end of 2034 (10 years after the child reaches the age of majority).

Disabled Eligible Designated Beneficiaries

When an employee designates a disabled individual as an eligible designated beneficiary, specific rules apply regarding required minimum distributions.

Definition of Disability

- The definition of disability for purposes of section 401(a)(9) is based on section 72(m)(7).

- **For individuals 18 or older**, disability is defined as being unable to engage in any substantial gainful activity due to a medically determinable physical or mental impairment that is expected to result in death or be of long-continued and indefinite duration.
- **For individuals under 18**, disability is defined as having a medically determinable physical or mental impairment that results in marked and severe functional limitations, which is expected to result in death or be of long-continued and indefinite duration.
- **A safe harbor** is provided: if the Commissioner of Social Security has determined that an individual is disabled within the meaning of 42 U.S.C. 1382c(a)(3), that individual will be deemed disabled for purposes of section 401(a)(9). However, an individual can still be considered disabled even without the Social Security determination if they meet the general standards for disability.

Treatment as an Eligible Designated Beneficiary

- A disabled individual is considered an eligible designated beneficiary.
- As an eligible designated beneficiary, a disabled individual can use the life expectancy rule for distributions.
- If a designated beneficiary is disabled as of the date of the employee's death, they remain an eligible designated beneficiary even after reaching the age of majority. This is in contrast to a minor child beneficiary who is not disabled and who will cease to be an eligible designated beneficiary upon reaching the age of majority.
- **Documentation of the disability must be provided to the plan administrator no later than October 31 of the calendar year following the calendar year of the employee's death**. This deadline also applies to a minor child who is disabled.
- For an employee who died in 2020, 2021, 2022, or 2023, documentation of disability does not need to be furnished to the plan administrator until October 31, 2025.
- The documentation must include a statement from a licensed health care practitioner that certifies the beneficiary is unable to engage in substantial gainful activity due to a physical or mental impairment that is expected to be of long-continued and indefinite duration.
- The documentation requirements for a disabled beneficiary do not need to be provided to an IRA custodian.[33]
- If the documentation requirements are not met, the disabled individual will not be treated as a disabled eligible designated beneficiary.
- If a disabled beneficiary was also a minor child of the employee, they will continue to be treated as an eligible designated beneficiary after reaching the age of majority only if the documentation requirements are met.
- If a surviving spouse is also disabled at the time of the employee's death, then the surviving spouse will be treated as disabled for purposes of the applicable multi-beneficiary trust rules only if the documentation requirements are met.

[33] Treasury Reg. §1.408-8(b)(4)(i)

Distribution Rules

- **If the disabled beneficiary meets the requirements for an eligible designated beneficiary, they can take distributions over their lifetime**.
- If the disabled beneficiary is taking life expectancy payments and dies, the remaining interest must be distributed by the end of the tenth calendar year following the year of the beneficiary's death.

Special Rules

- If a plan provides for an election between the 10-year rule and life expectancy payments, the plan can specify that only a surviving spouse can make this election. This may affect disabled beneficiaries who are not the surviving spouse.
- A plan can provide that a particular distribution method applies to certain categories of eligible designated beneficiaries.

Trusts

- If a trust is named as a beneficiary, special rules apply to determine if the trust beneficiaries are eligible designated beneficiaries.
- **An applicable multi-beneficiary trust** is a see-through trust with more than one beneficiary where at least one beneficiary is an eligible designated beneficiary who is either disabled or chronically ill.
    - A type I applicable multi-beneficiary trust is a trust that will be divided into separate trusts for each beneficiary upon the death of the employee, where at least one beneficiary is disabled or chronically ill.
    - A type II applicable multi-beneficiary trust is one in which no beneficiary other than a disabled or chronically ill beneficiary has a right to the employee's interest until the death of all the disabled or chronically ill beneficiaries.
- For a type II applicable multi-beneficiary trust, if a beneficiary who is not disabled or chronically ill is entitled to distributions after the death of the disabled or chronically ill beneficiaries, that beneficiary is treated as a beneficiary of the disabled or chronically ill beneficiary.
- If a see-through trust has a disabled beneficiary, and the trust is to be divided into separate trusts upon the employee's death, the rules of section 401(a)(9) may be applied separately to the separate interests of the beneficiaries.
- For a type II applicable multi-beneficiary trust, the restriction on payments from the trust before the death of the disabled or chronically ill individual applies to any other beneficiary, including organizations described in section 408(d)(8)(B)(i).
- If a trust provides for a disabled or chronically ill beneficiary's interest to be terminated to preserve eligibility for public benefits, the trust can still be treated as an applicable

multi-beneficiary trust as long as other beneficiaries cannot receive payments before the death of the disabled or chronically ill beneficiary, regardless of whether the disabled beneficiary's interest is terminated.

Examples

- If an employee dies in 2022 and designates their disabled child as the sole beneficiary, and the child meets documentation requirements, the child can continue to take life expectancy payments during their lifetime, even after reaching the age of majority.
- If the documentation requirements are not met, the child ceases to be an eligible designated beneficiary upon reaching the age of majority.

These provisions ensure that disabled beneficiaries receive the required minimum distributions while accounting for their unique circumstances.

Chronically Ill Individual Eligible Designated Beneficiary

The final regulations provide specific guidelines for chronically ill individuals who are designated as eligible designated beneficiaries.

Definition of Chronically Ill

- A chronically ill individual is defined according to section 7702B(c)(2). Internal Revenue Code Section 7702B(c)(2) defines a "chronically ill individual" as someone who meets at least one of the following criteria:
  - **Unable to perform at least two activities of daily living (ADLs) for at least 90 days:**
    - This means the individual needs substantial assistance from another person to perform at least two of the following ADLs for a period of at least 90 days due to a loss of functional capacity:[34]
      - Eating
      - Toileting
      - Transferring (moving from bed to chair, etc.)
      - Bathing
      - Dressing
      - Continence
  - **Having a level of disability similar to the level described in the prior bullet:**
    - The Treasury Department and the Department of Health and Human Services have established regulations to determine what other disabilities are considered similar in severity to the inability to perform two or more ADLs.
  - **Requiring substantial supervision to protect from threats to health and safety due to severe cognitive impairment:**

[34] IRC §7702B(c)(2)(A)(i)

    - This means the individual has a severe cognitive impairment, such as Alzheimer's disease or dementia, and requires substantial supervision to protect them from threats to their health and safety.
- This definition is further specified such that an individual will only be treated as chronically ill under section 7702B(c)(2)(A)(i) (inability to perform two or more ADLs) if a licensed health care practitioner certifies that, as of the date of certification, the individual cannot perform at least two activities of daily living without substantial assistance from another individual. The period of this inability must be indefinite and reasonably expected to be lengthy.

Treatment as an Eligible Designated Beneficiary

- A chronically ill individual is considered an eligible designated beneficiary.
- As an eligible designated beneficiary, a chronically ill individual can use the life expectancy rule for distributions.
- The regulations specify that **documentation of the chronic illness must be provided to the plan administrator by October 31 of the calendar year following the calendar year of the employee's death**.
- The documentation must include a certification from a licensed health care practitioner.
- If the designated beneficiary is chronically ill under section 7702B(c)(2)(A)(i), the documentation must also include a certification from a licensed health care practitioner that, as of the date of the certification, the individual is unable to perform at least 2 activities of daily living without substantial assistance and that this inability is indefinite and expected to be lengthy.
- For an employee who died in 2020, 2021, 2022, or 2023, documentation of chronic illness does not need to be furnished to the plan administrator until October 31, 2025.
- The documentation requirements for a chronically ill beneficiary do not need to be provided to an IRA custodian.
- If the documentation requirements are not met, the chronically ill individual will not be treated as an eligible designated beneficiary.
- If a surviving spouse is also chronically ill at the time of the employee's death, the surviving spouse will be treated as chronically ill for purposes of the applicable multi-beneficiary trust rules only if the documentation requirements are met.
- If a designated beneficiary is the employee's minor child who is also chronically ill, they will continue to be treated as an eligible designated beneficiary after reaching the age of majority only if the documentation requirements are met.

Distribution Rules

- If the chronically ill beneficiary meets the requirements for an eligible designated beneficiary, they can take distributions over their lifetime.

- If a chronically ill beneficiary is taking life expectancy payments and dies, the remaining interest must be distributed by the end of the tenth calendar year following the year of the beneficiary's death.

Special Rules

- A plan can provide that a particular distribution method applies to certain categories of eligible designated beneficiaries, which may affect chronically ill beneficiaries.
- The final regulations do not permit plan administrators to rely on self-certifications from a designated beneficiary of chronic illness. Instead, documentation from a licensed healthcare practitioner is required.

Trusts

- If a trust is named as a beneficiary, special rules apply to determine if the trust beneficiaries are eligible designated beneficiaries.
- An applicable multi-beneficiary trust is a see-through trust with more than one beneficiary where at least one beneficiary is an eligible designated beneficiary who is either disabled or chronically ill.
    - A type I applicable multi-beneficiary trust is a trust that will be divided into separate trusts for each beneficiary upon the death of the employee, where at least one beneficiary is disabled or chronically ill.
- A type II applicable multi-beneficiary trust is one in which no beneficiary other than a disabled or chronically ill beneficiary has a right to the employee's interest until the death of all the disabled or chronically ill beneficiaries.
- For a type II applicable multi-beneficiary trust, if a beneficiary who is not disabled or chronically ill is entitled to distributions after the death of the disabled or chronically ill beneficiaries, that beneficiary is treated as a beneficiary of the disabled or chronically ill beneficiary.
- If a see-through trust has a chronically ill beneficiary and the trust is to be divided into separate trusts upon the employee's death, the rules of section 401(a)(9) may be applied separately to the separate interests of the beneficiaries.
- For a type II applicable multi-beneficiary trust, the restriction on payments from the trust before the death of the disabled or chronically ill individual applies to any other beneficiary, including organizations described in section 408(d)(8)(B)(i).
- If a trust provides for a disabled or chronically ill beneficiary's interest to be terminated to preserve eligibility for public benefits, the trust can still be treated as an applicable multi-beneficiary trust as long as other beneficiaries cannot receive payments before the death of the disabled or chronically ill beneficiary, regardless of whether the disabled beneficiary's interest is terminated.

These regulations ensure that chronically ill beneficiaries receive required minimum distributions while considering their specific circumstances and needs.

No More than Ten Years Younger Eligible Designated Beneficiary

The final regulations include specific provisions for a designated beneficiary who is no more than 10 years younger than the employee, defining them as an **eligible designated beneficiary** for the purposes of required minimum distributions. This status affects how distributions are calculated and the timeframe for when they must be completed.

Definition

- An individual is considered to be no more than 10 years younger than the employee if their date of birth is within 10 years of the employee's date of birth. For example, if an employee's date of birth is October 1, 1953, then a beneficiary born on or before October 1, 1963, would meet this requirement.

Treatment as an Eligible Designated Beneficiary

- A designated beneficiary who is no more than 10 years younger than the employee qualifies as an **eligible designated beneficiary**. This classification is important because it allows for the use of the life expectancy rule for distributions.

Distribution Rules

- If the employee dies before their required beginning date, an eligible designated beneficiary can take distributions over their lifetime.
- If an eligible designated beneficiary who is no more than 10 years younger than the employee dies before the employee's interest is fully distributed, the remaining portion must be distributed within 10 years of the eligible designated beneficiary's death.
- For a defined contribution plan, if the employee dies after the required beginning date, and the beneficiary is an eligible designated beneficiary, the beneficiary may take distributions over their lifetime, using their own remaining life expectancy, or the employee's remaining life expectancy if it is longer.

Multiple Beneficiaries

- If an employee has multiple designated beneficiaries, and at least one of them is *not* an eligible designated beneficiary (such as someone more than 10 years younger), then the employee is generally treated as not having an eligible designated beneficiary. This means the 10-year rule, rather than life expectancy payments, will apply.
- However, there are exceptions. For example, if one of the beneficiaries is a minor child of the employee, that beneficiary being an eligible designated beneficiary means that the

employee is treated as having an eligible designated beneficiary even if there are other beneficiaries who are not eligible.

Trusts as Beneficiaries

- When a trust is named as the beneficiary, special rules apply to determine if the trust beneficiaries are eligible designated beneficiaries.
- If a see-through trust is used, the beneficiaries of the trust are generally considered designated beneficiaries, and the age of the oldest beneficiary is used to determine the distribution period. If the oldest beneficiary is more than 10 years younger than the employee, then the 10-year rule applies, unless the trust is an applicable multi-beneficiary trust.
- If a trust is structured so that a beneficiary who is not more than 10 years younger than the employee is the primary beneficiary and any other beneficiary is only entitled to the funds if the primary beneficiary dies before full distribution, then the other beneficiary is disregarded for the purposes of determining the applicable distribution period.

These regulations ensure that beneficiaries who are within 10 years of the employee's age can receive distributions over their lifetime as an eligible designated beneficiary while also setting a time limit on how long the distributions can be spread out after the death of the eligible designated beneficiary.

See-Through Trusts and Required Minimum Distributions

The final regulations address "see-through" trusts and their impact on Required Minimum Distribution (RMD) rules, particularly when a trust is named as a beneficiary of a retirement plan or IRA. These regulations clarify which trust beneficiaries are considered designated beneficiaries for RMD purposes, and how to determine the applicable distribution period.

Definition of a See-Through Trust

- A see-through trust is a trust that meets specific requirements allowing the beneficiaries of the trust, rather than the trust itself, to be treated as the designated beneficiaries of the employee for RMD purposes.
- To qualify as a see-through trust, the following conditions must be met:
    - The trust is valid under state law or would be valid except for the lack of a corpus.
    - The trust is irrevocable, or it will become irrevocable upon the death of the employee.
    - The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable from the trust instrument.
    - Specific documentation requirements are met.

Identifying Trust Beneficiaries

- Generally, a beneficiary of a see-through trust is treated as a beneficiary of the employee if they can receive amounts from the trust representing the employee's interest, and those amounts are not contingent upon or delayed until the death of another trust beneficiary who did not predecease the employee.
- The regulations distinguish between two types of see-through trusts: conduit trusts and accumulation trusts.
    - **Conduit Trust**: A conduit trust requires all plan distributions received by the trustee to be paid directly to, or for the benefit of, primary beneficiaries during their lifetimes.
        - In a conduit trust, only the primary beneficiaries who could receive amounts during their lifetime are treated as beneficiaries of the employee.
        - A trust will not fail to be treated as a conduit trust merely because the trust terms requiring that distributions from the plan, upon receipt by the trustee, are paid directly to, or for the benefit of, trust beneficiaries do not apply after the death of all of the primary beneficiaries.
    - **Accumulation Trust**: An accumulation trust is any see-through trust that is not a conduit trust.
        - In an accumulation trust, beneficiaries who could receive amounts accumulated in the trust that were not distributed to other beneficiaries during their lifetimes are also treated as beneficiaries of the employee.

Disregarded Beneficiaries

- Certain beneficiaries of a see-through trust can be disregarded for RMD purposes.
    - A beneficiary is not treated as a beneficiary of the employee if they can only receive payments after the death of another trust beneficiary who is a residual beneficiary (and not a primary beneficiary) who did not predecease the employee.
    - A beneficiary is also disregarded if their entitlement is conditioned on the death of a young individual and the trust terms require a full distribution to that individual by the later of the end of the year following the employee's death or the end of the year including the tenth anniversary of the date the individual reaches the age of majority.
- The regulations do not adopt a broad disregard for beneficiaries with remote contingent interests.

Documentation Requirements

- Plan administrators may require either a copy of the trust instrument or a list of the trust beneficiaries with a description of their conditions of entitlement.

- The final regulations do not permit a trustee to certify to a plan administrator the list of beneficiaries to be treated as beneficiaries of the employee.
- Trust documentation is not required to be provided to an IRA custodian.

Special Rules for Applicable Multi-Beneficiary Trusts

- An applicable multi-beneficiary trust is a see-through trust with more than one beneficiary, where all beneficiaries are designated beneficiaries, and at least one is an eligible designated beneficiary who is either disabled or chronically ill.
- There are two types of applicable multi-beneficiary trusts:
    - Type I (not included in final regulations): A trust that will be divided into separate trusts for each beneficiary upon the employee's death. The final regulations do not include a definition of a type I applicable multi-beneficiary trust because a broader rule permits separate application of section 401(a)(9) to separate interests of beneficiaries if the trust is divided immediately upon the employee's death.
    - Type II: A trust in which no beneficiary other than a disabled or chronically ill beneficiary has a right to the employee's interest until the death of all disabled or chronically ill beneficiaries.
        - For type II trusts, certain organizations described in section 170(b)(1)(A) are treated as designated beneficiaries.
        - If a trust provides for the termination of a disabled or chronically ill beneficiary's interest to preserve public benefits eligibility, the trust may still be treated as an applicable multi-beneficiary trust if no other beneficiary can receive payments until the death of the disabled or chronically ill beneficiary.
- The final regulations allow separate application of section 401(a)(9) to the separate interests of beneficiaries of a see-through trust if the trust is to be divided immediately upon the death of the employee into separate shares, and there is no discretion as to how the separate trusts will receive post-death distributions.

RMD Calculations

- For RMD purposes, the designated beneficiary is generally the oldest beneficiary of the trust, unless the trust is an applicable multi-beneficiary trust.
- If a see-through trust is structured so that a beneficiary who is not more than 10 years younger than the employee is the primary beneficiary and any other beneficiary is only entitled to the funds if the primary beneficiary dies before full distribution, then the other beneficiary is disregarded for the purposes of determining the applicable distribution period.

These regulations provide detailed guidance for plan administrators and trustees to correctly identify beneficiaries of see-through trusts and apply the appropriate RMD rules, ensuring compliance with section 401(a)(9) of the Code.

Provisions Related to Corrections of RMD Errors

The final regulations include several provisions for correcting errors related to Required Minimum Distributions (RMDs). These provisions address both the failure to distribute the required amount and the associated excise tax.

Excise Tax on Insufficient Distributions

- If the amount distributed to a payee from a qualified retirement plan or eligible deferred compensation plan for a calendar year is less than the required minimum distribution for that year, section 4974 imposes an excise tax on the payee.
- The excise tax is generally equal to **25 percent** of the amount by which the required minimum distribution exceeds the actual amount distributed during the calendar year.
- This tax applies to qualified retirement plans and eligible deferred compensation plans.

Reduced Excise Tax with Corrective Distribution

- The excise tax rate is reduced to **10 percent** if the taxpayer takes a corrective action.
- To qualify for the reduced 10% excise tax, the taxpayer must, by the last day of the correction window:
    - Receive a corrective distribution from the applicable plan of the amount by which the required minimum distribution for the calendar year exceeds the actual amount distributed.
    - Submit a return reflecting the excise tax.
- The **correction window** ends on the earliest of:
    - The date a notice of deficiency under section 6212 with respect to the tax imposed by section 4974(a) is mailed.
    - The date on which the tax imposed by section 4974(a) is assessed.
    - The last day of the second taxable year that begins after the end of the taxable year in which the tax under section 4974(a) is imposed.

Corrective Distribution Rules

- The corrective distribution must be made from the plan from which the minimum distribution was required.
- If the minimum distribution could have been taken from any one of a number of qualified retirement plans (such as an IRA or a section 403(b) plan), the corrective distribution may be taken from any one of those qualified retirement plans.

Waiver of Excise Tax

- The excise tax under section 4974 may be waived if the payee establishes to the satisfaction of the Secretary that:
    - The failure to distribute the required minimum distribution was due to reasonable error; and
    - Reasonable steps are being taken to remedy the failure.

Automatic Waiver

- The tax is automatically waived if, in the case of a designated beneficiary, a distribution would have been required under these regulations had they applied before January 1, 2025, and no distribution was taken in 2021, 2022, 2023, or 2024. This applies to a beneficiary who is a designated beneficiary of an employee who died in 2020, 2021, 2022, or 2023, and after the employee's required beginning date, provided that the beneficiary was not an eligible designated beneficiary who used the lifetime or life expectancy payments exception under section 401(a)(9)(B)(iii).
- The excise tax under paragraph (a) is waived automatically if the distribution was not made in the calendar year of the individual's death. However, this is only the case if the beneficiary takes a corrective distribution in the amount needed to satisfy that distribution requirement no later than the tax filing deadline (including extensions thereof) for the taxable year of that beneficiary that begins with or within that calendar year (or, if later, the last day of the calendar year following that calendar year).[35]

Disregard of Certain Distributions

- Certain distributions are disregarded when determining if the required minimum distribution has been made. These include:
    - Prohibited allocations treated as deemed distributions under section 409(p).
    - Distributions of premiums for health and accident insurance under § 1.402(a)–1(e)(1)(i) (except certain distributions with respect to eligible retired public safety officers from governmental plans).
    - Amounts treated as distributed with respect to collectibles under section 408(m).
    - Permissible withdrawals from an eligible automatic contribution arrangement under section 414(w).

Other Considerations

- If an IRA owner engages in a prohibited transaction or borrows money using an individual retirement annuity as security, the amounts treated as distributed cannot be used to satisfy

[35] Treasury Reg. §54.4974-1(g)(3)

the RMD for a calendar year. However, pursuant to § 1.401(a)(9)–5(a)(1), the required minimum distribution amount will never exceed the entire account balance on the date of the distribution.

- If an amount is distributed from a plan and rolled over to another plan (receiving plan), then the rules of § 1.401(a)(9)–7(b) apply for purposes of determining the benefit and required minimum distribution under the receiving plan.

These provisions aim to allow for the correction of RMD errors, either through reduced excise tax rates or waivers, if specific conditions are met.