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19th Annual **Oregon Tax Institute**



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Thursday, June 6, 2019, 9 a.m.–5:15 p.m.

Friday, June 7, 2019, 9 a.m.–4:30 p.m.

10.5 General CLE credits and
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19TH ANNUAL OREGON TAX INSTITUTE

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19th Annual Oregon Tax Institute

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Save the Date!

20th Annual
Oregon Tax Institute

Thursday, June 11, 2020
Friday, June 12, 2020

**Multnomah Athletic Club, 1849 SW Salmon St.,
Portland**



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SCHEDULE

Thursday, June 6, 2019

8:00 Registration and Continental Breakfast

9:00 Section 199A: Where Are We Now?
Stephen Looney, *Dean Mead, Orlando, FL*

10:15 Break

10:30 Current IRS Enforcement Objectives: How the IRS Detects and Pursues Objectives and Taxpayer Defense Alternatives
Dennis Perez, *Hochman Salkin Toscher Perez PC, Beverly Hills, CA*

11:45 Lunch and Presentation of the Taxation Section Award of Merit to Jan Pierce, L&C Low-Income Taxpayer Clinic

1:30 A Whole New World: State Tax Post-TCJA and Wayfair
Stephen Kranz, *McDermott Will & Emery LLP, Washington, DC*
Kathleen Quinn, *McDermott Will & Emery LLP, Washington, DC*

2:45 Break

3:00 Estate Planning and Administration After the Tax Cuts and Jobs Act
Charles Redd, *Stinson Leonard Street LLP, St. Louis, MO*

4:00 Break

4:15 Blockchain and Cryptocurrency: New Technology, Old Tax Rules
Lisa Zarlenga, *Steptoe & Johnson LLP, Washington, DC*

5:15 Adjourn to Hosted Reception

Friday, June 7, 2019

8:00 Late Registration and Continental Breakfast

9:00 Qualified Opportunity Zones: Finding the New Emerald City in Tax Law
Lou Weller, *Weller Partners LLP, Sausalito, CA*

10:15 Break

10:30 Tax Practice Ethics—Contingent Fees and Conflicts of Interest
Karen Hawkins, *Yachats, OR*

Noon Lunch: City of Portland Revenue Division Updates
Scott Karter, *Audit and Accounting Division Manager, City of Portland Office of Management and Finance Revenue Division, Portland, OR*
Tyler Wallace, *Tax Division Manager, City of Portland Office of Management and Finance Revenue Division, Portland, OR*

1:15 Recent Federal Income Tax Developments
Professor Bruce McGovern, *South Texas College of Law, Houston, TX*

2:45 Break

3:00 Recent Federal Tax Income Tax Developments (continued)

4:30 Adjourn

FACULTY

Karen Hawkins, *Yachats, OR*. Ms. Hawkins is past chair of the American Bar Association Taxation Section as well as the section's Subcommittee on Civil Penalties and IRS Liaison Meetings Committee. She is past chair of the State Bar of California Taxation Section. She is a Fellow of the American College of Tax Counsel and serves on the Board of Tax Analysts. Ms. Hawkins is the founder of the San Francisco Pro Se/Pro Bono Tax Court project, and in the early 2000s she played a key role in the successful efforts to reform the "innocent spouse" statutes in both federal and California law. Her honors include the 2002 V. Judson Klein Award and 2012 Joanne Garvey Award from the State Bar of California Section of Taxation, the 2004 National Pro Bono Award from the American Bar Association Tax Section, and the 2008 Jules Ritholz Memorial Merit Award from the ABA Taxation Section Civil & Criminal Tax Penalties Committee. In 2012, Golden Gate University School of Law named its Tax Law Library Collection after Ms. Hawkins, and in 2015, she was awarded an honorary LL.B. Ms. Hawkins speaks and writes extensively on all aspects of ethics in tax practice.

Scott Karter, *Audit and Accounting Division Manager, City of Portland Office of Management and Finance Revenue Division, Portland, OR*. Mr. Karter is a CPA who has spent 25 years with the City of Portland Revenue Division. Prior to his current position, he was a Revenue Auditor, Senior Revenue Auditor, and Audit Supervisor.

Stephen Kranz, *McDermott Will & Emery LLP, Washington, DC*. Mr. Kranz helps clients prevent and resolve tax problems throughout their life cycle, starting with tax planning, compliance, financial statement implication analysis, audit defense and litigation, legislative monitoring and advocacy, and the formation and leadership of taxpayer coalitions. He has authored articles for professional publications, speaks at national conferences and is interviewed frequently by journalists covering state and local tax developments. On March 12, 2014, he appeared before the US House Judiciary Committee as an expert on alternative approaches to the Internet Sales Tax issues, and he has appeared in a similar capacity before other government agencies. Mr. Kranz is past president of the Business Advisory Council Streamlined Sales Tax Governing Board, a member and past chair of the District of Columbia Bar State and Tax Committee, and a member of the Tax Foundation board of directors. He is admitted to practice in the District of Columbia, Minnesota, and North Dakota.

Stephen Looney, *Dean Mead, Orlando, FL*. Mr. Looney practices in the areas of tax, corporate, partnership, business, and health care law, focusing on entity formations, acquisitions, dispositions, redemptions, liquidations, and reorganizations. His clients include closely held businesses, with an emphasis on medical and other professional practices. Mr. Looney is a member of the Missouri Society of CPAs, past chair of the American Bar Association Tax Section S Corporations Committee, and a member of the *Corporate Taxation* Board of Advisors and Department Heads and coeditor of the journal's "Recent Developments" column. He is also a Fellow and Regent of the American College of Tax Counsel and a past member of the Southern Federal Tax Institute Board of Trustees. Mr. Looney writes and speaks nationally on a variety of tax subjects. His articles have appeared in a number of professional publications, including the *Journal of Passthrough Entities*, *Journal of Taxation*, *Corporate Taxation Journal*, *The Tax Lawyer*, *Business Entities*, the *Journal of S Corporation Taxation*, the *Journal of Partnership Taxation*, and the *Journal of Corporate Taxation*. He is coauthor of the two-volume treatise *Tax Planning for S Corporations*, published by Lexis-Nexis. Mr. Looney is a Florida Board Certified Tax Lawyer, and he is admitted to practice in Florida, Texas, and Missouri.

Professor Bruce McGovern, *South Texas College of Law, Houston, TX*. Professor McGovern's areas of expertise are agency and partnership, corporate and partnership taxation, corporations, and federal income taxation. He is a frequent speaker and author, including writing and presenting annual reviews of recent federal income tax developments, and he is the coauthor of *Agency, Partnerships and Limited Liability Companies: Cases and Materials*. 2nd ed. (Durham: Carolina Academic Press, 2013).

FACULTY (Continued)

Dennis Perez, *Hochman Salkin Toscher Perez PC, Beverly Hills, CA*. Mr. Perez has extensive experience in the representation of clients in civil and criminal tax litigation and in tax disputes and controversies before the Internal Revenue Service and all of the California taxing agencies. Mr. Perez was formerly a senior trial attorney with District Counsel, Internal Revenue Service, in Los Angeles. Mr. Perez is a Certified Tax Specialist by the California State Bar Board of Certification and a Fellow of the American College of Tax Counsel. He is a coauthor of the BNA Portfolio *Tax Crimes*. He is past chair of the *Los Angeles Lawyer* Editorial Board and the first-ever recipient of the magazine's Sam Lipsman Service Award established in memory of the late publisher. Mr. Perez has served as an Adjunct Professor in the Golden Gate University Graduate School of Taxation. He frequently lectures on advanced civil and criminal tax topics at seminars and before national, state, and local bar associations and accountancy groups.

Kathleen Quinn, *McDermott Will & Emery LLP, Washington, DC*. Ms. Quinn focuses her practice on state and local tax matters. She represents business and individual taxpayers at all stages of state and local tax controversies, including the audit, administrative, and judicial levels. She also advises clients on state and local tax planning opportunities and the state and local tax consequences of corporate restructurings and other business transactions. Ms. Quinn received her LL.M. from New York University. She is admitted to practice in New York.

Charles Redd, *Stinson Leonard Street LLP, St. Louis, MO*. Mr. Redd concentrates his practice in estate planning, estate and trust administration, and related litigation. Mr. Redd is an elected member of the American Law Institute, a Fellow of the American College of Trust and Estate Counsel, a member of the Bar Association of Metropolitan St. Louis, and a member of the Estate Planning Council of St. Louis. He serves as cochair of the *Trusts & Estates* magazine Editorial Advisory Board and authors a regular column in the magazine. Mr. Redd was chair of the Missouri Bar Health Care Durable Power of Attorney Subcommittee and played a significant role in the drafting and enactment of the Missouri Durable Power of Attorney for Health Care Act. He was the principal drafter of the recently enacted Missouri Family Trust Company Act. In 2018, he was inducted into the Estate Planning Hall of Fame by the National Association of Estate Planners and Councils, and he is the 1991 recipient of the Missouri Bar President's Award. He frequently writes and lectures nationally on topics in the trusts and estates field. Mr. Redd is admitted to practice in Wisconsin, Missouri, and Illinois.

Tyler Wallace, *Tax Division Manager, City of Portland Office of Management and Finance Revenue Division, Portland, OR*.

Lou Weller, *Weller Partners LLP, Sausalito, CA*. Mr. Weller has extensive experience designing and implementing strategies for real estate acquisitions, transfers, exchanges, leases, financing, workouts, business startups, limited liability companies, partnership and joint venture formations, capital raising through placement of partnership interests and stock, and counseling clients on achieving business and personal tax planning objectives. Mr. Weller is a Fellow of the American College of Tax Counsel and is active in various professional and civic organizations. He is past chair of the American Bar Association Tax Section Real Estate Committee and its Subcommittee on Like-Kind Realty Exchanges. Among numerous other publications, Mr. Weller is coauthor of the treatise *Real Property Exchanges*, Third Edition, published by California Continuing Education of the Bar, and he is the Real Estate Department Editor of the *Journal of Taxation*. He is a frequent speaker and author in the fields of tax, business law and real estate.

FACULTY (Continued)

Lisa Zarlenga, *Steptoe & Johnson LLP, Washington, DC*. Ms. Zarlenga represents public and private companies on federal income taxation issues, with a focus on tax policy issues with respect to tax legislation and Treasury guidance as well as on corporate transactional and planning matters. Drawing on her experience as Tax Legislative Counsel at the US Treasury Department's Office of Tax Policy, she helps clients advocate for and resolve tax policy issues before the Treasury Department and IRS involving proposed and pending regulations and other administrative guidance and before Congress involving legislation. Ms. Zarlenga also advises clients on structuring tax-free and taxable acquisitions and dispositions, tax-free spin-offs, and internal restructurings, in restructuring financially troubled businesses, and on the special rules governing consolidated groups. Ms. Zarlenga is admitted to practice in the District of Columbia and Ohio as well as before the U.S. Supreme Court. She holds an LL.M. in Taxation from Georgetown University Law Center.

Chapter 1

New Section 199A: Where Are We Now?

STEPHEN LOONEY
Dean Mead
Orlando, Florida

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NEW SECTION 199A: WHERE ARE WE NOW?

§1.01 Introduction

The Tax Cuts and Jobs Act (“TCJA”) made significant changes to the Internal Revenue Code of 1986, as amended (“Code”). Two of the most significant changes made by the TCJA are the new deduction available to certain pass-through entities and sole proprietorships under Section 199A, as well as the reduction of the tax rate applicable to “C” corporations to a flat 21%.

This outline will examine the new deduction available to many pass-through entities and sole proprietorships, specifically including S corporations, both to so-called “qualified trades or businesses” and to “specified service trades or businesses.” Additionally, the outline will discuss new terms used in Section 199A, as well as the many unanswered questions and open issues under Section 199A that are primarily attributable to the speed at which the TCJA was drafted, revised and passed into law, leaving little, if any, legislative history regarding the interpretation of Section 199A.

These unanswered questions and open issues were left to be answered by the Internal Revenue Service (“IRS”), which after receiving substantial input from practitioners, industry groups and tax professional groups, including the American Bar Association Section of Taxation and the American Institute of Certified Public Accountants (“AICPA”), issued Proposed Regulations on Section 199A on August 8, 2018 (the “Proposed Section 199A Regulations” or the “Proposed Regulations”).

On October 16, 2018, a public hearing was held regarding the Proposed Regulations. In response to the Proposed Regulations, the IRS received 335 comment letters from tax professionals and taxpayers.

On January 18, 2019, the IRS issued Final Regulations under new Section 199A (the “Section 199A Regulations” or the “Final Regulations”). The Final Regulations are comprised of 274 pages (both the Preamble to the Final Regulations as well as the Final Regulations themselves), and the IRS also concurrently issued Notice 2019-07,¹ which details a proposed safe harbor under which a rental real estate enterprise may be treated as a trade or business solely for purposes of Section 199A. Additionally, the IRS concurrently issued Revenue Procedure 2019-11,² which provides additional guidance on the definition of W-2 wages, including amounts treated as elective deferrals.

The Preamble to the Final Regulations states that the IRS considered all of the 335 comments submitted to them on the Proposed Regulations. Obviously, some comments were accepted and many comments were rejected by the IRS. For the most part, the changes are taxpayer-friendly, but there are certainly winners and losers in connection with the changes made (or not made) in the Final Regulations.

¹ 2019 - __, I.R.B. __ (Jan. 18, 2019).

² 2019 - __, I.R.B. __ (Jan. 18, 2019).

Lastly, this outline will briefly discuss the effect Section 199A, as well as the reduction in the corporate tax rate to a flat 21%, could have on choice of entity decisions. First, some of the anomalies of Section 199A will be examined to demonstrate how Section 199A may apply differently to S corporations, partnerships and sole proprietorships under identical factual situations, thus affecting choice of entity just among those entities. The outline will also briefly look at the broader question of whether an entity should be operated as a pass-through entity versus a C corporation in light of the changes made by the TCJA.

§1.02 **Overview of the Section 199A Regulations**

[1] **In General.**

The Section 199A Regulations address computational, definitional and anti-abuse guidance and are generally favorable to taxpayers. The Section 199A Regulations contain six substantive areas. The operational rules for application of Section 199A are set forth in Reg. § 1.199A-1, and provide guidance on the computation of the deduction for individuals with taxable income at, below, or above the threshold amount (\$315,000 for married taxpayers filing jointly and \$157,500 for other taxpayers), including application of Section 199A to taxpayers within the phase-in range above the threshold amount (between \$315,000 and \$415,000 for married taxpayers filing jointly and between \$157,500 and \$207,500 for other taxpayers). Once a taxpayer's taxable income exceeds the fully phased-in amounts (\$415,000 for married taxpayers filing jointly and \$207,500 for other taxpayers), the wage and capital limitations fully apply to owners of qualified trades or businesses ("QTBs"), and owners of specified service trades or businesses ("SSTBs") are not eligible for the Section 199A deduction at all.

In the event that an owner of a QTB is fully subject to the wage and capital limitations, those limitations provide that the 20% of QBI deduction shall be limited to the greater of (1) the taxpayer's allocable share of 50% of the W-2 wages of the QTB; or (2) the taxpayer's allocable share of 25% of the W-2 wages of the QTB plus 2.5% of the unadjusted basis immediately after acquisition of the "qualified property" used in such trade or business.

As will be discussed in more detail below, an individual's §199A deduction can in no case exceed 20% of the amount by which the individual's taxable income exceeds such individual's net capital gain for the taxable year. Reg. §1.199A-1(d)(1).

[2] **Wages and UBIA of Qualified Property.**

Rules on determining W-2 wages and the unadjusted basis of qualified property ("UBIA") are set forth in Reg. § 1.199A-2. In conjunction with the release of the Proposed Regulations, the IRS also released Notice 2018-64³, which provides for three methods for calculating W-2 wages (which are similar to the rules previously prescribed for determining W-2 wages under former Section 199 as set forth in Rev. Proc. 2006-22)⁴. In connection with the Final Regulations, the IRS provided further guidance on the three methods for calculating W-2 Wages

³ 2018-35 I.R.B. 347.

⁴ 2006-23 I.R.B. 1033.

in Rev. Proc. 2019-11⁵. Wages will generally be included in determining the wage and capital limitation of a QTB as long as the QTB is the common law employer of an employee, even if a different entity (such as a certified professional employer organization under Section 7705) issues the W-2 to the employee. This is very welcome guidance as any other interpretation would have likely resulted in costly business restructurings.

[3] QBI, Qualified Real Estate Investment Trust Dividends and Qualified Publicly Traded Partnership Income.

Guidance on determining QBI, qualified real estate investment trust dividends, and qualified publicly traded partnership income is set forth in Reg. § 1.199A-3.

[4] Aggregation Rules.

A new set of aggregation rules (not the aggregation rules under Section 469 for passive activity losses which many commentators had requested be applied) are provided under Reg. § 1.199A-4. Consequently, taxpayers will be permitted to aggregate separate trades or businesses (even if conducted in different legal entities), provided certain requirements are met.

[5] Specified Service Trades or Businesses.

On the critical question of whether a business constitutes a QTB or SSTB, Reg. § 1.199A-5 sets forth definitions for the following enumerated professions: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services. Reg. § 1.199A-5 also defines what constitutes investing and investment management, trading, and dealing in securities, partnership interests or commodities. For the most part, the Section 199A Regulations are taxpayer-friendly and side with the majority of commentators by narrowly defining what constitutes a SSTB. In particular, the Section 199A Regulations take a very narrow view as to what is included as a SSTB where the principal asset of the trade or business is the reputation or skill of one or more of its employees or owners.

[6] RPEs, PTPs and Trusts and Estates.

Relevant pass-through entities (“RPEs”), publicly traded partnerships (“PTPs”), trusts and estates are addressed in Reg. § 1.199A-6. RPEs are a new term introduced by the Section 199A Regulations.

[7] Anti-Abuse Rules.

Although the Section 199A Regulations are generally taxpayer-friendly, anti-abuse provisions largely prohibit the so-called “Crack-and-Pack” strategy, which involves spinning-off a portion of an SSTB to a separate entity so that the spun-off entity can claim the Section 199A deduction as a QTB. Additionally, the Section 199A Regulations provide an anti-abuse rule where a trust (or trusts) are used for a principal purpose of avoiding, or using more than one, Threshold

⁵ See note 2, *supra*.

Amount. Anti-abuse rules regarding multiple trusts are also contained in the regulations issued under Section 643.

[8] Fiscal Year Taxpayers.

The Regulations also address how to treat income received from a fiscal-year pass-through entity when part of the income received by an individual is received before January 1, 2018. The Section 199A Regulations allow an individual to take a deduction for all of the income received from a fiscal-year filer, which could include income earned by the pass-through entity in 2017.

[9] Effective Dates.

The rules under the Final Regulations generally apply to tax years ending after the date the Final Regulations were published (January 18, 2019). However, taxpayers may rely on the Final Regulations in their entirety, or on the Proposed Regulations in their entirety, for taxable years ending in calendar year 2018. Additionally, the anti-abuse rule contained in Final Reg. Section 1.199A-5(c)(2) regarding the so-called “crack and pack” strategy, as well as the rebuttable presumption treating former employees as employees set forth in Final Reg. Section 1.99A-5(d)(3), apply to taxable years ending after December 22, 2017. Finally, the anti-abuse rule contained in Final Reg. § 199A-6(d)(3)(vii) regarding the anti-abuse rule for the creation of a trust to avoid exceeding the Threshold Amount applies to taxable years ending after December 22, 2017, and the anti-abuse rule contained in Reg. Section 1.643(f)-1 regarding the treatment of multiple trusts applies to taxable years ending after August 16, 2018 (although the IRS expressed its opinion that the anti-abuse rule under Reg. Section 1.643(f)-1 generally should be applicable prior to August 16, 2018).

§1.03 Tax Rates

[1] Ordinary Income Tax Rates.

[a] The TCJA retains seven rate brackets, but changes five of the rates, including the top rate. Furthermore, the Act changes the thresholds for each bracket. The new rates are set forth below:

2017 Rates	TCJA Rates
10%	10%
15%	12%
25%	22%
28%	24%
33%	32%
35%	35%
39.6%	37%

[b] The top marginal rate applies to taxable income above \$500,000 (up from \$418,400) for single taxpayers and head of household filers and \$600,000 (up from \$470,700) for married individuals filing joint returns and surviving spouses.

[2] Tax Rate on Qualified Business Income.

Assuming that a taxpayer can fully utilize the Section 199A deduction without being subject to any limitations, the maximum tax rate on “Qualified Business Income” is 29.6%⁶.

[3] Capital Gain Tax Rates.

The capital gains tax rates of 0%, 15%, and 20% remain unchanged. However, the income levels at which the different rates apply are now indexed using Chained CPI-U.

[4] Tax Rate on Qualified Dividends.

The maximum tax rate applicable to qualified dividends remains unchanged at 20%.

[5] Reductions in Corporate Tax Rates.

[a] Effective for all tax years of a C corporation beginning after 12/31/17, all corporate taxable income will be subject to tax at a flat 21% rate.

[b] Previously, under Code § 11(b), corporations were taxed at a rate of (i) 15% on taxable income between \$0 - \$50,000; (ii) 25% on taxable income between \$50,001 - \$75,000; (iii) 34% on taxable income between \$75,001 - \$10,000,000; and (iv) 35% on taxable income in excess of \$10,000,000.

[c] Unlike most of the other changes under the Act, this change is “permanent.”

[6] Tax Rate on C Corporation Earnings Distributed to Shareholders.

The maximum marginal federal tax rate on a C corporation’s income that is distributed (or deemed distributed), as a dividend to its shareholders is 36.8%⁷, or in the event the 3.8% net investment income tax is applicable, will be 39.8%⁸. Additionally, the maximum marginal tax rate will be even higher in states such as Florida that impose state income taxes on C corporations but not on pass-through entities or individuals. Thus, the maximum marginal tax rate on a C corporation’s income that is distributed or deemed distributed as a dividend to its shareholders in Florida (where the maximum state corporate tax rate is 5.5%) will be 43.12%⁹.

§1.04 Choice of Entity Statistics

Although LLCs have gained increasing popularity over the last decade, the number of entities taxed as S corporations still exceeds the number of entities taxed as partnerships for federal

⁶ $\$100 \text{ QBI} \times 20\% \text{ deduction} = \$20. \quad \$80 (\$100 - \$20 \text{ QBI Deduction}) \times 37\% = 29.6\%.$

⁷ $\$100.00 \times 21\% \text{ tax} = \$21 \text{ tax at corporate level. } \$79 (\$100 - \$21 \text{ corporate level tax}) \times 20\% \text{ qualified dividend rate} = \$15.8. \quad 21 + 15.8 = 36.8\%.$

⁸ $\$100 \times 21\% = \$21 \text{ tax at corporate level. } \$79 (\$100 - \$21 \text{ corporate level tax}) \times 23.8\% = \$18.80. \quad 21 + 18.80 = 39.8\%.$

⁹ $\$100 \times 5.5\% \text{ Florida corporate tax} = \$5.50 \text{ Florida tax at corporate level. } \$94.5 (\$100 - \$5.50 \text{ Florida corporate level tax}) \times 21\% \text{ federal tax} = 19.85 (\$100 - \$5.50 \text{ Florida corporate tax} - \$19.85 \text{ federal corporate tax}) \times 23.8\% = \$17.77. \quad 5.5 + 19.85 + 17.77 = 43.12\%.$

tax purposes, and it is projected to stay that way for the foreseeable future, as set forth in the table below published by the IRS (Document 6292, Office of Research, Analysis and Statistics, Fiscal Year Return Projections for the United States: 2018-2025, Rev. 8/2018):

<u>Statistics Regarding Choice of Entity</u>				
	<u>2017</u> (Actual)	<u>2019</u> (Projected)	<u>2022</u> (Projected)	<u>2025</u> (Projected)
Form 1065	4,046,325	4,222,700	4,498,600	4,774,500
Form 1120S	4,842,706	4,988,300	5,275,000	5,590,900
Form 1120	1,649,386	1,677,200	1,623,100	1,571,900

This is the second set of statistics issued by the IRS since Congress passed the TCJA, and it was expected that there would be a large increase in the projected number of “C” corporations due to the dramatic decrease in the tax rate applicable to “C” corporations. Inexplicitly, however, these statistics are in line with the statistics published by the IRS prior to the TJCA. Perhaps the IRS simply did not have time to take into account the effect of the TCJA, or believe that there will not be a dramatic shift to S corporations prior to 2026, when Section 199A is set to expire.

§1.05 **Deduction for Qualified Business Income of S Corporations, Partnerships, LLCs and Sole Proprietorships**

Effective January 1, 2018, the Tax Cuts and Jobs Act, formally entitled “An Act to Provide for Reconciliation Pursuant to Titles II and IV of the Concurrent Resolution on the Budget for Fiscal Year 2018” (the “Tax Cuts and Jobs Act” or the “TCJA”), enacts new Internal Revenue Code (“Code”) Section 199A. Under Section 199A, for taxable years beginning after December 31, 2017 and before January 1, 2026, taxpayers (which includes estate and trusts), but which excludes C corporations, generally may deduct twenty percent (20%) of the QBI of an S corporation, partnership, LLC (taxed as a partnership) or S corporation, or a sole proprietorship allocable to such shareholder, partner, member or sole proprietor.

Although new Section 199A also provides rules for deductions for dividends received from qualified real estate investment trusts, dividends from qualified cooperatives and income from publicly traded partnerships, this outline will focus on the “QBI Component” of the deduction applicable for owners of S corporations, partnerships, LLCs and sole proprietorships.

The driving force behind the TCJA (and the bulk of the tax savings) go to large publicly traded multi-national C corporations because of the reduction of the corporate tax rate to a flat 21%. Many industry groups and practitioners campaigned hard to achieve some parity for pass through entities and sole proprietorships in light of the huge rate reductions being given to C corporations in the TCJA. This is extremely important because pass through entities and sole proprietorships make up the largest number of entities in the U.S. far outnumbering C corporations, and employing approximately 57% of the work force. To make the playing field more level due

to the tax cut from 35% to a flat 21% for C corporations, and to provide for “Main Street” businesses versus “Wall Street” businesses, Congress was pressured by these industry groups and practitioners into doing something for pass through entities and sole proprietorships. Although the House version contained a different tax break for pass through entities and sole proprietorships, the final version of the TCJA ended up being in the form of a deduction being generally equal to 20% of an owner’s allocable share of the QBI of the entity.

In order to determine a taxpayer’s QBI deduction, the taxpayer and practitioner must make their way through a maze of rules, limitations, thresholds, new defined terms, phase-ins and phase-outs of limitations, and a plethora of other issues.

The deduction is sometimes referred to as the “20% pass-through deduction” or the “QBI deduction.” As mentioned above, in addition to the 20% pass-through deduction (or QBI deduction), there is a separate and distinct deduction under Section 199A equal to 20% of a taxpayer’s qualified REIT dividends and publicly-traded partnership income for the year. After these two separate deductions are computed, they are added together and subjected to the so-called “overall limitation,” which is equal to 20% of the excess of the taxpayer’s taxable income for the year over the sum of the taxpayer’s net capital gain for the year.

[1] The Deduction in General.

For taxable years beginning after December 31, 2017 and before January 1, 2026, taxpayers (including estates and trusts) other than corporations generally may deduct 20% of the QBI of an S corporation, partnership, LLC or a sole proprietorship **allocable** to such shareholder, partner, member or sole proprietor.

In order to obtain the full benefit of the deduction without being subject to the wage and capital limitations discussed below, the taxable income of the shareholder, partner, member or sole proprietor must be less than \$157,500 or less than \$315,000 in the case of a married taxpayer filing jointly (the “Threshold Amounts”). Consequently, a taxpayer receiving the full benefit of the deduction would see a reduction in such taxpayer’s top marginal tax rate on QBI to 29.6% (37% top marginal individual tax rate x 20% = 7.4% deduction; 37% - 7.4% = 29.6%).

Example #1: Sole Proprietor (Single-Member LLC) In a Qualified Trade or Business with Taxable Income Less than Threshold Amount. Assume A is the sole owner of a qualified trade or business through a single-member disregarded LLC. The business has no employees and no substantial fixed assets. The QBI from the business is \$200,000 and the combined taxable income of A and his wife is \$300,000.

Because the taxable income of the taxpayer is below the Threshold Amount of \$315,000 for married individuals filing jointly, A’s deduction will be equal to \$40,000 (20% x \$200,000 of QBI).

§1.06 **Operational Rules and Definitions**

[1] Overview.

Reg. § 1.199A-1 provides operational rules for calculating the § 199A qualified business income deduction and provides a number of definitions that apply for purposes of § 199A and Reg. § 1.199A-1 through § 1.199A-6. For purposes of applying the rules of Reg. § 1.199A-1 through § 1.199A-6, the Section 199A Regulations provide that a reference to an “individual” includes a reference to a trust (other than a grantor trust) or an estate to the extent that the § 199A deduction is determined by the trust or estate under the rules of Reg. § 1.199A-6.

[2] Definitions.

Regulations § 1.199A-1(b)(1)-(16) sets forth a number of definitions under the Regulations.

[a] An aggregated trade or business means two or more businesses that have been aggregated pursuant to the aggregation rules of Reg. § 1.199A-4.

[b] The term Applicable Percentage means, with respect to any taxable year, 100% reduced (but not below zero) by the percentage equal to the ratio that the taxable income of the individual for the taxable year in excess of the Threshold Amount, bears to \$50,000 (or \$100,000 in the case of a joint return).

[c] The term net capital gain means net capital gain as defined in Section 1222(11) plus any qualified dividend income, as defined in Section 1(h)(11)(B) for the taxable year.

[d] The term Phase-In Range means a range of taxable income, the lower limit of which is the Threshold Amount, and the upper limit of which is the Threshold Amount plus \$50,000 (or \$100,000 in the case of a joint return).

[e] The term Qualified Business Income (“QBI”) means the net amount of qualified items of income, gain, deduction and loss with respect to any trade or business and is discussed in more detail below in connection with the provisions of Reg. § 1.199A-3(b).

[f] The term QBI Component means the amount determined under Proposed Reg. § 1.199A-1(d)(2). Again, this outline will focus on the QBI Component.

[g] The term Qualified PTP Income is discussed under the provisions of Reg. § 1.199A-3(c)(3).

[h] The term Qualified REIT Dividends is discussed under the provisions of Reg. § 1.199A-3(c)(2).

[i] The term Reduction Amount means, with respect to any taxable year, the “excess amount” multiplied by the ratio that the taxable income of the individual for the taxable year in excess of the Threshold Amount, bears to \$50,000 (or \$100,000 in the case of a joint return). In

general, the excess amount is 20% of the QBI over the greater of 50% of W-2 wages or the sum of 25% of W-2 wages plus 2.5% of the UBIA of qualified property.

[j] A new term, Relevant Pass-Through Entity (“RPE”), means a partnership (other than a PTP) or an “S” corporation that is owned, directly or indirectly by at least one individual, estate, or trust. A trust or estate is treated as an RPE to the extent it passes through QBI, W-2 wages, UBIA of qualified property, Qualified REIT Dividends and/or Qualified PTP Income.

[k] The term Specified Service Trade or Business (“SSTB”) will be discussed in more detail below in connection with the provisions of Reg. § 1.199A-5(b).

[l] The Threshold Amount means, for any taxable year beginning before 2019, \$157,500 (or \$315,000 in the case of a married taxpayer filing a joint return). For any taxable year beginning after 2018, the Threshold Amount is the dollar amount referenced above increased by an amount equal to such dollar amount, multiplied by the cost-of-living adjustment determined under § 1(f)(3) for the calendar year in which the taxable year begins. The amount of any increase is rounded as provided in § 1(f)(7).¹⁰

[m] The term Total QBI Amount means the net total QBI from all trades or businesses (including an individual’s share of QBI from trades or businesses conducted by RPEs).

[n] Reg. § 1.199-1(b)(13) defines a Trade or Business for purposes of § 199A as a § 162 trade or business (“Section 162 Trade or Business”) other than the trade or business of performing services as an employee. Additionally, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a § 162 trade or business will nevertheless be treated as a trade or business for purposes of § 199A if the property is rented or licensed to a trade or business which is commonly controlled under Reg. § 1.199A-4(b)(1)(i), regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under the rules of Reg. § 1.199A-4. The trade or business requirement, and particularly its application to rental real estate, is discussed in more detail below.

[o] The unadjusted basis immediately after acquisition (“UBIA”) of qualified property is discussed in more detail below in connection with Reg. § 1.199A-2(c).

[p] The term W-2 Wages means a trade or business’s W-2 Wages properly allocable to QBI is discussed in more detail in connection with Reg. § 1.199A-2(b).

[3] Computation of § 199A Deduction for Individuals with Taxable Income Not Exceeding Threshold Amount.

If an individual’s taxable income does not exceed the applicable “Threshold Amount”, such individual’s § 199A deduction is determined by adding 20% of the QBI Amount (including QBI attributable to an SSTB) and 20% of the combined amount of Qualified REIT Dividends and Qualified PTP Income (including the individual’s share of Qualified REIT

¹⁰ In 2019 the Threshold Amount is \$160,770 (or \$321,400 in the case of a married taxpayer filing a joint return).

Dividends, and Qualified PTP Income from RPEs). That amount is then compared to 20% of the amount by which the individual's taxable income exceeds the individual's net capital gain for the taxable year, and the lesser of these two amounts is the individual's § 199A deduction. Reg. § 1.199A-1(c)(1).

[a] Negative QBI. If the total QBI Amount is less than zero, the portion of the individual's § 199A deduction related to QBI is zero for the taxable year and the negative total QBI Amount is treated as negative QBI from a separate trade or business in the succeeding taxable year of the individual for purposes of § 199A. Reg. § 1.199A-1(c)(2)(i). A similar rule and separate calculation applies where the combined amount of REIT Dividends and Qualified PTP Income is less than zero. Reg. § 1.199A-1(c)(2)(ii).

[4] Computation of the § 199A Deduction for Individuals With Taxable Income Above the Threshold Amount.

[a] In General. The § 199A deduction is determined for individuals with taxable income for the taxable year that exceeds the Threshold Amount by adding the QBI Component and 20% of the combined amount of Qualified REIT Dividends and Qualified PTP Income, and comparing such amount to 20% of the amount by which the individual's taxable income exceeds his or her net capital gain for the taxable year. The lesser of those two amounts is the individual's § 199A deduction. Reg. § 1.199A-1(d)(1).

[b] Computational Rules. The QBI Component is determined by applying the following computational rules in the following order, for an individual with taxable income for the taxable year that exceeds the Threshold Amount:

[i] If the individual's taxable income is within the Phase-In Range, then only the "applicable percentage" of QBI, W-2 Wages and UBIA of Qualified Property for each SSTB is taken into account for purposes of determining the individual's § 199A deduction. Where the individual's taxable income exceeds the Phase-in Range, then the individual's § 199A deduction is zero with respect to an SSTB. Reg. § 1.199A-1(d)(2)(i).

[ii] When an individual chooses to aggregate trades or businesses under the rules of Reg. § 1.199A-4, the individual must combine the QBI, W-2 Wages, and UBIA of qualified property of each trade or business within an aggregated trade or business **prior** to applying the "wage and capital limitations" (sometimes referred to as the W-2 Wages and UBIA of qualified property limitations). Reg. § 1.199A-1(d)(2)(ii).

[iii] If an individual's QBI from at least one trade or business is less than zero, the individual must offset the QBI attributable to each trade or business that produced net positive QBI with the QBI from each trade or business that produced net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses with positive QBI. The W-2 Wages and UBIA of qualified property from the trades or businesses which produced net negative QBI are **not** taken into account for purposes of determining the § 199A deduction for the taxable year and

are **not** carried over to the subsequent year. Reg. § 1.199A-1(d)(2)(iii)(A). If an individual's QBI from **all** trades or businesses combined is less than zero, the QBI component is zero for the taxable year, and the negative amount is treated as negative QBI from a separate trade or business in the succeeding year of the individual for purposes of § 199A. Additionally, the W-2 Wages and UBIA of qualified property from the trades or businesses which produce negative QBI are **not** taken into account for purposes of computing the § 199A deduction are **not** carried over to the subsequent year. Reg. § 1.199A-1(d)(2)(iii)(B).

[iv] The QBI Component is the sum of such amounts determined for each trade or business. For each trade or business (including trades or businesses operated through RPEs), the individual must determine the lesser of (1) 20% of the QBI for that trade or business; or (2) the greater of 50% of W-2 Wages with respect to that trade or business, or the sum of 25% of W-2 Wages with respect to such trade or business plus 2.5% of the UBIA of qualified property with respect to such trade or business. Reg. § 1.199A-1(d)(2)(iv)(A).

[v] Where an individual's taxable income is within the Phase-In Range and the amount determined under the wage and capital imitations is less than 20% of the QBI with respect to such trade or business, the QBI component for the trade or business will be reduced by the "reduction amount". Reg. § 1.199A-1(d)(2)(iv)(B). For an example of how the phase-in rules work for Qualified Trades of Businesses ("QTBs"), see Example 3 below, and for an example of how the phase-in rules work for SSTBs, see Example 5 below.

[vi] The Final Regulations clarify that for taxpayers with taxable income within the phase-in range, QBI from an SSTB must be reduced by the applicable percentage before the application of the netting and carryover rules described in Reg. Section 1.199A-1(d)(2)(iii)(A).

[c] Negative Combined Qualified REIT Dividend/Qualified PTP Income. If the combined amount of REIT Dividends and Qualified PTP Income is less than zero, the portion of the individual's § 199A deduction related to Qualified REIT Dividends and Qualified PTP Income will be zero for the taxable year, and the negative combined amount will be carried forward and used to offset the combined amount of REIT Dividends/PTP Income in the succeeding taxable year of the individual for purposes of § 199A. Reg. § 1.199A-1(d)(3).

[5] Special Rules.

[a] Effect of Deduction. In the case of a partnership or "S" corporation, § 199A is applied at the partner or shareholder level. The § 199A deduction has **no** effect on the adjusted basis of a partner's interest in the partnership, the adjusted basis of a shareholder's stock in an "S" corporation, or an "S" corporation's accumulated adjustments account. Reg. § 1.199A-1(e)(1).

[b] Disregarded Entities. An entity with a single owner that is treated as disregarded as an entity separate from its owner is disregarded for purposes of Section 199A and Reg. §§ 1.199A-1 through 1.199A-6. Reg. § 1.199A-1(e)(2).

[c] Self-Employment Tax and Net Investment Income. The § 199A deduction does **not** reduce net earnings from self-employment under § 1402 or the amount of net investment income under § 1411. Reg. § 1.199A-1(e)(3).

[d] Income from Commonwealth of Puerto Rico. If all of an individual’s QBI from sources from within the Commonwealth of Puerto Rico is taxable under § 1 for a taxable year, then for purposes of determining the QBI of such individual for such taxable year, the term “United States” will include the Commonwealth of Puerto Rico. Reg. § 1.199A-1(e)(4).

[e] Coordination With Alternative Minimum Tax. For purposes of determining alternative minimum taxable income under § 55, the deduction allowed under § 199A(a) for a taxable year is equal in amount to the deduction allowed under § 199A(a) in determining regular taxable income for such taxable year. In other words, the § 199A deduction is allowable for both regular tax and alternative minimum tax purposes. Reg. § 1.199A-1(e)(5).

[f] Imposition of Accuracy-Related Penalty and Underpayments. Section 6662(a) provides a penalty for an underpayment of tax required to be shown on a return. Under § 6662(b)(2), the penalty applies to the portion of any underpayment that is attributable to a substantial understatement of income tax. A substantial understatement of income tax is defined under § 6662(d)(1) as an understatement that exceeds the greater of 10% of the tax required to be shown on the return, or \$5,000. Section 6662(d)(1)(C) provides a special rule in the case of any taxpayer who claims the deduction allowed under § 199A for the taxable year, which requires that § 6662(d)(1)(A) be applied by substituting 5% for 10%. Section 6662(d)(1)(C) and Reg. § 1.199A-1(e)(6). The purpose of lowering the percentage from 10% to 5% in order for the § 6662(a) penalty to apply, was that Congress believed this would discourage taxpayers from “playing games” or manipulating the § 199A deduction.

[g] Reduction for Income Received from Cooperatives. Reg. § 1.199A-1(e)(7) discusses the computation of the § 199A deduction in the case of any trade or business of a patron of a specified agricultural or horticultural cooperative. The Section 199A deduction applicable to members of a cooperative is beyond the scope of this outline.

§1.07 Trade or Business Requirement and Rental Real Estate

As discussed in more detail below, the term “QBI” generally means the net amount of qualified items of income, gain, deduction and loss with respect to any “qualified trade or business.” The taxpayer must first, however, determine if the activity being conducted rises to the level of a “trade or business” before determining whether the activity is a qualified trade or business. The Final Regulations retain and slightly re-word the definition of a trade or business as set forth in the Proposed Regulations. Specifically, for purposes of Section 199A and the Regulations thereunder, a trade or business is defined as a trade or business under Section 162 (a “Section 162 Trade or Business”) other than the trade or business of performing services as an employee. Unfortunately, after nearly a century of case law on this issue, there is no “bright line” test of when an activity constitutes a Section 162 Trade or Business.¹¹

¹¹ See, e.g., *Comm’r. v. Goetzinger*, 480 U.S. 23 (1987) and *Higgins v. Comm’r.* 312 U.S. 212 (1941). Generally, in order to qualify as a Section 162 Trade or Business, the business must be regular, continuous and substantial. Id.

As such, the Section 162 Trade or Business standard remains problematic, especially with respect to rental real estate activities. The Preamble to the Final Regulations provide that in determining whether a rental real estate activity is a Section 162 Trade or Business, relevant factors might include, but are not limited to: the type of rental property (commercial real property versus residential property); the number of properties rented; the owners or the owners' agents day-to-day involvement; the types and significance of any ancillary services provided under the lease; and the terms of the lease (for example, a net lease versus a traditional lease and short-term lease versus a long-term lease). In order to provide further clarity as to when a rental real estate activity constitutes a Section 162 trade or business, the IRS issued Notice 2019-07,¹² which sets forth a safe harbor for when a rental activity will rise to the level of a Section 162 Trade or Business.

[1] Rev. Proc. 2019-07 Safe Harbor.

The requirements in order for a real estate activity to meet the safe harbor under Rev. Proc. 2019-07 are as follows:

- Separate books and records must be maintained for the rental real estate activity;
- At least 250 hours or more of “rental services” must be performed per year for the rental real estate activity; and
- The taxpayer must maintain contemporaneous records, including time reports or similar documents, regarding hours of all services performed, a description of all services performed, the dates on which such services are performed and who performed such services.

[a] 250 Hours of Service Requirement. Generously, in determining whether the 250 hours of service requirement is met, the taxpayer/owner is allowed to include services provided by owners, employees, and independent contractors, and time spent on maintenance, repairs, collection of rent, payment of expenses, provision of services to tenants, and efforts to rent the property. However, hours spent by any person with respect to the owner's capacity as an investor, such as arranging financing, procuring property, reviewing financial statements or reports on operations, planning, managing or constructing long-term capital improvements, and traveling to and from the real estate are **not** considered to be hours of service with respect to the rental real estate. It should be kept in mind that failing to meet the safe harbor does not necessarily preclude a rental real estate activity from being treated as a Section 162 Trade or Business for purposes of Section 199A (but makes it much more difficult).

[b] Property Used as a Personal Residence and Triple Net Leases. This safe harbor cannot be used by a taxpayer for the rental of any residence that the taxpayer uses as a personal residence for more than fourteen (14) days during the year. Even more significantly, the Final Regulations provide that a taxpayer cannot use the safe harbor for any property rented on a “triple net lease” basis. Under Notice 2019-07, a triple net lease “includes” a lease agreement that requires that the tenant or lessee pay taxes, fees, and insurance, and to be responsible for

¹² See Note 1, *supra*.

maintenance activities for the property in addition to rent and utilities. This potentially leaves the door open for other leases, such as where leases are restructured to provide that the lessor will pay for the real estate taxes and/or insurance on the property, to possibly be treated as triple net leases by the IRS, and thus not fall within the safe harbor.

Additionally, the final regulations create quite a conundrum for taxpayers owning multiple properties either directly, or through one or more disregarded entities, that are leased on a triple net lease basis. The classic example is where an individual owns a number of commercial properties (assume, for example, the taxpayer owns fifty (50) commercial rental properties) through separate limited liability companies that each lease the properties on a triple net lease basis, and that the individual owns a management company that provides rental services with respect to all fifty (50) properties, with the individual working full time seeking tenants, negotiating leases, and handling the various needs of the building's occupants, and otherwise performing additional qualifying rental services as described in Notice 2019-07.

From an intuitive standpoint, the individual certainly seems to be in the trade or business of owning and managing rental real estate. However, unless each separate property rises to the level of a trade or business, each of the rental activities would not be eligible to be combined under the aggregation rules set forth in Regulations Section 1.199A-4. The triple net lease nature of each property would appear to preclude the rental properties from falling within the Notice 2019-07 safe harbor to be treated as a Section 162 Trade or Business, and possibly prevent such properties from being eligible for the Section 199A deduction.

Consequently, it can be expected that many taxpayers will seek to restructure existing leases so that they are not characterized as triple net leases (through the provision of maintenance and other rental services), and can therefore fall within the safe harbor.

[2] Rentals to a Related Party.

The definition of a trade or business also includes the rental or licensing of tangible or intangible property to a related trade or business if the rental or licensing activity and the other trade or business are commonly controlled. The Final Regulations provide that the related party rules under Sections 267(b) and 707(b) will be used to determine related parties for purposes of this special rule. The Final Regulations also clarify that the special rule only applies to situations in which the related party is an individual or relevant past-through entity (“RPE”), and as such, will not include a rental to a C corporation. An RPE is defined as a partnership, other than a publicly traded partnership (“PTP”), or an S corporation that is owned, directly or indirectly, by at least one individual, estate, or trust. Additionally, a trust or estate is treated as an RPE to the extent it passes through QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, or qualified PTP income.

[3] Determination of Separate Trades or Businesses.

The Final Regulations decline to address how to delineate separate Section 162 Trades or Businesses within an entity and when an entity's combined activities should be considered as a single Section 162 Trade or Business. However, the Preamble to the Final Regulations indicates that no trade or business will be considered separate or distinct unless a

complete separate set of books and records is kept for such trade or business. The Preamble to the Final Regulations also provides that the IRS believes that multiple trades or businesses will generally not exist within an entity unless different methods of accounting could be used for each trade or business under the Section 446 Regulations.

§1.08 **Qualified Business Income**

Provided a taxpayer is engaged in a Section 162 Trade or Business, the taxpayer must determine the QBI for each separate qualified trade or business. As briefly mentioned above, the term “QBI” generally means the net amount of “qualified items of income, gain, deduction and loss” with respect to any “qualified trade or business” of the taxpayer. Qualified items of income, gain, deduction and loss mean items of income, gain, deduction and loss to the extent such items are effectively connected with the conduct of a trade or business within the United States. However, in the case of a taxpayer who otherwise has QBI from sources within the commonwealth of Puerto Rico, provided all of the income is taxable, the taxpayer’s income from Puerto Rico will be included in determining the individual’s QBI.

[1] Investment Related Income Excluded From QBI.

Qualified items also do not include investment-related income, deductions or loss. Specifically, qualified items do not include, among other things, short-term capital gain or loss, long-term capital gain or loss, dividend income or interest income.

[2] Reasonable Compensation and Guaranteed Payments Excluded From QBI.

Additionally, QBI does not include any amount paid by an S corporation that is treated as reasonable compensation to the taxpayer, nor does it include any guaranteed payments made by a partnership to a partner for services rendered with respect to the trade or business or any other amounts paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services.

[a] Where a qualifying trade or business does not have depreciable property or any wages other than those paid to the owner or owners of the business, a determination should be made on the amount of Form W-2 compensation to be paid to the owner so that the W-2 limit is not zero, while at the same time leaving some QBI on which to apply the 20% since any reasonable compensation will reduce QBI.

[b] The formula for obtaining the maximum deduction is 20% (y - x) equal to 50% of x, where y is the income prior to the payment of wages and x is the amount of W-2 wages. Consequently, approximately 28.57% of income should be paid as wages in order to maximize the deduction. For example, assume \$1,000,000 of QBI, with the same taxable income and no wages paid to employees other than shareholders (and no significant qualified property). If the qualifying trade or business is formed as an S corporation and wages are paid to the taxpayer, approximately 28.57% of the QBI should be paid as income to the shareholder in order to maximize the deduction, as this would result in a deduction of approximately \$142,850 (\$1,000,000 of QBI minus \$285,700 W-2 wages to S corporation shareholder results in \$714,300 of QBI x 20% = \$142,860, while the W-2 wage limitation would be equal to 50% of \$285,700, or \$142,850). Keep in mind that this formula is applicable only to an S corporation with no employees other than the shareholder or

shareholders of the S corporation (and such compensation still must be “reasonable compensation”).

[3] Qualified Trade or Business.

A qualified trade or business means a trade or business other than an SSTB and other than the trade or business of being an employee.

[a] Trade or Business of Performing Services as an Employee. Regulations § 1.199A-5(d)(1) provides that the trade or business of performing services as an employee is not a trade or business for purposes of Section 199A and the Regulations thereunder. Consequently, no items of income, gain, loss and deduction from the trade or business of performing services as an employee constitute QBI within the meaning of Section 199A and Reg. § 1.199A-3. The common law relationship of employer and employee exists when the person for whom the services are performed has the right to direct and control the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. The Preamble to the Proposed Regulations provides that it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he or she has the right to do so.

[b] Presumption for Former Employees. Proposed Regulations § 1.199A-5(d)(3)(i) provided that solely for purposes of Section 199A(d)(1)(B), an individual that was properly treated as an employee for federal employment tax purposes by the person to which he or she provided services and who was subsequently treated as other than an employee by such person with regard to the provision of substantially the same services directly or indirectly to the person (or related person), is presumed to be in the trade or business of performing services as an employee with regard to such services. The Final Regulations soften this rule somewhat by providing that the presumption will apply to the individual only if such individual was an employee of the entity during the three-year period prior to the date such individual was treated as other than an employee with respect to such entity. This presumption may be rebutted upon a showing by the individual that, under federal tax law, regulations and principles (including common-law employee classifications rules), the individual is performing services in a capacity other than as an employee. The presumption also applies regardless of whether the individual provides services directly or indirectly through an entity or entities. Example 3 of Reg. § 1.199A-5(d)(3)(iii) sets forth an example of where such presumption is rebutted where an employee becomes a partner in an engineering firm so that his status as a partner will be respected and such person will not be treated as an employee under Section 199A.

[4] Mechanics of Deduction.

The deduction reduces a taxpayer’s taxable income but not his or her adjusted gross income (i.e., it is a “below the line” deduction). However, the deduction is available whether one itemizes deductions or takes the standard deduction.

[5] Carryover of Loss to Reduce QBI in Subsequent Taxable Year.

Under Section 199A(c)(2), if the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less

than zero, such amount will be treated as a loss from a qualified trade or business in the succeeding taxable year. Consequently, even if such loss is used in computing taxable income in Year 1, when you get to Year 2, that QBI loss carries over and reduces the QBI for Year 2 solely for purposes of computing the 20% of QBI deduction. Additionally, under Section 172(d)(8), if a taxpayer has a Section 199A deduction in a year in which such taxpayer has a net operating loss, the taxpayer's net operating loss does not include the Section 199A deduction.

[6] Qualified Business Income and Regulations Section 1.199A-3.

As previously mentioned, this outline focuses primarily on the provisions of Regulations § 1.199A-3 used in determining the QBI Component for an individual.

[a] In General. QBI must be determined and reported for each trade or business by the individual or RPE that directly conducts the trade or business before applying the aggregation rules of Reg. § 1.199A-4.

[b] Definition of QBI. Reg. § 1.199A-3(b)(1) provides that the term QBI means, for any taxable year, the net amount of qualified items of income, gain, deduction and loss with respect to any trade or business of the taxpayer, provided the other requirements of § 199A are satisfied.

[i] Gain or loss attributable to assets of a partnership giving rise to ordinary income under § 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and as such, is taken into account for purposes of computing QBI.

[ii] The Section 199A regulations provide that income attributable to a guaranteed payment for the use of capital (as well as for services) is **not** considered to be attributable to a trade or business, and consequently is not taken into account for purposes of computing QBI. However, the partnership's deduction associated with the guaranteed payment for the use of capital will be taken into account for purposes of computing QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for federal income tax purposes. A number of commentators argued that guaranteed payments for the use of capital under Section 707(c) should not be excluded from the definition of QBI. Additionally, a number of commentators suggested that Section 707(a) payments received by a partner for services rendered with respect to a trade or business should be included in QBI. The IRS declined to adopt these recommendations so that guaranteed payments for capital and payments under Section 707(a) for services rendered by a partner to a partnership are excluded from QBI, just as amounts received by an S corporation shareholder as reasonable compensation (W-2 wages) or by a partner as a guaranteed payment for services are **not** taken into account as qualified items of income, gain, deduction, or loss, and therefore are excluded from QBI.

[iii] Section 481 adjustments (whether positive or negative) will be taken into account for purposes of computing QBI to the extent that the requirements of

§ 199A are otherwise satisfied, but only if the adjustment arises in taxable years after December 31, 2017.

[iv] In general, losses or deductions which were previously disallowed (including under § 465, § 469, § 704(d) and § 1366(d)), which are allowed in the taxable year are also taken into account for purposes of computing QBI for such taxable year. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 are **not** taken into account in a later taxable year for purposes of computing QBI. The Final Regulations provide that any losses disallowed, suspended, or limited under the provisions of Section 465, 469, 704(d) and 1366(d), or any other similar provisions, shall be used, for purposes of Section 199A and the regulations thereunder, in order from the oldest to the most recent on a FIFO (first-in, first-out) basis.

[v] In general, a deduction under § 172 for a net operating loss is not considered with respect to a trade or business and therefore, is not taken into account in computing QBI. However, an excess business loss under the provisions of Section 461(l) is treated as a net operating loss carryover to the following taxable year and is taken into account for purposes of computing QBI in the subsequent taxable year in which it is deducted.

[c] Qualified Items of Income, Gain, Deduction and Loss. This term generally means items of gross income, gain, deduction, and loss to the extent that such items are effectively connected with the conduct of a trade or business within the United States and included or allowed in determining taxable income for the taxable year. Reg. § 1.199A-3(b)(2)(i).

[iv] Reg. § 1.199A-3(b)(2)(ii) specifies that the following items are **not** taken into account as a qualified item of income, gain, deduction or loss in computing QBI:

- a. Any item of short-term capital gain, short-term capital loss, long-term capital gain, long-term capital loss. The Proposed Regulations provided a specific reference to Section 1231 which treats certain gains of a trade or business as capital gain (and losses as ordinary losses). In order to avoid any unintended inferences, the Final Regulations remove the specific reference to Section 1231, and provide that any item of short-term capital gain, short-term capital loss, long-term capital gain or long-term capital loss, **including any item treated as one of such items under any other provision of the Code**, is not taken into account as a qualified item of income, gain, deduction, or loss. As a result, qualified dividends received by a taxpayer are excluded from the definition of QBI.
- b. Any dividend, income equivalent to a dividend or payment in lieu of dividends described in § 954(c)(1)(G).

- c. Any interest income other than interest income which is properly allocable to a trade or business. The Section 199A Regulations specifically provide that interest income attributable to an investment of working capital, reserves, or similar accounts is not properly allocable to a trade or business.
- d. Any item of gain or loss described in § 954(c)(1)(C) (transactions in commodities) or § 954(c)(1)(D) (excess foreign currency gains) applied in each case by substituting “trade or business” for “controlled foreign corporation”.
- e. Any item of income, gain, deduction or loss taken into account under § 954(c)(1)(F) (income for notational principal contracts) determined without regard to § 954(c)(1)(F)(ii) and other than items attributable to notational principal contracts entered into in transactions qualifying under § 1221(a)(7).
- f. Any amount received from an annuity which is not received in connection with a trade or business.
- g. Any qualified REIT Dividends or Qualified PTP Income.
- h. Reasonable compensation received by a shareholder from an “S” corporation. Note that the “S” corporation’s deduction for such reasonable compensation will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for federal income tax purposes.
- i. Any guaranteed payment described in § 707(c) received by a partner with respect to the trade or business. However, the partnership’s deduction for such guaranteed payment will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for federal income tax purposes.
- j. Any payment described in § 707(a) received by a partner for services rendered with respect to the trade or business. Again, however, the partnership’s deduction for such payment will reduce QBI if the deduction is properly allocable to the trade or business and is otherwise deductible for federal income tax purposes.

[d] Income from Puerto Rico. For purposes of determining QBI, the term “United States” will include the Commonwealth of Puerto Rico in the case of any taxpayer with QBI for any taxable year from sources within the Commonwealth of Puerto Rico if all of such receipts are taxable under § 1 for such taxable year. Reg. § 1.199A-3(b)(3).

[e] Expenses for all wages paid (or incurred in case of an accrual basis taxpayer) must be taken into account in computing QBI regarding of the application of the W-2 Wage limitation. Reg. § 1.199A-3(b)(4).

[f] In the case of an individual or RPE directly conducting multiple trades or businesses, where such items of QBI are properly attributable to more than one of the trades or businesses, the individual or RPE must allocate those items among the several trades or businesses to which they are attributable using a “reasonable method” based on all the facts and circumstances. The Section 199A regulations provide that the individual or RPE may use a different reasonable method for different items of income, gain, deduction and loss, but that the chosen reasonable method for each item must be consistently applied from one taxable year to the next and must clearly reflect the income and expenses of each trade or business. The books and records maintained for a trade or business also must be consistent with any allocations of items of QBI thereunder. Reg. § 1.199A-3(b)(5).

[g] Regulation § 1.199A-3(c) sets forth the meanings of Qualified REIT Dividends and Qualified PTP Income, and provides that the rules applicable to the determination of QBI also applies to the determination of a taxpayer’s allocable share of income, gain, deduction, and loss from a PTP.

§1.09 **Wage and Capital Limitations**

For businesses other than a “specified service trade or business” (which will be discussed below), and for which the taxpayer’s taxable income exceeds \$207,500 (\$157,500 + \$50,000 phase-in amount), or \$415,000 (\$315,000 + \$100,000 phase-in amount) if married filing jointly, the deductible amount for each qualified trade or business carried on by the S corporation, partnership, LLC or sole proprietorship is, as discussed above, the lesser of (1) 20% of the taxpayer’s allocable share of QBI with respect to the qualified trade or business; or (2) the greater of (a) the taxpayer’s allocable share of 50% of the W-2 wages with respect to the qualified trade or business, or (b) the taxpayer’s allocable share of the sum of 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all “qualified property” (the “wage and capital limitations,” or sometimes referred to as the “W-2 and UBIA of qualified property limitations”).

[1] **W-2 Wages.**

W-2 wages are wages paid to an employee, including any elective deferrals into a Section 401(k)-type vehicle or other deferred compensation. W-2 wages do not include, however, things like payments to an independent contractor or management fees. This definition raises issues for employees employed by an affiliated management company that leases the employees to an operating business or businesses. The question is whether wages paid by the management company or other third party can be taken into account with respect to each qualified trade or business even though it is operated in a separate taxable entity. The Section 199A Regulations answer this question affirmatively so long as the individual or RPE is the common law employer of such employees. Additionally, because a partner is not an “employee” of the partnership under Rev. Rul. 69-184, 1969-1 C.B. 256, and a sole proprietor is not an “employee” of the sole proprietorship, neither guaranteed payments made to a partner nor any other payments made to a

partner or a sole proprietor appear to qualify as W-2 wages (which can either be advantageous or disadvantageous depending upon the circumstances as illustrated in Examples 8, 9 and 10 below).

[a] Section 199A(b)(4) specifically defines W-2 wages by reference to Sections 6051(a)(3) and (8). This mirrors, in part, the language in Section 199(b) as it existed prior to TCJA relating to the Domestic Production Activities Deduction. Guidance on wage issues had been issued under prior Section 199 in Rev. Proc. 2006-22, 2006-1 C.B. 1033 and in the Section 199 Regulations. Revenue Procedure 2006-22 provided three safe harbors for determining the definition of wages for purposes of old Section 199: (1) the “Modified Box Method” which uses the lesser of Box 1 or Box 5 of the Form W-2; (2) the “Modified Box 1 Method” which adds a modified Box 1 amount subtracting amounts not subject to federal income tax withholding, added to the deferrals reported in Box 12; and (3) the “Tracking Method” where the amounts subject to federal income tax withholding are tracked, deferrals are added, and other modifications made. The Section 199A Regulations, as well as Notice 2018-64, which was also issued by the IRS on August 8, 2018, essentially adopted the prior regulations issued under Section 199 and Rev. Proc. 2006-22 in determining what constitutes “wages” for purposes of Section 199A. This was further clarified by the IRS with the issuance of Rev. Proc. 2019-11 in connection with the Final Regulations. The definition of “wages” as provided in Rev. Proc. 2019-11 is discussed in more detail below.

[b] Section 199A wages do not include any amount which is not properly included in a return filed with the Social Security Administration on or before the sixtieth (60th) day after the due date, including extensions, for such return. Consequently, compliance with such reporting rules is necessary to get credit for the maximum amount of W-2 wages.

[2] Allocable Share.

If there is more than one owner of the pass-through entity, it must be kept in mind that the owners are only entitled to their “allocable share” of QBI, W-2 wages and UBI of qualified property. For an S corporation, a shareholder’s allocable share will be equal to his or her percentage ownership of the stock of the S corporation. For partnerships, where special allocations may be made under Section 704(b), a partner’s allocable share of QBI and of W-2 wages will be equal to the amount of wages of the qualifying trade or business allocated to such partner by the partnership.

[3] W-2 Wages and Regulations Section 1.199A-2.

Reg. § 1.199A-2(b) provides further guidance on calculating the trade or business’s W-2 Wages properly allocable to QBI.

[a] W-2 Wages. The determination of W-2 Wages must be made for each trade or business by the individual or RPE that directly conducts the trade or business before applying the aggregation rules of Proposed Reg. § 1.199A-4. Any W-2 Wages paid by an RPE must be determined and reported by the RPE for each trade or business it conducts. If not so determined and reported for each trade or business, W-2 Wages will be assumed to be zero. Reg. § 1.199A-2(b)(1) provides a 3-step process for determining the W-2 Wages paid with respect to a trade or business that are properly allocable to QBI.

[i] First, each individual or RPE must determine its total W-2 Wages paid for the taxable year.

[ii] Second, each individual or RPE must allocate its W-2 Wages between or among one or more trades or businesses.

[iii] Third, each individual or RPE must determine the amount of such wages with respect to each trade or business that are allocable to the QBI of the trade or business.

[b] Definition of W-2 Wages. The term “W-2 Wages” means with respect to any person for any taxable year of such person, the amounts described in § 6051(a)(3) and § 6051(a)(8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. As such, the term “W-2 Wages” includes the total amount of wages as defined in § 3401(a) plus the total amount of elective deferrals within the meaning of § 402(g)(3), the compensation deferred under § 457, and the amount of designated ROTH contributions (as defined in § 402(a)). Reg. § 1.199A-2(b)(2)(i).

[c] Employees Taken Into Account For W-2 Wage Limitations. In general, the Form W-2, “Wage and Tax Statement,” or any subsequent form or document used in determining the amount of W-2 wages are those issued for the calendar year during individual’s or RPE’s taxable year for wages paid to employees (or former employees) of the individual or RPE for employment by the individual or RPE. Employees of the individual or RPE are limited to employees of the individual or RPE as defined in Section 3121(d)(1) and (2), and for purposes of Section 199A, includes officers of an S corporation and employees of an individual or RPE under common law.

[i] Of critical importance, the Section 199A Regulations provide that in determining W-2 wages, an individual or RPE may take into account any W-2 wages paid by another person and reported by the other person on Forms W-2 with the other person as the employer listed in box c of the Forms W-2, provided that the W-2 wages were paid to common law employees or officers of the individual or RPE for employment by the individual or RPE. Under such circumstances, the person paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that person. The Section 199A Regulations specifically provide that persons that pay and report W-2 wages on behalf of or with respect to others can include certified professional employer organizations under Section 7705, statutory employers under Section 3401(d)(1) and agents under Section 3504. Reg. § 1.199A-2(b)(2)(ii).

[ii] The Section 199A Regulations reiterate that the term W-2 wages does not include any amount that is not properly included in a return filed with the Social Security Administration on or before the sixtieth (60th) day after of the due date (including extensions) for such return. Reg. § 1.199A-2(b)(2)(iii).

[d] Acquisition or Disposition of a Trade or Business. In the case of an acquisition or disposition of a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business that causes more than one individual or entity to be the employer of the employees of the acquired or disposed of trade or business during the calendar year, the W-2 Wages of the individual or entity for the calendar year of the acquisition or disposition are allocated between each individual or entity based on the period during which the employees of the acquired or disposed of trade or business were employed by the individual or entity, regardless of which permissible method is used for reporting predecessor and successor wages on Form W-2, “Wage and Tax Statement.” Reg. § 1.199A-2(b)(2)(iv)(B)(1). The term “acquisition or disposition” includes an incorporation, a formation, a liquidation, a reorganization or a purchase or sale of assets. Reg. § 1.199A-2(b)(2)(iv)(B)(2).

[e] Allocation of Wages to Trades or Businesses. After calculating total W-2 Wages for a taxable year, each individual or RPE that directly conducts more than one trade or business must allocate those wages among its various trades or businesses. W-2 Wages must be allocated to the trade or business that generated those wages. Where W-2 Wages are allocable to more than one trade or business, Reg. § 1.199A-2(b)(3) provides that the portion of the W-2 Wages allocable to each trade or business is determined in the same manner as the expenses associated with those wages are allocated among the trades or businesses under Reg. § 1.199A-3(b)(5).

[f] Allocation of Wages to QBI. Once W-2 Wages for each trade or business have been determined, each individual RPE must identify the amount of W-2 Wages properly allocable to QBI for each trade or business. Reg. § 1.199A-2(b)(4) provides that W-2 Wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI under Reg. § 1.199A-3.

[g] Non-Duplication Rule. Amounts that are treated as W-2 Wages for a taxable year under any method cannot be treated as W-2 Wages of any other taxable year. Additionally, an amount cannot be treated as W-2s by more than one trade or business. Reg. § 1.199A-2(b)(5).

[h] Rev. Proc. 2019-11. As mentioned above, Revenue Procedure 2019-11, issued concurrently with the Final Regulations, provides additional guidance on the definition of W-2 wages. The Revenue Procedure provides three methods for calculating W-2 wages, as defined in Section 199A(b)(4) and Reg. Section 1.199A-2, for purposes of Section 199A(b) and the Regulations thereunder.

The Revenue Procedure provides that W-2 wages calculated thereunder are not necessarily the W-2 wages properly applicable to QBI and eligible for use in computing this Section 199A limitations. Only W-2 wages that are properly allocable to QBI may be taken into account in computing the Section 199A(b)(2) W-2 wage limitations. Consequently, after computing W-2 wages under the Revenue Procedure, the taxpayer must determine the extent to which the W-2 wages are properly allocable to QBI. Then, the properly allocable W-2 wages amount is used in determining the W-2 wages limitation under Section 199A(b)(2) for that trade or business. Additionally, the Revenue Procedure provides that the discussions of “wages” in the Revenue Procedure and in Regulations under Section 199A are for purposes of Section 199A only and have no application in determining whether amounts are wages: under Section 3121(a) for

purposes of the Federal Insurance Contributions Act (“FICA”); under Section 3306(b) for purposes of the Federal Unemployment Tax Act (“FUTA”); under Section 3401(a) for purposes of federal income tax withholding; or for any other wage-related determination.

[i] Section 4 of Rev. Proc. 2019-11 sets forth the definition of W-2 wages (which is consistent with the definition under the Final Regulations) and the correlation of those definitions with the numbered boxes on the Form W-2.

[ii] For any taxable year, a taxpayer must calculate W-2 wages for purposes of Section 199A(b)(2) using one of three methods described in Sections 5.01, 5.02 and 5.03 of the Revenue Procedure.

[iii] Under the first method, the so-called “Unmodified Box Method,” W-2 wages are calculated by taking, without modification, the lesser of the total entries in box 1 of all Forms W-2 filed with the Social Security Administration (“SSA”) by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer; or the total entries in box 5 of all Forms W-2 filed with the SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer.

[iv] Under the “Modified Box 1 Method,” the taxpayer makes modifications to the total entries in box 1 of Forms W-2 filed with respect to employees of the taxpayer. W-2 wages under this method are calculated as follows:

- Total the amount in box 1 of all Forms W-2 filed with the SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer;
- Subtract from the above paragraph amounts included in box 1 of Forms W-2 that are not wages for federal income tax withholding purposes, including amounts that are treated as wages for purposes of income tax withholding under Section 3402(o) (for example, supplemental unemployment compensation benefits within the meaning of Rev. Rul. 90-72)¹³; and
- Add to the amount obtained in the immediately preceding paragraph, the total of the amounts that are reported in box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer that are properly coded D, E, F, G and S.

[v] Under the last method, the so-called “Tracking Wages Method,” the taxpayer actually tracks total wages subject to federal income tax withholding and

¹³ 1990-2 C.B. 211.

makes appropriate modifications. W-2 wages under this method are calculated as follows:

- Total the amount of wages subject to federal income tax withholding that are paid to employees of the taxpayer for employment by the taxpayer and that are reported on Forms W-2 filed with the SSA by the taxpayer for the calendar year; plus
- The total of the amounts that are reported in box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G and S.

[vi] Section 6 of Rev. Proc. 2019-11 prescribes special rules for the calculation of W-2 wages in the case of taxpayers with a short taxable year.

[4] Qualified Property.

For purposes of Section 199A, “qualified property” means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, which is used in the production of QBI sometime during the taxable year, and for which the depreciable period has not expired before the close of the taxable year. In the case of qualified property held by an RPE, the applicable taxable year is the taxable year of the RPE. Additionally, the Final Regulations clarify that a taxpayer who transfers an interest in an RPE prior to the close of the RPE’s taxable year is not entitled to a share of UBIA from the RPE. The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed in service by the taxpayer and ending on the **later** of (a) the date ten years after such date; or (b) the last day of the full year in the asset’s normal depreciation period. Again, with respect to a shareholder of an S corporation, such shareholder’s “allocable share” of the unadjusted basis of qualified property will be equal to his or her percentage ownership in the stock of the S corporation. However, with respect to partners of a partnership (including LLCs taxed as partnerships), the partner’s allocable share of the unadjusted basis of qualified property will be equal to the percentage of Section 704(b) book depreciation allocated to such partner by the partnership.

Example #2. LLC Taxed as a Partnership in a Qualified Trade or Business with Income in Excess of Threshold Amount Plus Phase-In Amounts. A is a 30% owner of an LLC which has QBI of \$3,000,000. The LLC paid wages of \$1,000,000 and the LLC’s unadjusted basis in qualified property is \$200,000.

A’s deduction will be equal to the lesser of:

1.	<u>Total QBI</u> \$3,000,000	<u>Allocable Share (30%)</u> \$900,000	<u>20% Deduction</u> \$180,000
	<i>and the greater of:</i>		
2(a)	<u>Total W-2 Wages</u> \$1,000,000	<u>Allocable Share (30%)</u> \$300,000	<u>50% Limitation</u> \$150,000

<i>or</i>			
2(b)	<u>Total W-2 Wages</u>	<u>Allocable Share (30%)</u>	<u>25% Limitation</u>
	\$1,000,000	\$300,000	\$75,000
<i>plus</i>			
	<u>Unadjusted Basis</u>	<u>Allocable Share (30%)</u>	<u>2.5% Limitation</u>
	\$200,000	\$60,000	\$1,500
	TOTAL		<u>\$76,500</u>

Thus, A is entitled to a deduction of \$150,000.

[5] UBIA and Regulation Section 1.199A-2.

Reg. § 1.199A-2(a)(3) provides that the determination of the UBIA of qualified property must be made for each trade or business by the individual or RPE that directly conducts the trade or business before applying the aggregation rules of § 1.199A-4. In the case of qualified property held by an RPE, each partner or shareholder’s share of the UBIA of qualified property is an amount which bears the same proportion to the total UBIA of qualified property as the partner or shareholder’s share of Section 704(b) book depreciation bears to the RPE’s total book depreciation with respect to the property for the year. This represents a change from the Proposed Regulations that determined a partner’s share of the UBIA of qualified property by reference to the partner’s share of tax depreciation, rather than how depreciation would be allocated for Section 704(b) book purposes on the last day of the taxable year. In the case of qualified property held by an “S” corporation, each shareholder’s share of the UBIA of qualified property is a share of the unadjusted basis proportionate to the ratio of shares in the “S” corporation held by the shareholder over the total shares of the “S” corporation. If the UBIA of the qualified property is not determined and reported for each trade or business, the UBIA of such qualified property is presumed to be zero.

[a] UBIA of Qualified Property. Consistent with the definition of qualified property set forth in § 199A(b)(6), Reg. § 1.199A-2(c)(1)(i) provides that the term qualified property means, with respect to any trade or business of an individual or RPE for a taxable year, tangible property of a character subject to the allowance for depreciation under § 167(a):

[i] which is held by, and available for use in, the trade or business at the close of the taxable year;

[ii] which is used at any point during the taxable year in the trade or business’s production of QBI; and

[iii] the depreciable period of which has not ended before the close of the individual or RPE’s taxable year.

[b] Improvement to Qualified Property. In the case of any addition to, or improvement of, qualified property that has already been placed in service by the individual or RPE, such addition or improvement is treated as separate qualified property first placed in service on the date such addition or improvement is placed in service. Reg. § 1.199A-2(c)(1)(ii).

[c] Adjustments Under §743(b) and § 734(b). In a departure from the Proposed Regulations, the Final Regulations provide that Section 743(b) basis adjustments will be treated as qualified property to the extent the Section 743(b) basis adjustment reflects an increase in the fair market value of the underlying qualified property. Specifically, the Final Regulations define “excess Section 743(b) basis adjustment” as an amount determined with respect to each item of qualified property equal to the excess of the partner’s Section 743(b) basis adjustment with respect to each item over an amount that would represent the partner’s Section 743(b) basis adjustment with respect to the property, but calculated as if the adjusted basis of all of the partnership property was equal to the UBIA of such property. The excess Section 743(b) basis adjustment is treated as a separate item of qualified property placed in service when then transfer of the partnership interest occurs. However, the IRS refused to adopt a similar rule that Section 734(b) basis adjustments on a distribution of property should be taken into account in determining a partner’s share of the UBIA of qualified property.

[d] Property Acquired Near Year-End. Property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer can demonstrate that the principal purpose of the acquisition and disposition was a purpose other than increasing the § 199A deduction. Reg. § 1.199A-2(c)(1)(iv). The Final Regulations clarify that the 120 day period begins on the date of acquisition of the property.

[e] Carryover Basis Property and Other Rules. The Final Regulations clarify that additional first-year depreciation allowable under § 168 will not affect the applicable recovery period for the qualified property. Additionally, UBIA of qualified property is determined without regard to any adjustments described in § 1016(a)(2) or § 1016(a)(3), any adjustments for tax credits claimed by the taxpayer, or any adjustments for any portion of basis for which the taxpayer has elected to treat as an expense (for example, under § 179).

Another controversial aspect of the Proposed Regulations concerned the determination of UBIA of qualified property received in a non-taxable transaction. The Proposed Regulations provided that the UBIA of qualified property contributed to a partnership in a Section 721 transaction generally equals the partnership’s tax basis under Section 723 (a carryover basis) rather than the contributing partner’s original UBIA of the qualified property. Similarly, the Proposed Regulations provided that the UBIA of qualified property contributed to an S corporation in a Section 351 transaction is determined by reference to Section 362 (a carryover basis). Many commentators expressed that this rule could result in a step-down in the UBIA of qualified property due merely to a change in entity structure and suggested that the UBIA of qualified property contributed to a partnership under Section 721 or to an S corporation under Section 351 be determined as of the date it was first placed in service by the contributing partner or shareholder. In response to these comments, the Final Regulations provide that qualified property contributed to a partnership or S corporation in a non-recognition transaction should generally retain its UBIA on the date it was first placed in service by the contributing partner or shareholder.

[f] Depreciable Period of Qualified Property. The term depreciable period means, with respect to qualified property of a trade or business, the period beginning on the date the property was first placed in service by the individual or RPE and ending on the later of the date

that is ten years after such date, or the last day of the last full year in the applicable recovery period that would apply to the property under § 168(c). Reg. § 1.199A-2(c)(2)(i).

[g] Qualified Property Acquired in Transactions Subject to § 1031 or § 1033. Final Reg. Section 1.199A-2(c)(2)(iii) provides special rules for determining the date on which replacement property that is of like-kind to relinquished property or is similar or related in service or use to in involuntary converted property is first placed in service by the individual or RPE in a like-kind exchange or in an involuntary conversion. For the portion of the individual's or RPE's UBIA in such replacement property that does not exceed the individuals or RPE's UBIA in the relinquished property or involuntarily converted property, the date such portion in the replacement property was first placed in service by the individual or RPE is the date on which the relinquished property or involuntarily converted property was first placed in service by the individual or RPE. For the portion of the individual's or RPE's UBIA in such replacement property that exceeds the individual's or RPE's UBIA in the relinquished property or involuntarily converted property, such portion in the replacement property is treated as separate qualified property that the individual or RPE first placed in service on the date on which the replacement property was first placed in service by the individual or RPE. Consequently, qualified property acquired in a like-kind exchange or in an involuntary conversion may have two separate placed in service dates under the Final Regulation for purposes of determining the UBIA of the property. This results in the depreciable period under Section 199A for the exchanged basis of the replacement qualified property ending before the depreciable period for the excess basis of the replacement qualified property ends.

[i] The Proposed Regulations also provided that that the UBIA of qualified property received in a Section 1031 like-kind exchange (or in a Section 1033 involuntary conversion) would be equal to the adjusted basis of the relinquished property transferred in the exchange, which would result in a downward adjustment as a result of depreciation deductions previously taken under Section 168. The Final Regulations change this result by providing that the UBIA of qualified property that a taxpayer receives in a Section 1031 like-kind exchange (or in a transaction qualifying under the involuntary conversion rules of Section 1033) will be equal to the UBIA of the relinquished property. However, if a taxpayer either receives money or property not of a like kind to the relinquished property ("other property") or provides money or other property as part of the exchange, the taxpayer's UBIA in the replacement property is adjusted. The taxpayer's UBIA in the replacement property is adjusted downward by the excess of any money or the fair market value of other property received by the taxpayer in the exchange over the taxpayer's appreciation in the relinquished property ("Excess Boot"). Appreciation for this purpose is the excess of the relinquished property's fair market value on the date of the exchange over the fair market value of the relinquished property on the date of acquisition by the taxpayer. This reduction for Excess Boot in the taxpayer's UBIA in the replacement property reflects a partial liquidation of the taxpayer's investment in qualified property.

[ii] If the taxpayer adds money or other property to acquire replacement property, the taxpayer's UBIA in the replacement property is adjusted upward by

the amount of money paid or the fair market value of the other property transferred to reflect additional taxpayer investment.

[iii] The rules are similar for qualified property acquired pursuant to an involuntary conversion under Section 1033, except that appreciation for this purpose is the difference between the fair market value of the converted property on the date of the conversion over the fair market value of the converted property on the date of acquisition by the taxpayer. Additionally, under Section 1033, “other property” is property not similar or related in service or use to the converted property.

[iv] When qualified property that is not of like-kind to the relinquished property or qualified property that is not similar or related in service or use to the involuntarily converted property is received in a Section 1031 or 1033 transaction, such qualified property is treated as separate qualified property that the individual RPE first placed in service on the date on which such qualified property was first placed in service by the individual or RPE. Reg. § 1.199A-2(c)(2)(iii)(B).

[v] Reg. § 1.199A-2(c)(2)(iv) provides that if an individual or RPE acquires qualified property in a transaction described in Section 168(i)(7)(B) (pertaining to treatment of transferees in certain non-recognition transactions, the individual or RPE must determine the date on which the qualified property was first placed in service as follows:

(A) For the portion of the transferee’s UBIA in the qualified property that does not exceed the transferor’s UBIA in such property, the date such portion was first placed in service by the transferee is the date on which the transferor first placed the qualified property in service; and

(B) For the portion of the transferees’ UBIA in the qualified property that exceeds the transferor’s UBIA in such property, such portion is treated as separate qualified property that the transferee first placed in service on the date of the transfer.

[h] UBIA of qualified property acquired from decedent. The Final Regulations provide that for qualified property acquired from a decedent and immediately placed in service, the UBIA of the property will generally be the fair market value at the date of the decedent’s death under Section 1014. Additionally, the Final Regulations provide that a new depreciable period for property commences as of the date of the decedent’s death.

§1.10 Phase-In of Wage and Capital Limitations

For taxpayers having taxable income between \$157,500 and \$207,500 (\$157,500 plus \$50,000), or with respect to married individuals filing jointly having taxable income between \$315,000 and \$415,000 (\$315,000 plus \$100,000), the wage and capital limitations are phased in. Specifically, if the wage and capital limit is less than 20% of the taxpayer's QBI with respect to the qualified trade or business, the taxpayer's deductible amount is determined by reducing 20% of QBI by the same proportion of the difference between 20% of the QBI and the wage and capital limit as the excess of the taxable income of the taxpayer over the threshold amount bears to \$50,000 (\$100,000 in the case of a joint return). Once the taxpayer has \$207,500 of taxable income, or \$415,000 of taxable income in the case of a married individual filing a joint return, the wage and capital limitations apply fully to the taxpayer.

Example #3: S Corporation In a Qualified Trade or Business with Taxable Income Within the Phase-In Range.

A and B are married. A's allocable share of the QBI of an S corporation is \$300,000. A's allocable share of the W-2 wages paid by the S corporation is \$40,000. A's allocable share of the unadjusted basis of the qualified property is \$100,000. The combined taxable income of A and B is \$385,000.

Step 1: Determine what would A's deduction have been if the wage and labor limitation did not apply. 20% of \$300,000 = \$60,000.

Step 2: Determine A's "Excess Amount" by looking at the difference between \$60,000 and the amount which would be deductible if wage and capital limitations applied in full. Greater of:

4. 50% of \$40,000 = \$20,000; or
5. (25% of \$40,000) plus (2.5% of \$100,000) = \$12,500.

A's Excess Benefit is \$40,000 (\$60,000 - \$20,000).

Step 3: Figure Percentage of Taxable Income of A over Threshold Amount:

$$\begin{array}{r} \$385,000 \\ < \$315,000 > \end{array}$$

$$\$70,000 / \$100,000 = 70\%$$

Step 4: A loses 70% of \$40,000 Excess Benefit or \$28,000

A is therefore entitled to a deduction of:

<i>20% of QBI</i>	<i>\$60,000</i>
<i>Reduction of \$40,000 Benefit</i>	<i><\$28,000></i>
	<u><i>\$32,000</i></u>

§1.11 **Specified Service Trade or Business**

Section 199A defines a “specified service trade or business” as any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities. It should be noted that engineering and architecture services are specifically excluded from the definition of a specified service trade or business.

Because a specified service trade or business includes both “consulting” businesses, brokerage businesses, and “any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners,” there was (and to a lesser degree, still is) uncertainty and unanswered questions as to whether certain businesses constitute a specified service trade or business, and thus a substantial amount of litigation was expected to ensue on this critical issue. Fortunately, as will be discussed in more detail below, the Section 199A Regulations answer many of the questions by narrowly defining specified service trades or businesses, including the “catch all” for any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. As with other areas of Section 199A, even after issuance of the Final Section 199A Regulations, there are still a number of open issues dealing with the definition of a “qualified trade or business” versus a “specified service trade or business” and the effect each may have on the other.

[1] Deduction Allowed for Specified Service Trade or Business if Taxable Income Less than Threshold Amounts.

Even though an SSTB is not a qualified trade or business, such business will nevertheless be eligible for the 20% of QBI deduction provided that the taxpayer’s taxable income is less than the Threshold Amounts of \$315,000 in the case of married individuals filing joint returns and \$157,500 for all other taxpayers.

Example #4: Specified Service Trade or Business with Taxable Income Below Threshold Amount.

A is a partner in a law firm operated as an LLC taxed as a partnership. A is married and has total taxable income of \$300,000 with his wife. A’s allocable share of the QBI of the law firm is \$250,000, his allocable share of W-2 wages of the law firm is \$60,000 and his allocable share of the unadjusted basis of the qualified property of the law firm is \$40,000.

Even though A derives his income from a specified service trade or business, he will receive a deduction of \$50,000 (\$250,000 x 20%). Because A's taxable income is below the Threshold Amount of \$315,000, the wage and labor limitation won't apply (the greater of \$30,000 (50% of \$60,000) or \$16,000 (25% of \$60,000 plus 2.5% of \$40,000)).

[2] Phase-Out of Deduction For Specified Service Trades or Businesses.

The ability to take the deduction for 20% of QBI for a specified service trade or business is phased out for a taxpayer having taxable income between \$315,000 and \$415,000 in the case of married individuals filing joint returns, and between \$157,500 and \$207,500 for all other taxpayers. Specifically, for a taxpayer with taxable income within the phase-out range, the taxpayer takes into account only the “applicable percentage” of qualified items of income, gain, deduction or loss, and of allowable W-2 wages. The “applicable percentage” with respect to any taxable year is 100% reduced by the percentage equal to the ratio of the excess of the taxable income of the taxpayer over the threshold amount bears to \$50,000 (or \$100,000 in the case of a joint return).

Example #5: Specified Service Trade or Business with Taxable Income Within the Phase-In (or Phase-Out) Range. A (a lawyer) and B are married. A's allocable share of the QBI of the law firm (an S corporation) is \$300,000. A's allocable share of wages paid by the law firm is \$40,000. A's allocable share of the unadjusted basis of the law firm's qualified property is \$100,000. The combined taxable income of A and B is \$385,000.

Step 1: Determine what would A's deduction have been if the wage and labor limitation did not apply at all. 20% of \$300,000 = \$60,000.

Step 2: Determine how much of A's \$100,000 “phase-in” threshold has been exceeded:

$$\begin{aligned} & \$385,000 \\ & < \$315,000 > \\ & \$70,000 / \$100,000 = 70\% \end{aligned}$$

Step 3: Determine A's “Applicable Percentage” by subtracting 70% from 100% = 30%.

<u>QBI</u>	<u>Applicable Percentage (30%)</u>
\$300,000	\$90,000
<u>W-2 Wages</u>	<u>Applicable Percentage (30%)</u>
\$40,000	\$12,000

<u>Unadjusted Basis</u>	<u>Applicable Percentage (30%)</u>
\$100,000	\$30,000

Step 4: Determine A's deduction using the "Applicable Percentage" numbers: equal to the lesser of:

4. 20% of QBI of \$90,000 = \$18,000; or
5. the greater of:
 - (a) 50% of \$12,000 = \$6,000; or
 - (b) 25% of \$12,000 plus 2.5% of \$30,000 = \$3,750.

Step 5: Determine the excess of the deduction allowed to A if W-2 limitation did not apply over amount deductible if wage limitation fully phased-in: \$18,000 - \$6,000 = \$12,000.

Step 6: Determine Percentage of Taxable Income of A over Threshold Amount:

$$\begin{array}{c} \$385,000 \\ < \underline{\$315,000} > \\ \$70,000 / \$100,000 = 70\% \end{array}$$

Step 7: A loses 70% of \$12,000 benefit or \$8,400:

A is therefore entitled to a deduction of:

20% of QBI	\$18,000
Reduction of \$12,000 Benefit	<u><8,400></u>
Total Deduction	<u>\$9,600</u>

As can be seen from Example #5, the phase-out rule for specified service trades or businesses is much harsher than the phase-in rule for qualified trades or businesses. In Example #3 dealing with a qualified trade or business, based on the identical facts contained in Example #5, the taxpayer was entitled to a deduction under Section 199A of \$32,000, whereas in Example #5 dealing with a specified service trade or business, the taxpayer was allowed a deduction of only \$9,600.

[3] No Deduction Allowed if Specified Service Trade or Business and Taxable Income Exceeds Threshold Amount Plus Phase-In.

The deduction for 20% of QBI is not available for shareholders, partners, members or sole proprietors of an SSTB whose taxable income is \$207,500 or above, or in the case of married individuals filing a joint return, \$415,000 or above.

Example #6: Specified Trade or Business with Taxable Income over Threshold Plus Phase-In (Phase-Out) Range.

A is a partner in a law firm. A is married and has taxable income of \$1,000,000 with her husband. A's allocable share of income of the law firm is \$700,000, her allocable share of the W-2 wages of the law firm is \$200,000 and her share of the unadjusted basis of qualified property is \$100,000.

A is entitled to no deduction at all because the law firm is a specified service trade or business and A's taxable income exceeds \$415,000. A is completely "phased-out" of any deduction.

If, on the other hand, the business had been a qualified trade or business, A's deduction would be equal to the lesser of:

4. 20% of \$700,000 = \$140,000; or
5. the greater of:
 - (a) $50\% \times \$200,000 = \$100,000$, or
 - (b) $25\% \times \$200,000$ plus $2.5\% \times \$100,000 = \$52,500$.

A would therefore be entitled to a deduction of \$100,000 if the business had not been an SSTB.

[4] Specified Service Trades or Business and Regulations Section 1.199A-5.

Reg. § 1.199A-5 sets forth definitions for the following enumerated professions: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services and brokerage services, Reg. § 1.199A-5 also defines what constitutes investing in investment management, trading, and dealing in securities, partnership interests or commodities. These trades or businesses, including any trade or business where the principal or asset of such trade or business is the reputation or skill of one or more of its employees or owners, are treated as "Listed SSTBs" under Reg. § 1.199A-5(b)(1). The Final Regulations are mostly taxpayer-friendly and side with the majority of commentators by narrowly defining what constitutes a Listed SSTB. Additionally, the Final Regulations (as did the Proposed Regulations) take a very narrow view as to what is included as an SSTB where the principal asset of the business is the reputation or skill of one or more of its employees or owners.

The Preamble to the Proposed Regulations states that Section 199A is a new Code provision intended to benefit a wide range of businesses, and makes references to Section 1202(e)(3)(A), Section 448(d)(2) and Regulations Section 1.448-1T(e)(4)(i), and provides that although the sections are not definitive for purposes of determining whether a trade or business is an SSTB, guidance can be taken from such sources. Section 448 prohibits certain taxpayers from computing taxable income under the cash receipts and disbursements method of accounting and provides qualified personal service corporations generally are not subject to the prohibition from using the cash method. The definition of an SSTB under Section 199A is substantially similar to the list of service trades or businesses provided in Section 448(d)(2)(A) and Reg. Section 1.448-1T(e)(4)(i). The Preamble goes on to provide that Section 448(d)(2) emphasizes the direct

provision of services by the employees of a trade or business, rather than the application of capital. Consistent with the ordinary rules of statutory construction and the legislative history of Section 199A, the Preamble to the Proposed Regulations provide that Reg. Section 1.199A-5(b) draws upon the existing guidance under Section 448(d)(2) when appropriate for purposes of Section 199A and generally follows the guidance issued under Section 448(d)(2) with some modifications. The Preamble states that case law under Section 448 provides that whether a service is performed in a qualifying field under Section 448(d)(2) is to be decided by examining all relevant indicia and is not controlled by state licensing laws, and that this approach is also appropriate for Section 199A purposes. Although the Preamble extensively discusses Section 448 and the Regulations thereunder, as well as Section 1202, the Section 199A Regulations themselves contain no reference to Section 448.

The Final Regulations add two rules of general application with respect to SSTBs. First, the Final Regulations specify that the rules for determining whether a business is a SSTB within the meaning of Section 199(d)(2) applies solely for purposes of Section 199A, and thus, may not be taken into account for purposes of applying any other provision of law, except to the extent that such a provision expressly refers to Section 199A(d). Second, the Final Regulations include a hedging rule that is applicable to any trade or business conducted by an individual or an RPE. The hedging rule provides that income, deduction, gain, or loss from a hedging transaction entered into in the normal course of a trade or business is included as income, deduction, gain or loss from that trade or business. A hedging transaction for these purposes is defined in Reg. Section 1.1221-2(b) and the timing rules of Reg. Section 1.446-4 are also applicable.

[a] Meaning of Services Performed in the Fields of Health. The performance of services in the field of health means the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists and other similar health care professionals performing services in their capacity as such. Contrary to Section 448 and the statement in the Preamble to the Proposed Regulations discussed above, the Final Regulations drop the additional language contained in the Proposed Regulations that indicated that the medical professionals were required to “provide medical services directly to a patient” in order to fall within the field of health. The performance of services in the field of health does not include the provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient. As an example of an excluded service, the Section 199A Regulations provide that the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or the research, testing, and manufacture and/or sales of pharmaceuticals or medical devices. Reg. § 1.199A-5(b)(2)(ii).

[i] The Final Regulations provide some clarity beyond that contained in the Proposed Regulations regarding when a business is classified as an SSTB. The IRS noted in the Preamble to the Final Regulations that skilled nursing, assisted living and similar facilities provide multi-faceted services to their residents, and that whether such facility and its owners are in the trade or business of performing services in the field of health requires a facts and circumstances inquiry that is beyond the scope of the Final Regulations. However, the Final Regulations do provide a specific example of one such facility offering services that the IRS does

not believe rises to the level of performance of services in the field of health. This example clearly provides that the facility's income is derived solely from the provision of living facilities to its residents, and that the facility contracted with outside healthcare organizations to provide any medical services to the residents.

[ii] Likewise, the Final Regulations contain an example of an outpatient surgery center where the IRS finds the surgery center is not a trade or business providing services in the field of health. However, in the example, the entity is a private organization that owns a number of facilities throughout the country and it is expressly provided that the entity does **not** employ physicians, nurses or medical assistants, but enters into agreements with other professional medical organizations or directly with medical professionals to perform the procedures and provide all medical care. The example also expressly provides that the patients are only billed by the surgery center for facility costs related to the procedure, and that any fees for the provision of the procedure itself were billed by the medical provider to the patients. The example concludes that the surgery center did **not** perform services in the field of health within the meaning of Section 199A so that it is treated as a QTB (rather than a SSTB) for purposes of the Section 199A deduction.

The problem with the example set forth in the final regulations is that it is not a “real world” example, and as such, few, if any, taxpayers will fall within the confines of the safe-harbor example. In practice, almost all surgery centers are either wholly-owned by physicians, or at least partially-owned by physicians with the remaining portion being owned by one of the national surgery center companies (e.g., AmSurg). Also, most surgery centers have some medical personnel as direct employees (or through a PEO or similar arrangement), but the patients are not paying fees to the surgery center for any specific services such personnel render to such patients. The surgery center simply receives the prescribed “facility fee” from the patient and the doctor performing the surgery is paid separately for his or her professional services through their medical practice (which clearly is an SSTB). In the author's opinion, the owners of the surgery center, whether they are doctors or not, and whether or not the surgery center actually employs some medical personnel directly or contracts with a third party to provide such services, should qualify for the 199A deduction. The same would be true for dialysis centers. The business is either an SSTB or it's not, and ownership should have no bearing on the answer. Likewise, whether such business directly employs medical personnel or it contracts with a third party to provide such services should not have a bearing on its status as an SSTB. This is an issue many accountants are facing right now as they need to file returns for these entities and they are in a dilemma as to how to treat surgery centers (and similar businesses) because of the facts of the example contained in the Final Regulations.

Page 24 of Blue Book provides that the SSTB provision “identifies some service businesses that generally give rise to income from labor services, that is, labor income, and excludes those businesses from the [QBI] provision (subject to a phase-in).” (emphasis added). Footnote 123 in the Blue Book provides that “the field of health means the provision of medical services by physicians, nurses, dentists and other similar healthcare professionals.” The focus on “labor income” and “labor services” supports the position that surgery centers and dialysis centers should **not** be treated as SSTBs---they effectively charge for the real estate, improvements and equipment (the “facility fee”), and therefore should be excluded from the definition of an SSTB

even though they are tangentially related to the provision of nonqualified health services. The focus on listed individuals, not entities, that are healthcare professionals is consistent with the “labor income” principle.

[iii] The Preamble to the Final Regulations also address the sale of pharmaceuticals and medical devices by a retail pharmacy by providing that such activities are not by themselves a trade or business performing services in the field of health. However, the Final Regulations also provide an example of services provided by a retail pharmacy through a pharmacist that do constitute performance of services in the field of health.

[iv] The Preamble to the Final Regulations also discuss arguments made by commentators that veterinary medicine should not be considered an SSTB. Citing Rev. Ruling 91-30, 1991-1 C.B. 61, the IRS stated that it believed it was appropriate to continue the long-standing treatment of veterinary services as the performance of services in the field of health for purposes of Section 199A in the Final Regulations.

[b] Meaning of Services Performed in the Field of Law. The performance of services in the field of law means performance of services by individuals such as lawyers, paralegals, legal arbitrators, mediators and similar professionals performing services in their capacity as such. The performance of services in the field of law does not include the provision of services that do not require skills unique to the field of law, for example, the provision of services in the field of law does not include the provision of services by printers, delivery services, or stenography services. Reg. § 1.199A-5(b)(2)(iii).

[c] Meaning of Services Performed in the Field of Accounting. The performance of services in the field of accounting means performance of services by individuals such as accountants, enrolled agents, return preparers, financial auditors, and similar professionals performing services in their capacity as such. Reg. § 1.199A-5(b)(2)(iv). The field of accounting does not include, however, payment processing and billing analysis.

[d] Meaning of Services Performed in the Field of Actuarial Science. The performance of services in the field of actuarial science means the provision of services by individuals such as actuaries and similar professionals performing services in their capacity as such. Reg. § 1.199A-5(b)(2)(v). However, the field of actuarial science does not include the provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial cost of risks or uncertainty of events.

[e] Meaning of Services Performed in the Field of Performing Arts. The performance of services in the field of the performing arts means performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors and similar professionals performing services in their capacity as such. The performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Likewise, the performance of services in the field of performing arts does not include the provision of services by persons who

broadcast or otherwise disseminate video or audio of performing arts to the public. Reg. § 1.199A-5(b)(2)(vi).

[f] Meaning of Services Performed in the Field of Consulting. The performance of services in the field of consulting means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting specifically includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or economically similar services or the provision of training and educational courses. The determination of whether a person's services are sales or economically similar services will be based on all the facts and circumstances of that person's business, including the manner in which the taxpayer is compensated for the services provided. The performance of services in the field of consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of the trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services. Reg. § 1.199A-5(b)(2)(vii). The Final Regulations also clarify that a business which assists other businesses in meeting their personnel needs by referring job applicants to them is not engaged in the performance of services in the field of consulting when the compensation for the business referring job applicants is based on whether the applicants accept employment positions with the businesses searching for employees. Additionally, Final Reg. Section 1.199A-5(b)(2)(vii) provides that services within the fields of architecture and engineering are not treated as consulting services for purposes of Section 199A.

[g] Meaning of Services Performed in the Field of Athletics. The performance of services in the field of athletics means the performance of services by individuals who participate in athletic competition such as athletes, coaches and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards and racing. Again, the performance of services in the field of athletics does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Likewise, the performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public. Reg. § 1.199A-5(b)(2)(viii). The Preamble to the Proposed Section 199A Regulations provides that if a partnership owns a professional sports team, a partner's distributive share of income from the partnership's athletic trade or business is not QBI, regardless of whether the partner participates in the partnership's trade or business. Following the issuance of the Proposed Regulations, a number of commentators suggested that the definition of a trade or business involving the performance of services in the field of athletics should not include the trade or business of owning a professional sports team, since such owners are not directly performing athletic activities. The Final Regulations rejected the arguments of the commentators, stating that while sports club and team owners are not performing athletic services directly, that is not a requirement of Section 199A, which looks to whether there is income attributable to a trade or business involving the performance of services in a specified activity, and not to who performed the services.

[h] Meaning of Services Performed in the Field of Financial Services. The performance of services in the field of financial services means the provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings and raising financial capital by underwriting, or acting as a client's agent in the issuance of securities or similar services. This includes services provided by financial advisors, investments bankers, wealth planners and retirement advisors and other similar professionals performing services in their capacity as such. The Final Regulations also expressly provide that although the performance of services in the field of financial services does not include taking deposits or making loans (i.e., banking), it does include arranging lending transactions between a lender and borrower.

[i] Banking. Banking as such is specifically excluded from the definition of an SSTB. Reg. § 1.199A-5(b)(2)(ix). There were a number of comments that traditional banking activities, such as the performance of services that consist of dealing in securities, should be excluded from the definition of an SSTB when performed by a bank. The Final Regulations continue to exclude taking deposits or making loans from the definition of an SSTB involving the performance of financial services and also exclude the origination of loans from the definition of dealing in securities for purposes of Section 199A. However, the IRS expressly stated that it did not believe that there is a broad exemption from the listed SSTBs with respect to all services that may be performed by banks. This suggests that a subchapter S bank should segregate specified service activities from the trade or business of banking and operate such specified service activities as an SSTB separate from its banking trade or business, either within the same legal entity or in a separate entity.

[j] Meaning of Services Performed in the Field of Brokerage Services. The performance of services in the field of brokerage services include services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in § 475(c)(2)) for a commission or a fee. This would include services provided by stock brokers and similar professionals, but specifically exclude services provided by real estate agents and brokers or insurance agents or brokers. Reg. § 1.199A-5(b)(2)(x).

[k] Meaning of Services Performed in the Field of Investing and Investment Management. The performance of services that consist of investing and investment management refers to a trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments. The Final Regulations clarify that performance of services of investing and investment management does not include managing real property, including both direct and indirect management of real property through agents, employees and independent contractors. Reg. § 1.199A-5(b)(2)(xi). The Preamble to the Final Regulations provide that commission-placed sales of insurance policies generally will not be considered the performance of services in the field of investing and investment management for purposes of Section 199A.

[l] Meaning of the Provision of Services in Trading. The performance of services that consist of trading means a trade or business of trading in securities, commodities or partnership interest. Whether a person is a trader in securities, commodities or partnership interests is determined by taking into account all relevant facts and circumstances, including the source and

type of profit that is associated with engaging in the activity regardless of whether that person trades for the person's own account, for the account of others or any combination thereof. Reg. § 1.199A-5(b)(2)(xii). A taxpayer such as a manufacturer or a farmer, who engages in hedging transactions as part of their trade or business of manufacturing or farming, is not considered to be engaged in a trade or business of trading commodities.

[m] Meaning of the Provision of Services In Dealing. The performance of services that consist of dealing in securities means regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions and securities with customers in the ordinary course of a trade or business. The Section 199A Regulations provide that the performance of services to originate a loan is not treated as the purchase of a security from the borrower in determining whether the lender is performing services consisting of dealing in securities.

The performance of services that consist of dealing in commodities means regularly purchasing commodities from and selling commodities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions and commodities with customers in the ordinary course of a trade or business. Reg. § 1.199A-5(b)(2)(xiii). The Final Regulations clarify that the definition of dealing in commodities for purposes of Section 199A is limited to a trade or business that is dealing in financial instruments or otherwise does not engage in substantial activities with respect to physical commodities. In order to distinguish a trade or business that performs substantial activities with physical commodities from a trade or business that engages in a commodities trade or business by dealing or trading in financial instruments that are commodities, the Final Regulations adopt rules similar to the rules that apply to qualified active sales of commodities in Reg. Section 1.954-2(f)(2)(iii). In general, those rules require a person to be engaged in the active conduct of a commodities business as a producer, processor, merchant or handler of commodities and to perform certain activities with respect to such commodities.

The performance of services that consist of dealing in partnership interests means regularly purchasing partnership interests from and selling partnership interests to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign or otherwise terminate positions in partnership interests with customers in the ordinary course of a trade or business.

[n] Meaning of Trade or Business where the Principal Asset of Such Trade or Business is the Reputation or Skill of One or More Employees or Owners. The fear of many commentators that this provision could sweep in a large range of service businesses as SSTBs has been allayed by the Section 199A Regulations taking a very narrow view as to what is included as an SSTB where the principal asset of the business is the reputation or skill of one or more of its employees or owners. Specifically, Reg. § 1.199A-5(b)(2)(xiv) provides that the term “any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners” means any trade or business that consist of the following (or any combination thereof):

[i] A trade or business in which a person receives fees, compensation or other income for endorsing products or services;

[ii] A trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual’s likeness, name, signature, voice, trademark or other symbol associated with the individual’s identity; or

[iii] Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format. The term fees, compensation or other income includes the receipt of a partnership interest and the corresponding distributive share of income, deduction, gain or loss from the partnership, or the receipt of stock of an “S” corporation and the corresponding income, deduction, gain or loss from the “S” corporation stock.

[o] De Minimus Rule. For a trade or business with gross receipts of \$25 million or less for the taxable year, a trade or business is **not** an SSTB if less than 10% of the gross receipts of the trade or business are attributable to the performance of services in an SSTB. For purposes of determining whether this 10% test is satisfied, the performance of any activity incident to the actual performance of services in the field is considered the performance of services in that field. Reg. § 1.199A-5(c)(1)(i). For a trade or business with gross receipts of greater than \$25 million for the taxable year, a trade or business is not an SSTB if less than 5% of the gross receipts of the trade or business are attributable to the performance of services in an SSTB. Reg. § 1.199A-5(c)(1)(ii). The Final Regulations retain the *de minimis* rule, and the Preamble to the Final Regulations makes it clear that trades or businesses with gross income from a specified service activity in excess of the *de minimus* threshold are considered to be SSTBs (a “cliff” approach). However, the Final Regulations add an example demonstrating a situation in which a trade or business has income from a specified service activity in excess of the *de minimus* threshold but is able to demonstrate that the entity separately conducts another trade or business, so that the separate trade or business is **not** tainted by the SSTB conducted by the entity. See Reg. § 1.199A-5(c)(1)(iii)(B), Example 2.

[p] “Crack and Pack” Strategy. The IRS is aware that some taxpayers have contemplated a strategy to separate out parts of what otherwise would be an integrated SSTB, such as the administrative functions, in an attempt to qualify those separated parts for the § 199A deduction. The IRS felt that such a strategy was inconsistent with the purpose of § 199A. In a slight change from the Proposed Regulations, Final Reg. § 1.199A-5(c)(2) removes the eighty percent (80%) rule contained in the Proposed Regulations, and simply provides that if a trade or business provides property or services to an SSTB and there is fifty percent (50%) or more common ownership of such trades or businesses, the portion of the trade or business providing property or services to the fifty percent (50%) or more commonly-owned SSTB will be treated as a separate SSTB with respect to the related parties. For example, a dentist owns a dental practice and also owns an office building. The dentist rents half of the building to the dental practice and half the building to unrelated persons. Under these facts, the renting of half of the building to the dental practice would be treated as an SSTB. 50% or more common ownership includes direct or indirect ownership by related parties within the meaning of § 267(b) or § 707(b). The Final Regulations clarify that the anti-abuse rule contained in Reg. Section 1.199A-5(c)(2) only applies to those taxpayers who have fifty percent (50%) or more common ownership of each of the trades or businesses.

[q] Trade or Business Incidental to SSTB. The Proposed Regulations § 1.199A-5(c)(3) provided a rule that if a trade or business (that would not otherwise be treated as an SSTB) has 50% or more common ownership with an SSTB and shared expenses, including wages or overhead expenses with the SSTB, it is treated as incidental to an SSTB and, thus, as an SSTB, if the trade or business (that would normally not be an SSTB) represents no more than 5% of gross receipts of the combined business. As an example of this situation, the Proposed Regulations set forth a situation where a dermatologist provides medical services to patients through an LLC, and additionally sells skin care products to patients through the same LLC. The same employees and office space are used for the medical services and the sale of skin care products and the gross receipts with respect to the skin care product sales do not exceed 5% of the gross receipts of the LLC as a whole. Accordingly, the sale of skin care products is treated as incidental to the SSTB of performing services in the field of health and is treated as part of such SSTB. This rule was eliminated by the Final Regulations.

§1.12 Overall Limitation

In addition to the other limitations described above, the maximum amount of deduction available under new Section 199A (for all of a taxpayer's qualified trades or businesses) cannot exceed 20% of the excess of the taxpayer's taxable income less any capital gain for the taxable year.

Example #7: Taxable Income Limitation Applies. A is married and has \$100,000 of QBI. A has \$200,000 of long-term capital gains, \$30,000 of wages, and \$50,000 of itemized deductions, resulting in taxable income of \$280,000. A's deduction is limited to the lesser of:

4. *20% of QBI of \$100,000 = \$20,000; or*
5. *20% of (\$280,000 taxable income less \$200,000 of capital gain) = \$16,000.*

Additionally, it should be kept in mind that the overall limitation equal to twenty percent (20%) of the excess of the taxpayer's taxable income for the year over the sum of the taxpayer's net capital gain for the year, limits both the twenty percent (20%) "pass-through deduction" and the deduction equal to twenty percent (20%) of the taxpayer's qualified REIT dividends and publicly-traded partnership income for the year. In other words, after these two separate deductions are calculated, they are then added together and subjected to the overall limitation.

It should also be kept in mind that there are a number of items that may reduce a taxpayer's taxable income unrelated to QBI from a pass-through entity or sole proprietorship which can result in a reduction of the QBI deduction. One common example would be the standard deduction available to taxpayers.

§1.13 Aggregation Rules and Regulations Section 1.199A-4

Although a great number of practitioners argued that the grouping rules under § 469 should be adopted and applied in the § 199A context, the IRS felt that the § 469 grouping rules were not

appropriate for determining a trade or business for purposes of § 199A. Although finding that the grouping rules under § 469 were not appropriate to apply to § 199A, the IRS agreed with practitioners that some amount of aggregation should be permitted since it is not uncommon for what are commonly thought of as single trades or businesses to be operated across multiple entities. They are structured in this fashion for various legal, economic or other non-tax reasons. The IRS stated that allowing taxpayers to aggregate trades or businesses offer taxpayers a means of combining their trades or businesses for purposes of applying the W-2 Wage and UBIA of qualified property limitations and potentially maximizing the deduction under § 199A. Additionally, if such aggregation was not permitted, taxpayers could be forced to incur costs to restructure solely for tax purposes. Further, the IRS found that business and non-tax law requirements may not permit many taxpayers to restructure their operations, and as such, believed that the aggregation of separate trade or businesses, which meet certain requirements, should be allowed. Although it is generally beneficial for the taxpayer to aggregate trades or businesses where available, there are circumstances in which aggregation can be detrimental to the taxpayer. Thus, the practitioner must analyze the specific facts and circumstances to determine whether and how to aggregate trades or businesses if aggregation is available under Reg. § 1.199A-4.

[1] General Aggregation Rules.

Reg. § 1.199A-4(b)(1) provides that trades or business may be aggregated only if an individual can demonstrate that: (1) the same person or group of persons, directly or indirectly, owns 50% or more of each trade or business to be aggregated, meaning in the case of such trades or businesses owned by an “S” corporation, 50% or more of the issued and outstanding shares of stock of the corporation, or, in the case of such trades or businesses operated by a partnership, 50% or more of the capital or profits in the partnership (the ownership rule does not require that every person involved in the ownership determination own an interest in every trade or business, but rather, the rule is satisfied so long as one person or group of persons holds a fifty percent (50%) or more common ownership interest in each trade or business); (2) the ownership described in (1) above exists for a majority of the taxable year in which the items attributable to each trade or business to be aggregated are included in income (the Final Regulations clarify that the “majority of the taxable year” **must include the last day of the taxable year**); (3) all of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years; (4) none of the trades or businesses to be aggregated are an SSTB; and (5) the trades or businesses to be aggregated satisfy at least two of the following factors based on all the facts and circumstances: (a) the trades or businesses provide products and services that are the same or customarily offered together; (b) the trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; or (c) the trades or businesses are operated in coordination with, or in reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies). In response to a number of comments made with respect to the Proposed Regulations, the Final Regulations clarify that with respect to the first of the three factors (of which two factors must be met in order to aggregate), the trades or businesses need only to provide products, property, or services that are the same or customarily offered together. The Final Regulations also add examples clarifying when a real estate trade or business satisfies the aggregation rules.

[2] Operating Rules.

An individual may aggregate trades or businesses operated directly and the individual's share of QBI, W-2 Wages and UBIA of qualified property from trades or businesses operated through RPEs. Multiple owners of an RPE need not aggregate in the same manner. However, another significant change made by the Final Regulations allows aggregation to be made at the entity level rather than at the individual level. Accordingly, the Final Regulations permit an RPE to aggregate trades or businesses it operates directly or through lower-tier RPEs. The resulting aggregation must be reported by the RPE and by all owners of the RPE. In other words, the owners of an RPE are bound by the aggregation election made by the RPE. However, an individual or upper-tier RPE may aggregate additional trades or businesses with the lower-tier RPE's aggregation if such additional trades or businesses meet the requirements for aggregation. For those trades or businesses directly operated by the individual, the individual computes QBI, W-2 Wages and UBIA of qualified property for each trade or business before applying the aggregation rules. If an individual aggregates multiple trades or businesses, the individual must combine the QBI, W-2 Wages and UBIA of qualified property for all aggregated trades or businesses for purposes of applying the W-2 Wage and UBIA of qualified property limitations. Reg. § 1.199A-4(b)(2).

[3] Attribution Rules.

Under the Proposed Regulations, for purposes of determining ownership, an individual was considered as owning the interest in each trade or business owned, directly or indirectly, by or for the individual's spouse, and the individual's children, grandchildren, and parents (but not by the taxpayer's siblings). Prop. Reg. § 1.199A-4(b)(3). The Final Regulations replaced these limited family attribution rules with the broader attribution rules of Sections 267(b) and 707(b).

[4] Reporting and Consistency.

[a] General Rules. Once an individual chooses to aggregate two or more trades or businesses, the individual must consistently report the aggregated trades or businesses in all subsequent taxable years. An individual may, however, add a newly created or newly acquired trade or business to an existing aggregated trade or business if the aggregation rules are otherwise satisfied. If, in a subsequent year, there is a change in facts or circumstances such that an individual's prior aggregation of trades or businesses no longer qualifies for aggregation, then the trades or businesses will no longer be aggregated, and the individual must reapply the aggregation rules to determine a new permissible aggregation (if any). Reg. § 1.199A-4(c)(1).

[b] Individual Disclosure. For each taxable year, individuals must attach a statement to their returns identifying each trade or business aggregated under Reg. § 1.199A-4, and the statement must contain:

- [i] a description of each trade or business;
- [ii] the name and EIN of each entity in which a trade or business is operated;

[iii] information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed or during the taxable year; and

[iv] such other information as the IRS may require on forms, instructions or other published guidance.

If an individual fails to attach the statement required hereunder, the IRS may disaggregate the individual's trades or businesses. Reg. § 1.199A-4(c)(2). The Final Regulations clarify that the disaggregation is not permanent by providing that trades or businesses that are disaggregated by the IRS may not be re-aggregated for three (3) subsequent taxable years, similar to the typical period during which a tax return may be audited.

[c] Failure to Aggregate. The Final Regulations provide that a taxpayer's failure to aggregate trades or businesses will not be considered to be an aggregation under the aggregation rules, so that the taxpayer is **not** precluded from making an aggregation election later. Although the Final Regulations generally do not allow an initial aggregation election to be made on an amended return, because many individuals and RPEs were unaware of the aggregation rules when filing returns for the 2018 taxable year, the IRS will allow initial aggregations to be made on amended returns for the 2018 taxable year.

§1.14 **RPEs, PTPs, Trusts and Estates and Regulation Section 1.199A-6**

The Section 199A Regulations provide special rules for RPEs, PTPs, trusts and estates necessary for the computation of the § 199A deduction of their owners or beneficiaries.

[1] Computational and Reporting Rules for RPEs.

An RPE must determine and report information attributable to any trades or businesses it is engaged in necessary for the owners to determine their § 199A deduction. Specifically, under Reg. § 1.199A-6(b)(2), an RPE must determine the items necessary for individuals who own interests in the RPE to calculate their § 199A deduction as follows:

[a] First, the RPE must determine if it is engaged in one or more trades or businesses. The RPE must also determine whether any of its trades or businesses is an SSTB.

[b] Second, the RPE must apply the rules in Reg. § 1.199A-3 to determine the QBI for each trade or business engaged in directly.

[c] Third, the RPE must apply the rules in § 199A-2 to determine the W-2 Wages and UBIA of qualified property for each trade or business engaged in directly.

[d] Fourth, the RPE must determine whether it has any qualified REIT Dividends earned directly or through another RPE. The RPE must also determine the net amount of qualified PTP Income earned directly or indirectly through investments in PTPs.

[2] Reporting Rules for RPEs.

An RPE must separately identify and report on the Schedule K-1 issued to its owners for any trade or business engaged in directly by the RPE:

[a] each owner's allocable share of QBI, W-2 Wages and UBIA of qualified property attributable to each such trade or business; and

[b] whether any trades or businesses constitute an SSTB.

Additionally, an RPE must also report on an attachment to the Schedule K-1, any QBI, W-2 Wages, UBIA of qualified property, or SSTB determinations reported to it by any RPE in which the RPE owns a direct or indirect interest. The RPE must also report each owner's allocable share of any qualified REIT Dividends or Qualified PTP Income or loss received by the RPE (including through another RPE). If an RPE fails to separately identify or report on the Schedule K-1 (or any attachments thereto) issued to any owner any items described above, the owner's share (and the share of any upper-tier indirect owner) of positive QBI, W-2 Wages and UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero. Reg. § 1.199A-6(b)(3). The Final Regulations generally retain the rules relating to reporting of QBI, W-2 wages and UBIA of qualified property to the owners of an RPE, but modify the rule which provided that all of an RPE's items related to Section 199A are presumed to be zero because of a failure to report one item. Specifically, the Final Regulations revise the presumption to provide that if an RPE fails to separately identify and report an item of QBI, W-2 wages or UBIA of qualified property, the owner's share of each such unreported item of positive QBI, W-2 wages or UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero (rather than presuming all of these items to be zero).

[3] Computational and Reporting Rules for PTPs.

Each PTP must determine its QBI under the rules of Reg. § 1.199A-3 for each trade or business in which the PTP is engaged in directly. The PTP must also determine whether any of the trades or businesses it is engaged in directly is an SSTB. Additionally, each PTP is required to separately identify and report the information on Schedules K-1 issued to its partners. Each PTP must also determine and report any qualified REIT Dividends or Qualified PTP Income or loss received by the PTP including through an RPE, a REIT or another PTP. A PTP is not required to determine or report W-2 Wages or the UBIA of qualified property attributable to trades or businesses it is engaged in directly. Reg. § 1.199A-6(c).

[4] Application to Trusts, Estates and Beneficiaries.

[a] In General. A trust or estate computes its § 199A deduction based on the QBI, W-2 Wages, UBIA of qualified property, Qualified REIT Dividends, and Qualified PTP Income that are allocated to the trust or estate. An individual beneficiary of a trust or estate takes into account any QBI, W-2 Wages, UBIA of qualified property, Qualified REIT Dividends and Qualified PTP Income allocated from a trust or estate in calculating the beneficiary's § 199A deduction in the same manner as though the items had been allocated from an RPE. A trust or estate is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries, and is treated as an individual to the extent it retains the QBI and other items. Reg. § 1.199A-6(d)(1).

[b] Grantor Trust. To the extent that the grantor or other person is treated as owning all or a part of a trust under § 671 through § 679, such person computes its § 199A deduction as if that person directly conducted the activities of the trust with respect to the portion of the trust treated as owned by the grantor or another person. Reg. § 1.199A-6(d)(2).

[c] Non-Grantor Trusts and Estates. A trust or estate must calculate its QBI, W-2 Wages, UBIA of Qualified Property, Qualified REIT Dividends, and Qualified PTP Income. The QBI of a trust or estate must be computed by allocating qualified items of deduction described in § 199A(c)(3) in accordance with the classification of those deductions under Reg. § 1.652(b)-3(a), and deductions not directly attributable within the meaning of Reg. § 1.652(b)-3(b) are allocated in a manner consistent with the rules of Reg. § 1.652(b)-3(b). Any depletion and depreciation deductions described in § 642(e) and any amortization deductions described in § 642(f) that are otherwise properly included in the computation of QBI are included in the computation of QBI of the trust or estate, regardless of how those deductions may otherwise be allocated between the trust or estate and its beneficiaries for other purposes of the Code. Reg. § 1.199A-6(d)(3)(i).

[d] Allocation Among Trust or Estate and Beneficiaries. The QBI, W-2 Wages, UBIA of Qualified Property, Qualified REIT Dividends and Qualified PTP Income of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust or estate's distributable net income ("DNI") for the taxable year that it is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. The trust or estate's DNI is determined with regard to the separate share rule of § 663(c), but without regard to § 199A. If the trust or estate has no DNI for the taxable year, any QBI, W-2 Wages, UBIA of Qualified Property, Qualified REIT Dividends and Qualified PTP Income are allocated entirely to the trust or estate. Reg. § 1.199A-6(d)(3)(ii).

[e] Threshold Amount. The Threshold Amount applicable to a trust or estate is \$157,500 for any taxable year beginning before 2019. Thereafter, the Threshold Amount is \$157,500 increased by the cost of living adjusted provided in Reg. § 1.199A-1(b)(12). In a change from the Proposed Regulations, the Final Regulations specifically provide that for purposes of determining whether a trust or estate has taxable income that exceeds the Threshold Amount, the taxable income of the trust or estate is determined after taking into account any distribution deduction under Sections 651 or 661. Reg. § 1.199A-6(d)(3)(iv).

[f] Electing Small Business Trusts. Reg. § 1.199A-6(d)(3)(vi) provides that an electing small business trust ("ESBT") is entitled to the deduction under § 199A. The S portion of the ESBT must take into account the QBI and other items from any "S" corporation owned by the ESBT, the grantor portion of the ESBT must take into account the QBI and other items from any assets owned by a grantor or another person of a trust under § 671 through § 679, and the non-S portion of the ESBT must take into account any QBI and other items from any other entities or assets owned by the ESBT. The Final Regulations clarify that the S portion and non-S portion of an ESBT are treated as a single trust for determining applicable Threshold Amounts.

[g] Anti-Abuse Rule for Creation of a Trust to Avoid exceeding the Threshold Amount. Under Reg. § 1.199A-6(d)(3)(vii), a trust formed or funded with a principal purpose of avoiding, or using more than one, Threshold Amount for purposes of calculating the deduction

under Section 199A will not be respected as a separate trust entity for purposes of determining the Threshold Amount under Section 199A. The Final Regulations clarify that the anti-abuse rule is designed to thwart the creation of even one single trust with a significant purpose of avoiding, or using more than one, Threshold Amount. This should be contrasted with the anti-abuse rules set forth in Reg. § 1.643(f)-1(a), which only apply to multiple trusts.

§1.15 **Anti-Abuse Rules for Multiple Trusts**

[1] **General Rule.**

Reg. § 1.643(f)-1(a) provides that for purposes of Subchapter J, two or more trusts will be aggregated and treated as a single trust if such trust has substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of federal income tax. Spouses are treated as one person for this rule. In the Final Section 643(f) Regulations, the IRS removed the definition of “principal purpose” and the examples illustrating this rule that had been included in the Proposed Regulations.

The Preamble to the Final Regulations also provides that the IRS believes that the anti-abuse rules contained in Section 643(f) apply to any arrangement involving multiple trusts entered into or modified **prior** to the effective date of the Final Regulations.

§1.16 **Observations and Anomalies Created By Section 199A**

Clearly, the rules for the new deduction under Section 199A available to owners of S corporations, partnerships, LLCs and sole proprietorships are extremely complex (and certainly did not simplify the Code), especially where the taxpayer’s taxable income exceeds the threshold amounts (\$157,500 or \$315,000) discussed above. These new rules can result in different (and presumably unintended) results between S corporations, partnerships and sole proprietorships having the same amount of income, and thus may affect the taxpayer’s choice of entity decisions. These different results are primarily attributable to two factors.

[1] **Introduction.**

Because the Federal Insurance Contributions Act (“FICA”) and Federal Unemployment Tax Act (“FUTA”) taxes may be substantial, many shareholder-employees of S corporations have employed a strategy of decreasing the amount of wages that they receive from the S corporation and correspondingly increasing the amount of S corporation distributions made to them. One of the major advantages of operating as an S corporation rather than as a partnership (or LLC taxed as a partnership) is the ability to limit Social Security taxes or at least to have some clarity as to when and how Social Security taxes apply (as opposed to LLCs where the application of the self-employment tax to the members of an LLC is unclear at best.)

[a] **Social Security Taxes on Wages.** As part of FICA, a tax is imposed on employees and employers up to a prescribed maximum amount of employee wages. This tax is comprised of two parts, the Old-Age, Survivor, and Disability Insurance (OASDI) portion and the Medicare Hospital Insurance (HI) portion. The HI tax rate is 1.45% on both the employer and the

employee, and the OASDI tax rate is 6.2% on both the employer and the employee. The maximum wages subject to the OASDI tax rate is \$128,400 for 2018.

RRA '93 repealed the dollar limit on wages and self-employment income subject to the HI portion of the FICA tax as well as the self-employment tax. Thus, employers and employees will equally be subject to the 1.45% HI tax on *all* wages, and self-employed individuals will be subject to the 2.9% HI tax on *all* self-employment income.

Beginning in 2013, the HI portion of the Social Security tax increased from 2.9% (combined employer and employee) to 3.8% (combined employer and employee) for wages in excess of \$250,000 for married individuals filing jointly and in excess of \$200,000 for other taxpayers. Additionally, beginning in 2013, a taxpayer having modified adjusted gross income in excess of \$250,000 in the case of married individuals filing jointly and \$200,000 for other taxpayers is subject to the 3.8% net investment income tax.

[b] Health Care and Education Reconciliation Act of 2010. The Health Care and Education Reconciliation Act of 2010,¹⁴ imposes a tax on unearned income on partners, members of LLCs taxed as partnerships and S corporation shareholders. Specifically, Section 1411(a)(1) imposes a 3.8% tax on the lesser of (a) “net investment income” or (b) the excess of modified adjusted gross income over \$250,000 in the case of taxpayers filing a joint return and over \$200,000 for other taxpayers.¹⁵ Under Section 1411(c)(A)(i), “net investment income” includes gross income from interest, dividends, annuities, royalties, and rents other than such income which is derived in the ordinary course of a trade or business.¹⁶ Consequently, items of interest, dividends, annuities, royalties, and rents which pass through a partnership, LLC or S corporation to its partners, members or shareholders, will retain their character as net investment income and will be subject to the 3.8% tax on net investment income.

Additionally, the term “net investment income” includes: (1) any other gross income derived from a trade or business if such trade or business is a passive activity within the meaning of Section 469, with respect to the taxpayer; and (2) any net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business that is not a passive activity under Section 469 with respect to the taxpayer.

The Health Care and Education Reconciliation Act of 2010 also increased the Medicare portion of the FICA tax by .9% (to 3.8%) on wages in excess of \$250,000 in the case of taxpayers filing a joint return and more than \$200,000 for other taxpayers, as well as the Medicare portion of the self-employment tax by .9% (to 3.8%) on earnings from self-employment in excess of \$250,000 in the case of taxpayers filing a joint return and more than \$200,000 for other taxpayers.

These tax provisions are effective for tax years beginning after January 31, 2012.

¹⁴ Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.

¹⁵ *Id.* at sec. 1402, § 1411, 124 Stat. at 1061.

¹⁶ *Id.*

[c] Social Security Taxes and S Corporations. In order for shareholder-employees of S corporations to realize employment tax savings by withdrawing funds in the form of distributions rather than compensation, such distributions must not be recharacterized as “wages” for FICA purposes or as NESE for purposes of the SE Tax. For FICA and FUTA purposes, Sections 3121(a) and 3306(b), respectively, define the term “wages” to mean all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions.

Although it might appear at first glance that a shareholder’s distributive share of income from an S corporation constitutes NESE since a general partner’s distributive share of the income of any trade or business carried on by a partnership of which he is a member generally constitutes NESE subject to the SE Tax, in Rev. Rul. 59-221, the IRS found that an S corporation’s income does not constitute NESE for purposes of the SE Tax.¹⁷ Additionally, Section 1402(a)(2) specifically excludes from the definition of NESE dividends on shares of stock issued by a corporation.¹⁸

Consequently, neither a shareholder’s distributive share of income passed through from the S corporation under Section 1366 nor any S corporation distributions actually received by the shareholder from the S corporation constitute NESE subject to the SE Tax. In Rev. Rul. 66-327, the IRS found that the taxable income of an S corporation included in its shareholders’ gross income is not income derived from a trade or business for purposes of computing the shareholders’ net operating losses under Section 172(c).¹⁹ Similarly in PLR 8716060, the IRS concluded that the income derived by a shareholder-employee from an S corporation did not constitute net earnings from self-employment for self-employment tax purposes and that such taxpayer was not eligible to adopt a qualified pension plan based on the income derived from his S corporation since such income did not constitute earned income.²⁰

Because wages paid to shareholder-employees of S corporations are subject to Social Security taxes while S corporation distributions are not, shareholder-employees have an opportunity for significant tax savings by withdrawing funds from the S corporation in the form of distributions rather than wages. Prior to advising an S corporation with shareholder-employees to undertake such a tax planning strategy, however, the tax practitioner should analyze the economic and tax consequences that such a strategy will have on the S corporation and its shareholders.²¹

Although the amount of funds available for distribution to an S corporation’s shareholder-employees will increase as the wages paid to them decrease, all distributions made by

¹⁷ Rev. Rul. 59-221, 1959-1 C.B. 225.

¹⁸ Section 1402.

¹⁹ Rev. Rul. 66-327, 1966-2 C.B. 357.

²⁰ PLR 8716060 (Jan. 21, 1987).

²¹ See generally Stephen Looney & Ronald Levitt, “Reasonable Compensation Issues for Closely-held and Service Companies,” 61st N.Y.U. Ann. Inst. Fed. Tax’n 16 (2003); Looney & Comiter, “Reasonable Compensation: Dividends vs. Wages - A Reverse in Positions,” 7 J. Partnership Tax’n 364 (Winter 1991); Clements & Streer, “How Low Can Owner-Employee Compensation be Set to Save on Employment Taxes?” 2 J. S. Corp. Tax’n 37 (1990); Andrews, “Current Non-Stock Executive Compensation and Fringe Benefit Issues,” 1 S. Corp.: J. Tax, Leg. & Bus. Strategies 3 (1989); Spradling, “Are S Corp. Distributions Wages Subject to Withholding?” 71 J. Tax’n 104 (Aug. 1989).

the S corporation to its shareholders must be made in proportion to the number of shares held by such shareholders under Section 1361(b)(1)(D). Thus, if an S corporation which has both shareholders who are employees and shareholders who are not employees adopts a tax strategy to reduce Social Security taxes by minimizing wages and maximizing distributions, the increase in the amount of distributions received by the shareholders who are employees will be less than the amount by which their wages were reduced (since distributions must also be made to the shareholders who are not employees). Additionally, a program that minimizes the amount of wages paid to shareholder-employees will increase: (1) purchase price formulas based on earnings; and (2) bonus formulas based on earnings. Decreasing the amount of wages paid to shareholder-employees of S corporations also will reduce the contribution base for contributions to the corporation's qualified plans.

[2] S Corporations and Unreasonably Low Compensation - Reclassification Risks.

In Rev. Rul. 74-44, two shareholders of an S corporation withdrew *no salary* from the corporation and arranged for the corporation to pay them dividends equal to the amount that they would have otherwise received as reasonable compensation for services performed.²² This arrangement was made for the express purpose of avoiding payment of federal employment taxes. Based on the expansive definition of wages for FICA and Federal Unemployment Tax Act (“FUTA”) purposes (which includes all remuneration for employment), the IRS found that the dividends paid to the shareholders constituted wages for FICA and FUTA purposes. Rev. Rul. 74-44 did not, however, address the issue of what constitutes reasonable compensation in the S corporation context since the ruling expressly stated that the dividends were received by the shareholder-employees in lieu of the reasonable compensation that would have otherwise been paid to them. Despite this shortcoming, Rev. Rul. 74-44 clearly indicates that the payment of *no* compensation will be unreasonable where shareholder-employees provide substantial services to the corporation.²³

[a] In *Radtke v. United States*,²⁴ the court recharacterized distributions made to the sole shareholder (an attorney) of an S corporation (a law firm) as wages subject to FICA and FUTA taxes, where the shareholder made all of his withdrawals from the S corporation in the form of S corporation distributions and received no salary from the S corporation during the tax year. The court relied on a broad definition of wages for FICA and FUTA purposes as all remuneration for employment, and concluded that the dividend payments were remuneration for services performed by the shareholder for the S corporation. Likewise, in *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990), the court recharacterized dividend distributions made to a shareholder (an accountant) of an S corporation (an accounting firm) as wages subject to FICA and FUTA taxes where the shareholder received no salary during the tax year.

²² Rev. Rul. 74-44, 1974-1 C.B. 287.

²³ See also Rev. Rul. 71-86, 1971-1 C.B. 285 (president and sole shareholder of closely-held corporation found to be an “employee” of the corporation for employment tax purposes); Rev. Rul. 73-361, 1973-2 C.B. 331 (officer-shareholder of an S corporation who performed substantial services as an officer of the S corporation is an “employee” of the corporation for purposes of FICA, FUTA and income tax withholding); PLR 7949022 (Aug. 31, 1979) (shareholder-employees of S corporation who perform substantial services for S corporation treated as “employees” for employment tax purposes).

²⁴ *Radtke v. United States*, 895 F.2d 1196 (7th Cir. 1990).

[b] Additionally, in *Esser, P.C. v. United States*,²⁵ the court recharacterized amounts received by the sole shareholder, officer and director of a legal services S corporation, as wages subject to FICA and FUTA taxes, rather than as distributions. As in the *Radtke* and *Spicer Accounting* cases, the shareholder received **no salary** from the S corporation during the tax year.

[c] In *Cave v. Commissioner*,²⁶ the court held that all of the non-shareholder attorneys, as well as a law clerk, of a law firm were common law employees rather than independent contractors, and also recharacterized the distributions made to the sole shareholder of the law firm, who was determined to be a statutory employee, as wages subject to Social Security taxes.

[d] In *Watson P.C. v. United States*,²⁷ the Eighth Circuit Court of Appeals affirmed the decision of the district court recharacterizing a significant portion of dividend distributions made by an S corporation to its sole shareholder as wages subject to Social Security taxes.

During the years in issue, 2002 and 2003, David E. Watson, CPA (“Watson”), provided accounting services to a partnership (“LWBJ”) and its clients as an employee of David E. Watson P.C., an S corporation (the “S Corporation”). The S Corporation was a 25% partner in LWBJ. The IRS made assessments against Watson after it determined that portions of the dividend distributions from the S Corporation to Watson should be recharacterized as wages subject to employment taxes. Specifically, the IRS contended that \$130,730.05 out of a total of \$203,651 of dividend payments to Watson for 2002 should be recharacterized as wages subject to employment taxes, and that \$175,470 out of a total of \$203,651 of dividend payments to Watson for 2003 should be recharacterized as wages subject to employment taxes. In both years, Watson received a salary of \$24,000 in addition to the dividend distributions.

In his Motion for Summary Judgment, Watson argued that the intent of the S Corporation was controlling in determining the characterization of the payments from the S Corporation to Watson. Because the S Corporation clearly intended to pay Watson compensation of only \$24,000 per year, Watson contended that any amounts distributed in excess of the \$24,000 were properly classified as dividends. In support of his position, Watson cited *Electric & Neon, Inc. v. Commissioner*, *Paula Constr. Co. v. Commissioner*, and *Pediatric Surgical Associates, P.C. v. Commissioner*.²⁸

Citing Rev. Rul. 74-44, *Radtke*, *Spicer Accounting* and *Veterinary Surgical Consultants*, the district court found that the intent of the S Corporation was not controlling in determining the character of the payments, but rather that the analysis turns on whether the payments at issue were made as remuneration for services performed.²⁹ Consequently, the court

²⁵ *Esser, P.C. v. United States*, 750 F. Supp. 421 (D. Ariz. 1990).

²⁶ *Cave v. Commissioner*, 476 F. App'x 424 (5th Cir. 2012), *aff'g per curiam*, T.C. Memo 2011-48.

²⁷ *Watson P.C. v. United States*, 668 F.3d 1008 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010).

²⁸ *Electric & Neon Inc. v. Commissioner*, 56 T.C. 1324 (1971); *Paula Constr. Co. v. Commissioner*, 58 T.C. 1055 (1972); *Pediatric Surgical Assocs. v. Commissioner*, T.C. Memo 2001-81.

²⁹ Citing *Radtke v. United States*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting v. United States*, 918 F.2d 90 (9th Cir. 1990); *Veterinary Surgical Consultants v. Commissioner*, 117 T.C. 141 (2001), *aff'd sub nom.*, *Yeagle Drywall Co. v. Commissioner*, 54 F. App'x 100 (2nd Cir. 2002); Rev. Rul. 74-44, 1974-1 CB 287.

denied Watson's Motion for Summary Judgment because it found that there was a genuine issue of material fact as to whether the dividends paid to Watson by the S Corporation were remuneration for services performed subject to employment taxes.

After denying the taxpayer's Motion for Summary Judgment, the district court held a bench trial on the merits. At trial, the government's expert opined that the market value of Watson's accounting services was approximately \$91,044 per year for 2002 and 2003. The government's expert was a general engineer with the IRS and had worked on approximately 20 to 30 cases involving reasonable compensation issues. In forming his opinion as to Watson's salary, the government's expert relied on several compensation surveys and studies particularly relating to accountants. The district court ultimately adopted the government expert witness's opinion and determined that the reasonable amount of Watson's remuneration for services performed totaled \$91,044 for each of 2002 and 2003.

In addition to determining the issues of what constituted reasonable compensation to the sole shareholder of the S corporation and whether intent was the determinative factor in determining whether payments from an S corporation to its sole shareholder should be characterized as wages or as dividend distributions, the court first addressed the taxpayer's argument that the district court erred in allowing the government's expert to testify on the issue of reasonable compensation because he was not competent to testify on that issue. Specifically, the taxpayer asserted that the government's expert witness was not qualified, changed his opinion, relied on insufficient underlying facts, and used flawed methods in rendering his opinion. After reviewing all of these factors in detail, the court of appeals determined that the district court did not abuse its discretion in admitting the testimony of the government's expert witness, and found the taxpayer's arguments meritless.

In reaching its decision, the Eighth Circuit cited Rev. Rul. 74-44, *Radtke, Spicer Accounting* and *Veterinary Surgical Consultants* cases (discussed above), and concluded that the district court properly determined that the characterization of funds disbursed by an S corporation to its shareholders turns on an analysis of whether the payments at issue were made as remuneration for services performed.³⁰ The court went on to state that the district court found that the S corporation understated wage payments to its sole shareholder by \$67,044 in each year based on a variety of factors. These factors included the following evidence: (1) Watson was an exceedingly qualified accountant with an advanced degree and nearly 20 years in accounting and taxation; (2) Watson worked 35-45 hours per week as one of the primary earners in a reputable firm, which had earnings much greater than comparable firms; (3) the partnership had gross earnings of over \$2M in 2002 and nearly \$3M in 2003; (4) \$24,000 is unreasonably low compared to other similarly situated accountants; (5) given the financial position of the partnership, Watson's experience and his contributions to the partnership, a \$24,000 salary was exceedingly low when compared to the roughly \$200,000 the partnership distributed to Watson's S corporation in 2002 and 2003; and (6) the fair market value of Watson's services was \$91,034.

The Eighth Circuit next addressed the taxpayer's argument that instead of focusing on reasonableness, the district court should have focused on the S corporation's intent. While acknowledging that Section 162(a)(1) provides that the deductibility of compensation is a two

³⁰ *Id.*

prong test in that the compensation must both be reasonable in amount and in fact payments purely for services, the court, citing *Elliotts, Inc. v. Commissioner*,³¹ stated that courts usually only need to examine the first prong since the reasonableness prong generally subsumes the inquiry into compensatory intent in most cases. The court did state however, that in certain rare cases where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness.

In the case, the taxpayer cited *Pediatric Surgical Associates* in support of his position that taxpayer intent controls in FICA tax characterization cases. The Eighth Circuit found that even if intent does control, after evaluating all the evidence, the district court specifically found that the shareholder's assertion that the S corporation intended to pay him a salary of only \$24,000 a year to be less than credible. Additionally, the Eighth Circuit Court of Appeals went on to reject the argument made by the taxpayer that *Pediatric Surgical Associates* limited the amount that could be characterized as wages to the amount of revenue each shareholder-employee personally generated less expenses since, like *Pediatric Surgical Associates*, nonshareholder-employees also contributed to the S corporation's earnings. The Eighth Circuit Court of Appeals brushed this argument aside by saying that although they thought evidence of shareholder-employee billings and collections may be probative on the issue of compensation, in light of all the evidence presented to the district court in the case, they saw no error and affirmed the decision of the district court.

[e] In *Herbert v. Commissioner*,³² the Tax Court recharacterized a portion of the amounts the taxpayer claimed were used to pay business expenses as wages subject to Social Security taxes, finding the taxpayer's salary was unreasonably low. However, the Tax Court expressly rejected the IRS's contention that the taxpayer's salary be increased by \$52,600, primarily based on the salary paid by the S corporation to the shareholder in a prior year in which the business was not owned by the taxpayer.

In reaching this decision, the Tax Court believed and accepted the taxpayer's testimony that the taxpayer in fact paid significant expenses of the corporation with cash funds received from the corporation. Additionally, the court found that in spite of limited evidence before them, they believed that it was improper and excessive to charge the taxpayer with receipt from the corporation in 2007 of \$52,600 in additional wages. On the other hand, the court stated that the taxpayer's reported wages of \$2,400 was unreasonably low.

Consequently, citing *Mayson Mfg. Co. v. Commissioner*,³³ the Tax Court averaged the taxpayer's wages for 2002 through 2006, and used the average amount as the total for the taxpayer's 2007 wages subject to employment taxes (\$30,445).

[f] In *Sean McClary Ltd., Inc. v. Commissioner*,³⁴ the Tax Court recharacterized the distributions made by an S corporation to its sole shareholder as wages subject to Social Security taxes where the shareholder received no salary from the S corporation and also found that

³¹ *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983), rev'g T.C. Memo 1980-282.

³² *Herbert v. Commissioner*, T.C. Summ. Op. 2012-124.

³³ *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949).

³⁴ *Sean McClary Ltd., Inc. v. Commissioner*, T.C. Summ. Op. 2013-62.

the annual compensation formula contained in the Board of Directors minutes setting a salary of \$24,000 was unreasonably low.

Mr. McClary was the president, secretary, treasurer, sole director and sole shareholder of his S corporation. He managed all aspects of the S corporation's operations, including recruiting and supervising sales agents, conducting real estate sales, procuring advertising, purchasing supplies, and maintaining basic books and records, Mr. McClary often worked 12-hour days with few days off. For the year in issue, Mr. McClary supervised eight sales agents, four of whom generated sales commissions for the S corporation that year, but most of the S corporation's gross receipts were attributable to sales commissions generated by Mr. McClary himself.

For the year in issue, the S corporation did not issue a form W-2, Wage and Tax Statement, to Mr. McClary, nor did it claim a deduction for the amount paid to Mr. McClary as wages or compensation for services. During such year, Mr. McClary transferred a total of \$240,000 from the S corporation's account to his personal account.

In determining what portion of the \$240,000 of distributions should be recharacterized as wages, the IRS's expert witness found that \$100,755 represented reasonable compensation for services rendered by Mr. McClary for the year in issue. On the other hand, Mr. McClary argued that even though he did not pay himself a salary, the salary of \$24,000 set forth in the compensation arrangement in the corporation's minutes should be the only amount characterized as wages subject to Social Security taxes.

The Tax Court, citing the multi-factor test used in determining reasonable compensation for shareholder employees of C corporations, found that reasonable compensation for Mr. McClary's services during the year in issue was \$83,200, and as such, recharacterized \$83,200 of the \$240,000 distributed by the S corporation to Mr. McClary as wages subject to Social Security taxes.

[g] In *Glass Blocks Unlimited v. Commissioner*,³⁵ the Tax Court recharacterized the total distributions made by an S corporation to its president, sole shareholder and only full-time employee, of \$30,844 in 2007 and \$31,644 in 2008, as wages subject to Social Security taxes.

Citing *Veterinary Surgical Consultants P.C. v. Commissioner*,³⁶ an officer who performs more than minor services for a corporation and receives remuneration in any form for those services is considered an employee, and his or her wages are subject to the employer's payment of federal employment taxes. The court went on to find that the taxpayer was the S corporation's only officer, and sole full-time worker in 2007 and 2008 and performed substantially all the work necessary to operate the business.

³⁵ *Glass Blocks Unlimited v. Commissioner*, T.C. Memo 2013-180.

³⁶ *Veterinary Surgical Consultants P.C. v. Commissioner*, 117 T.C. 141 (2001), *aff'd sub. nom.*, *Yeagle Drywall Co. v. Commissioner*, 54 F. App'x 100 (2nd Cir. 2002).

The Tax Court went on to reject the taxpayer's argument that the distributions constituted repayment of shareholder loans, and the taxpayer's argument that the characterization of all distributions from the S corporation to him as wages constituted unreasonably high compensation to him, citing the multi-factor test used in *Elliotts, Inc. v. Commissioner*.³⁷ Consequently, the Tax Court found that the total amount of distributions made by the S corporation to its sole shareholder constituted wages subject to Social Security taxes for the years in issue.

[h] The *Watson* case, the *Herbert* case and the *McClary* case are the first reported decisions in which the court was presented with a situation which was not clearly abusive such as those presented in *Radtke* and *Spicer Accounting* (i.e., where **all** of the earnings of the S corporations were paid to the sole shareholder as dividend distributions and no salary was paid to the shareholder by the S corporation). The *Watson*, *Herbert*, and *McClary* cases likewise involve situations where only a portion of amounts not treated as wages are recharacterized as wages subject to Social Security taxes, **and each involves different methods in determining what constitutes "reasonable compensation" to the shareholder-employees of an S corporation**. Consequently, the *Watson*, *Herbert* and *McClary* decisions represent important victories for the IRS in being able to recharacterize dividend distributions as wages where at least some (but less than a reasonable) salary has been paid to the shareholder-employees of the S corporation. On the other hand, these cases can be viewed as favorable to taxpayers as they allowed personal service S corporations to distribute significant amounts of their income **without** being subject to Social Security taxes. However, the *Watson* case is somewhat troubling in its rejection of the decision reached in the *Pediatric Surgical Associates, P.C.* case (in which the IRS sought to recharacterize wages of a C corporation as dividend distributions rather than vice versa), in that the court did not seem to take into account the fact that dividend distributions can indeed be generated by the services of nonshareholder-employees of an S corporation or from other ancillary services not provided by the shareholder-employees of the S corporation.

[i] The *Radtke*, *Spicer Accounting* and *Esser* cases indicate that in **abusive situations**, such as **where the shareholders** of an S corporation make all withdrawals from the S corporation in the form of S corporation distributions and **receive no salary from the S corporation** during the tax year, the courts can and will recharacterize such distributions as wages subject to Social Security taxes. These earlier cases have been followed in more recent cases.³⁸

In non-abusive situations, however, the IRS may have difficulty in successfully asserting that distributions made by S corporations to shareholder-employees should be recharacterized as wages subject to Social Security taxes. In order for the IRS to recharacterize S corporation distributions as wages subject to Social Security taxes in non-abusive situations, the IRS would have to overcome: (i) the lack of express authority for its position (unlike the express authority granted to the IRS under Section 1366(e) to recharacterize dividend distributions as wages in the family context); (ii) the burden of overcoming the initial characterization of the

³⁷ *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983) rev'g T.C. Memo 1980-282.

³⁸ See *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 14 (2001); *Van Camp & Brennon v. United States*, 251 F.3d 862 (9th Cir. 2001); *Olde Raleigh Realty Corp. v. Commissioner*, T.C. Summ. Op. 2002-61; *David E. Watson P.C. v. United States*, 668 F.3d 1008 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010); *Herbert v. Commissioner*, T.C. Summ. Op. 2012-124; *Sean McClary Ltd., Inc. v. Commissioner*, T.C. Summ. Op. 2013-62; *Glass Blocks Unltd. v. Commissioner*, T.C. Memo 2013-180.

payment as a distribution; and (iii) the uncertainty surrounding the utilization of Section 162(a)(1) by the IRS in the employment context to bring salaries *up* to a reasonable level.

The key is obviously determining what is an abusive situation versus a non-abusive situation regarding reasonable compensation in the S corporation context. In IRS Fact Sheet 2008-25, August, 2012, the IRS provides that although there is no “bright line” test for determining what constitutes “reasonable compensation” to S corporation shareholder-employees, a multi-factor type analysis similar to the factors set forth in *Mayson Manufacturing Co.* should be used.³⁹ In *Herbert*, the court expressly stated that it was applying a multi-factor test to determine reasonable compensation, but actually used an average salary approach in determining the reasonable compensation of the shareholder-employee. The court in the *Watson* case relied on expert witness testimony as to the reasonableness of compensation, and in the *McClary* and *Glass Blocks* cases, the court cited that the multi-factor test was being used to determine the reasonableness of compensation without going into an in-depth analysis of those factors in such cases. In any event, it would seem absolutely inappropriate to apply the independent investor test to determine the reasonableness of compensation in the S corporation context, as that would result in all of the amounts being received by the shareholder-employees of an S corporation being characterized as wages other than the amounts determined to be a reasonable rate of return payable to the hypothetical independent investor.

[j] In IRS Fact Sheet FS-2008-25, the IRS clarified information that small business taxpayers should understand regarding the tax law for corporate officers who perform services for S corporations.⁴⁰ In the Fact Sheet, the IRS points out that just because an officer is also a shareholder of the S corporation, it does not change the requirement that payments to the corporate officer must be treated as wages, and that courts have consistently held that S corporation officer-shareholders who provide more than minor services to the corporation and who receive or are entitled to receive payments are employees whose compensation is subject to federal employment taxes.

The Fact Sheet goes on to discuss that although there are no “bright line” tests for determining what constitutes “reasonable compensation” to S corporation officer-shareholders, the following factors have been considered by the courts in determining reasonable compensation:

- Training and experience.
- Duties and responsibilities.
- Time and effort devoted to the business.
- Dividend history.
- Payments to non-shareholder employees.
- Timing and manner of paying bonuses to key people.
- What comparable business pay for similar services.

³⁹ IRS, FS-2008-25, “Wage Compensation for S Corporation Officers” (August 2008), <http://www.irs.gov/uac/Wage-Compensation-for-S-Corporation-Officers> (last updated Aug. 18, 2012).

⁴⁰ *Id.*

- Compensation agreements.
- The use of a formula to determine compensation.

Consequently, in non-abusive situations, a tax strategy of decreasing wages and correspondingly increasing distributions to shareholder-employees could result in substantial employment tax savings. As a result of this tax planning technique, the IRS, the Joint Committee on Taxation, the Department of Treasury, Congress and the press have issued reports and notices, introduced legislation and issued comments addressing the use of S corporations as a means of avoiding the self-employment tax.

[k] In PMTA 2017-005⁴¹, the IRS determined that the Tax Court does not have jurisdiction under Section 7436 to review a determination that a corporation is liable for additional employment taxes due to the IRS' recharacterization of payments made to, or on behalf of, corporate officers who were treated as employees.

In a number of prior cases⁴², the Tax Court has addressed the issue of whether an S corporation has paid unreasonably low compensation to its shareholder-employees so that it may reclassify distributions made by the S corporation to its shareholder-employees as wages subject to Social Security Taxes. In none of these prior cases has the IRS ever raised the issue that the Tax Court did not have jurisdiction over the case.

Section 7436(a) provides the Tax Court with jurisdiction to review certain employment tax determinations made by the IRS and the proper amount of employment tax under such determinations. Specifically, the Tax Court has jurisdiction to review determinations that (1) individuals are employees for purposes of employment taxes under Subtitle C of the Code (i.e., requiring reclassification of a non-employee to employee status); or (2) the person for whom services are performed is not entitled to relief under Section 530.

In PMTA 2017-005, the IRS reasoned that the dispute in issue was limited to the correct amount of payments required to be treated as “wages” for employment tax purposes, as opposed to a dispute as to whether the corporate officers were employees of the taxpayer under Section 3121(d)(1). Additionally, the IRS found that there was no dispute concerning entitlement to Section 530 relief. The Tax Court has previously held that it had jurisdiction with respect to an employment status controversy when four required elements are present: (1) an examination in connection with the audit of any person; (2) a determination by the IRS that “one or more individuals performing services for such person are employees of such person for purposes of subtitle C, or such person is not entitled to the treatment under subsection (a) of Section 530 of the Revenue Act of 1978 with respect to such individual”; (3) “an actual controversy” involving the determination as part of the examination; and (4) the filing of an appropriate pleading in the Tax Court.⁴³

⁴¹ March 30, 2017.

⁴² See *Radtke v. United States*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990); *Esser, P.C. v. United States*, 750 F. Supp. 421 (D Ariz 1990); *Watson P.C. v. United States*, 668 F.3d 1008 (8th Cir. 2012); *Herbert v. Commissioner.*, T.C. Summ. Op. 2012-124; *Sean McClary Ltd., Inc. v. Commissioner*, T.C. Summ. Op. 2013-62; and *Glass Blocks Unlimited v. Commissioner*, T.C. Memo 2013-180.

⁴³ *American Airlines, Inc. v. Comm'r*, 144 T.C. 24 (2015).

Consequently, the IRS concluded that because it was not making a determination regarding the employment status of the corporate officers when it recharacterized certain payments as wages that were not treated as wages but rather as distributions from the S corporation, and was also not making a determination with respect to entitlement to Section 530 relief, the Tax Court lacked jurisdiction to determine the correct amount of employment taxes due as a result of the employment tax assessment under Section 6201 on the additional wages.

The IRS went on to state that the position taken in PMTA 2017-005 was consistent with two recent Tax Court Orders. First, the IRS cited *Martin S. Azarian P.A. v. Comm'r*⁴⁴, where the taxpayer, an S corporation treated its sole owner and officer, Mr. Azarian, as an employee during the taxable periods at issue and reported wages paid to Mr. Azarian on forms W-2. The IRS sent the taxpayer Forms 4668, Employment Tax Examination Changes Report, which (1) concluded that the taxpayer failed to report reusable compensation paid to Mr. Azarian for the taxable periods in issue; (2) proposed increased annual wages to Mr. Azarian for those periods; and (3) concluded that taxpayer was liable for proposed employment tax increases and addition to taxes.

The taxpayer filed a petition requesting the Tax Court to overturn respondent's findings and the IRS filed a Motion to Dismiss for Lack of Jurisdiction on the grounds that (1) no Notice of Determination of Worker Classification was sent to the taxpayer, and (2) no other determination was made by the IRS which conferred jurisdiction on the Court. On February 21, 2017, the Tax Court issued an Order dismissing the case for lack of jurisdiction finding that the IRS did not make a determination under Section 7436(a)(2) regarding whether the taxpayer was entitled to relief under Section 530, and that since Mr. Azarian was treated as an employee for the taxable years in issue, the IRS did not make a determination that Mr. Azarian was an employee of the S corporation under Section 7436(a)(1). The Court stated that Section 7436(a)(1) only confers jurisdiction upon the Tax Court to determine the [“]correct and the proper amount of employment tax[“] when respondent makes a worker classification determination, not when respondent concludes that petitioner underreported reasonable wage compensation, as is the case here.”

Similarly, in *Patricia Arroyo, DDS Corp, Alex Mansilla and Mercedes P. Arroyo v. Comm'r*⁴⁵, the Tax Court dismissed the case with respect to Patricia Arroyo, DDS, Corp for lack of jurisdiction finding that the IRS had not made any determinations for purposes of Section 7436. Again, the IRS determined that the amounts treated as salaries paid to the corporate officers and reported on Form W-2 as wages were artificially low, recharacterized higher amounts as salaries, and thus as wages, and assessed additional employment taxes. On February 23, 2017, the Tax Court issued an Order dismissing the case for lack of jurisdiction stating that the taxpayer consistently treated the corporate officers as employees and contested only the IRS' determination that the compensation paid to the corporate officers was inadequate. Again, the Tax Court stated that because the IRS did not make a determination with respect to either of the two requisite matters specified in Section 7436(a)(1) or (2), the Court lacked jurisdiction to determine the correct amount

⁴⁴ Docket No. 28957-15, which was subsequently affirmed by the Eighth Circuit Court of Appeals (___ F3d __ (8th Cir. 2018), 122 AFTR2d 2018-5279).

⁴⁵ Docket No. 5874-15.

of employment taxes due as a result of the IRS' determination that the S corporation underreported the corporate officer's wages during the tax years at issue.

[l] In ILM 201735021, the IRS reaffirmed its position set forth in PMTA 2017-005, ruling that an employment tax audit of a business did not involve a worker classification issue related to payments made to a corporate officer, finding that the business treated the officer as an employee by withholding taxes from wages paid directly to the officer or through a professional employer organization (PEO).

The business was selected for an employment tax audit, and the IRS determined that wages paid to the corporate officer were unreasonably low. The IRS proposed recharacterizing portions of the distributions made by the business directly to the officer as wages and assessing additional employment taxes.

The position taken in ILM 201735021, that the audit of the S corporation taxable periods and taxable year does not involve worker classification, is consistent with the Tax Court's decision in *Martin S. Azarian P.A. v. Comm'r* (which was affirmed by the Eighth Circuit Court of Appeals), and the Tax Court's dismissal of the case for lack of jurisdiction in *Patricia Arroyo, DDS Corp, Alex Mansilla and Mercedes P. Arroyo v. Comm'r* (both of which were also cited in PMTA 2017-005). The IRS went on to state that these cases were dismissed by the Tax Court for lack of jurisdiction on the basis the IRS had not made any determinations for purposes of Section 7436 when the corporations treated the officers as employees by issuing them a Form W-2 reporting wages and did not claim entitlement to Section 530 relief. The Court stated that Section 7436 only confers jurisdiction on the court to determine the correct amount of employment tax when the IRS makes a worker classification determination or a determination that a taxpayer was not entitled to Section 530 relief, not when the IRS concludes that a taxpayer underreported reasonable wage compensation.

[m] If PMTA 2017-005 and ILM 201735021 are followed by the Tax Court, which they undoubtedly will in light of the Eighth Circuit's affirmation of the Tax Court's order of dismissal in the *Azarian* case discussed above, where the IRS recharacterizes a portion of the distributions made by an S corporation to its shareholder-employees as wages subject to social security taxes, taxpayers will have no choice but to pay the tax and file in District Court for a tax refund, putting taxpayers at a significant procedural and economic disadvantage in such cases. It is interesting to note that PMTA 2017-005 and ILM 201735021, as well as the two cases cited in those memorandums, seem contrary to a number of decisions previously issued by the Tax Court on the reclassification of distributions as wages where the IRS contended that the S corporation paid unreasonably low compensation to its shareholder-employees and where the Tax Court never questioned its jurisdiction in such matters.⁴⁶ Requiring taxpayers to pay the alleged tax and file for refund in District Court would result in the IRS having a substantial advantage in S corporation reclassification cases, and if followed, Congress should take action to grant the Tax Court expanded jurisdiction under Section 7436 so that it has jurisdiction to determine employment tax disputes where the issue is limited to the correct amount of payments required to be treated as "wages" for employment tax purposes.

⁴⁶ See note 32, *supra*.

[3] W-2 Wages Cannot be Paid to Partners of a Partnership or Sole Proprietors.

As mentioned above, unlike S corporations which pay W-2 wages to their shareholder-employees, W-2 wages cannot be paid to a partner of a partnership or to a sole proprietor, which can be a disadvantage where the business has no outside employees resulting in the wage limitation being equal to zero, or can be an advantage where the taxable income of the owners is below the threshold since there is no requirement for partnerships or sole proprietorship to make reasonable compensation payments to their owners.

Example #8: High Income Qualified Trade or Business with No Outside Employees. Assume that a qualified trade or business generates \$600,000 of QBI and that \$600,000 is also A's taxable income. Also assume that the QTB has no outside employees.

4. *Sole Proprietorship. Because a sole proprietor cannot pay himself a salary, and because A's taxable income is over the Threshold Amount as fully phased-in, the W-2 limitation will apply and A's deduction will be equal to 50% of zero W-2 wages, or zero.*

5. *Partnership. Even if A pays himself a guaranteed payment of \$150,000, that amount will still not qualify as W-2 wages, so again the amount of the deduction would be equal to 50% of zero W-2 wages, or zero.*

6. *S Corporation. Since S corporation shareholders are required to pay themselves "reasonable compensation", assume A pays himself \$150,000. In such case, A's deduction would be equal to the lesser of:*

(a) *20% of \$450,000 of QBI (\$600,000 QBI \$150,000 salary), or \$90,000.*

(b) *50% of \$150,000 W-2 wages, or \$75,000.*

Example #9: Low Income Qualified Trade or Business With No Outside Employees. Assume that A's business only generates \$300,000 of QBI and that \$300,000 is also A's taxable income. Also assume that the QTB has no outside employees.

1. *Sole Proprietorship. Because A's taxable income is below \$315,000, A will be entitled to a deduction of 20% of \$300,000, or \$60,000, because the wage limitations will not apply.*

2. *Partnership. Assuming no guaranteed payments are made by the partnership to A, A will likewise be entitled to a deduction equal to 20% of \$300,000 or \$60,000.*

3. S Corporation. *A still has to pay himself “reasonable compensation”, so assume A pays himself \$100,000. That will reduce A’s share of QBI from \$300,000 to \$200,000, so that in this situation A’s deduction would only be \$40,000 (20% of \$200,000).*

Example #10: High Income Qualified Trade or Business With Sufficient Outside Employees.

Assume that a qualified trade or business generates 600,000 of QBI and that \$600,000 is also A’s taxable income. Also assume that the QTB has outside employees (i.e., non-owner employees) to which it pays sufficient wages so that the wage and capital limitation under Section 199A do not apply and the owners therefore receive the full benefit of the 20% of QBI deduction under Section 199A.

1. Sole Proprietorship. *Because a sole proprietor cannot pay himself a salary, and because the W-2 limitation will not apply, A’s deduction will be equal to 20% of \$600,000 of QBI, or \$120,000.*

2. Partnership. *Assuming A pays himself no guaranteed payments, the amount of the deduction would again be equal to 20% of \$600,000 of QBI, or \$120,000.*

3. S Corporation. *Since S corporation shareholders are required to pay themselves “reasonable compensation,” assume A pays himself \$150,000 in salary. In such case, the \$150,000 would be excluded from the QBI, and A’s deduction would be equal to 20% of 450,000 of QBI (\$600,000 QBI - \$150,000 salary), or \$90,000.*

Clearly, in this context, the partnership or sole proprietorship would be advantageous to an S corporation from the point of view of maximizing the deduction available under Section 199A for 20% of QBI.

It is doubtful that Congress actually intended to have the 199A deduction be different depending on the type of entity the taxpayer is using where such entities are producing identical income. Although some practitioners thought it was possible that a “reasonable compensation” standard could be applied to partnerships and sole proprietorships the same as for S corporations (with such amounts being treated as W-2 wages) so that businesses having the same income would receive the same deduction under Section 199A, the Section 199A Regulations expressly provide that reasonable compensation principles were meant only to apply to S corporations and will **not** be extended to partnerships or sole proprietorships, so that the anomalous results discussed above will continue to exist among different types of pass-through entities.

A possible “work around” in the case of a partnership with no outside employees would be to form a tiered partnership structure, so that the upper-tier partnership would own a lower-tier partnership, and the lower-tier partnership could then pay “wages” to partners of the upper-tier

partnership. The Preamble to the Section 199A Regulations indirectly address this scenario by providing that a guaranteed payment paid by a lower-tier partnership to an upper-tier partnership retains its character as a guaranteed payment and is not included in QBI of a partner of the upper-tier partnership regardless of whether it is guaranteed to the ultimate recipient. However, the Section 199A Regulations do not seem to address this issue head-on by addressing whether the lower-tier partnership could pay “wages” to the partners of the upper-tier partnership. The IRS previously expressed doubt as to a similar type arrangement utilizing a disregarded entity to enable a partner to be treated as an employee for withholding purposes. Under the purported structure, a partnership creates a wholly-owned entity that is disregarded for federal income tax purposes, and has the partners of the partnership become employees of the disregarded entity, which for employment tax purposes, is treated as the employer having its own employer identification number and subject to W-2 withholding. On June 13, 2014, Curtis Wilson, IRS Associate Chief Counsel (Pass-Throughs and Special Industries) stated that the IRS is looking at this issue but that if use of the disregarded entity works, “it makes it pretty easy to get around what would otherwise be the general rule, and so ... we think it’s a stretch.”⁴⁷

§1.17 Effect of Tax Act on Choice of Entity

As a result of the reduced corporate tax rate for C corporations to a flat 21%, as well as the deduction for 20% of QBI of pass-through entities and sole proprietorships, choice of entity and structuring considerations may be affected, especially where the entity is not planning on distributing available cash to its owners. This portion of the outline focuses on the issue of determining whether a pass-through entity or a corporation is the better vehicle for operation of a business. The outline only raises some of the broader issues involved in such a choice of entity decision, focusing primarily on tax rates, and is by no means a comprehensive examination of the advantages and disadvantages of operating as a pass-through entity versus a “C” corporation.

[1] Double Tax on Earnings Imposed on C Corporations.

Although C corporations will continue to be subject to the so-called “double-tax” on their earnings, once at the corporate level and again at the shareholder level when the earnings of the corporation are distributed to its shareholders, the maximum combined double-tax rate will be reduced significantly from 48% (or 50.47% if the Net Investment Income tax is applicable), to 36.8% (or 39.8% if the Net Investment Income Tax is applicable). Additionally, in states like Florida which impose a corporate income tax (5.5%) on C corporations but not on S corporations, partnerships, LLCs or sole proprietorships, the maximum marginal tax rate on distributed earnings will be even higher than 39.8% (e.g., approximately 43.12% in Florida).⁴⁸ This should be contrasted to a top marginal tax rate of 37% on the income of a pass-through entity or sole proprietorship even if the taxpayer derives no benefit whatsoever from the deduction available under Section 199A, or a maximum marginal tax rate of 29.6% on the QBI of a pass-through entity or sole proprietorship where the taxpayer receives the full benefit of Section 199A without being subject to the wage and capital limitations. To the extent that a C corporation is not distributing its earnings, however, consideration also must be given to the possible application of reasonable

⁴⁷ See Elliot, “IRS Concerned About Dual Partner/Employee Workaround,” 2014 TNT 115-8 (June 16, 2014).

⁴⁸ See note 8, *supra*.

compensation arguments, the accumulated earning tax under Section 531 or the personal holding company tax under Section 541.

[a] Reasonable Compensation. Although traditionally unreasonable compensation arguments have been applied in the C corporation context to re-characterize unreasonably high compensation paid to shareholder-employees as dividends subject to double tax, it is possible that the IRS will apply unreasonably low compensation arguments (that have been applied in the S corporation area) to C corporations where the C corporation is retaining earnings taxed at the 21% flat tax rate and not paying any (or unreasonably low) compensation to its shareholder-employees, which would be taxed at a maximum marginal tax rate of 37% and also be subject to FICA taxes.

[b] Accumulated Earnings Tax. S corporations and other pass-through entities are not subject to the Accumulated Earnings Tax imposed under Section 531.

[i] General. The accumulated earnings tax is a penalty tax imposed upon C corporations that accumulate earnings in excess of the reasonable needs of the business, rather than pay them out to shareholders, with the purpose of avoiding taxes at the shareholders level.

[ii] Tax Base. The accumulated earnings tax applies to accumulated taxable income at a tax rate of 20%. Accumulated taxable income is the corporation's taxable income, subject to certain adjustments (as provided in Section 535(b)), reduced by: (A) the dividends-paid deduction, if any, and (B) the accumulated earnings credit.⁴⁹ The adjustments, as provided in Section 535(b), include: (A) income taxes accrued to the corporation for the year; (B) corporate charitable contributions over the 10% deduction limit under Section 170(b)(2); (C) the corporation's capital losses disallowed under Section 1211; and (D) the corporation's net capital gain for the year. The accumulated earnings credit is an amount that starts at \$250,000 but could be higher if justified by the reasonable business needs of the corporation. In other words, the accumulated earnings credit is designed to allow corporations to retain at least \$250,000 and as much of earnings as is supported by the reasonable needs of the business.⁵⁰ The minimum accumulated earnings credit is determined annually as the excess of \$250,000 over the corporation's accumulated earnings at the end of the preceding tax year.⁵¹ Thus, if a corporation had no prior years' accumulated earnings, the current year's minimum accumulated earnings credit would be \$250,000. If the corporation's prior year accumulated earnings were \$100,000, however, the minimum credit would be \$150,000 (\$250,000 minus \$100,000). Note that corporations performing services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting may claim a minimum accumulated earnings

⁴⁹ Section 531(a).

⁵⁰ Section 535(c).

⁵¹ Section 535(c)(2).

credit of only the excess of \$150,000 (rather than \$250,000) over accumulated earnings at the end of the preceding tax year.

[iii] Reasonable Business Needs. As mentioned above, there are two basic elements that must be present in order for the accumulated earnings tax to apply. First, there must be an accumulation of earnings beyond the reasonable needs of the business. Second, the earnings had to have been accumulated for the purpose of avoiding shareholder level taxes. Thus, a corporation is generally able to avoid the accumulated earnings tax if it can demonstrate that it retained the earnings for its reasonable business needs. Whether particular grounds indicate that earnings have been accumulated for reasonable business needs or beyond depends on the specific circumstances.⁵² Generally, an accumulation of earnings is excessive if it is more than what “a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business.”⁵³ In addition, the retained earnings must be directly connected with the needs of the corporation and must be for bona fide business purposes. The “business” of a corporation includes not only that which it has previously carried on but also any line of business it may undertake.⁵⁴

[iv] Tax Avoidance Purpose. Even if a corporation has accumulated earnings beyond its reasonable needs, the earnings must have been retained for the purpose of avoiding taxes at the shareholder level in order for the accumulated earnings tax to apply. Note, however, that unreasonable accumulations create a presumption of a tax-avoidance purpose, rebuttable by the corporation.⁵⁵ Tax avoidance needs only be one of the purposes, not the sole or dominating purpose, of the accumulation.⁵⁶ Although the Code does not specify the person or persons whose purpose is relevant in determining liability for the accumulated earnings tax, it is presumably the purpose of those who control the corporation, through stock ownership or otherwise, that is key. The following factors are among those considered in determining whether a corporation’s retention of earnings was motivated by a tax-avoidance purpose:

1. Dealings between the corporation and its shareholders, including loans and advances to shareholders and expenditures of corporate funds for the shareholders’ personal benefit (rather than paying dividends).⁵⁷

⁵² Reg. § 1.537-2(a).

⁵³ Reg. § 1.537-1(a).

⁵⁴ Reg. § 1.537-3(a). *See also* Reg. § 1.537-2(b) for examples of specific grounds for accumulations most frequently encountered in reasonable business needs cases.

⁵⁵ Section 533(a).

⁵⁶ *U.S. v. Donruss Co.*, 393 US 297 (1969).

⁵⁷ *See* Internal Revenue Manual 4.10.13.2.2 (03/16/2015).

2. Investing undistributed earnings in assets having no reasonable connection to the corporation's business.⁵⁸

3. A dividend history demonstrating that shareholder taxes were avoided by the corporation's failure to make distributions.⁵⁹

4. Corporate loans to friends or relatives of shareholders, as well as to other corporations owned directly or indirectly by the shareholders.⁶⁰

[v] Exceptions. The accumulated earnings tax imposed under Section 531 does not apply to a personal holding company within the meaning of Section 542, a foreign personal holding company within the meaning of Section 552, a corporation exempt from tax under Subchapter F, and a passive foreign investment company within the meaning of Section 1296.⁶¹

[vi] Recent Guidance. Although the accumulated earnings tax has not previously been a major consideration because of the higher corporate tax rate, the new flat 21% corporate tax rate applicable to "C" corporations may result in a resurgence of the accumulated earnings tax. A fairly recent Chief Counsel Advice demonstrates that even when the corporate tax rates were higher and the corporation did not have liquid assets, the IRS may assert the accumulated earnings tax.

In CCA 201653017⁶², the IRS concluded that a corporation may be subject to the accumulated earnings tax even though it lacked liquidity from which to make distributions to its sole shareholder. This development is one of the most current developments addressing the accumulated earnings tax (as the number of entities operating as C corporations has been dramatically less than the number of entities taxed as S corporations, partnerships or sole proprietorships), and should be considered by taxpayers who are currently considering forming or converting to C corporation status as a result of the reduction in the corporate tax rate to a flat 21% by the recently passed Tax Cuts and Jobs Act.

Under the facts of the CCA, a shareholder transferred to the corporation his entire interest in several partnerships. All the income and essentially all of the expenses reported by the corporation were flow-through items from the various partnerships. Since its inception and during the years in issue, the corporation conducted no business activity other than holding and maintaining the various partnership interests contributed to it by the shareholders. The corporation reported retained earnings for the tax years at issue that would have resulted in additional tax to the shareholder if distributed.

The taxpayer argued that it was not liable for the accumulated earnings tax because it did not have control over distributions from the partnerships in which it invests, and specifically

⁵⁸ Id.

⁵⁹ Id.

⁶⁰ Reg. § 1.537-2(c).

⁶¹ Section 532(b).

⁶² Dec. 30, 2016.

did not have liquid capital from which to distribute earnings to its shareholders and, therefore, should not be subject to the accumulated earnings tax.

The IRS pointed out that the taxpayer seemed to suggest that accumulated surplus must be represented by cash that is available for distribution. However, the accumulated earnings tax is based on accumulated taxable income and it is not concerned with the liquid assets of the corporation. The IRS also found that the consent dividend procedures provided by Section 565 would have allowed the taxpayer and shareholder to avoid the accumulated earnings tax irrespective of any lack of liquidity.

The IRS concluded in the legal memorandum that there was prima facie evidence that the corporation was formed to avoid income tax with respect to its shareholder and would be subject to the accumulated earnings tax irrespective of its lack of liquidity and lack of control over the partnerships in which it invests.

[vii] Observation. As a result of the substantial reduction of the tax rate applicable to C corporations to a flat 21% by TCJA, there has been substantial discussion regarding converting sole proprietorships and pass-through entities to C corporations (or forming new entities as C corporations rather than as a pass-through entity or sole proprietorship). However, as demonstrated by CCA 201653017, where a corporation does not distribute its earnings so as to incur the second level of tax at the shareholder level (even when it has no liquid assets to make such distributions), such corporation may well indeed be subject to the accumulated earnings tax imposed under Section 531.

[c] Personal Holding Company Tax. S corporations and other pass-through entities are not subject to the Personal Holding Company Tax imposed under Section 541.

[i] General. A closely held corporation whose income is largely of investment character may be a personal holding company (PHC), in which case a penalty tax is imposed on the “personal holding company income” if not distributed. The personal holding company tax is designed to prevent corporations from accumulating earnings rather than distributing the earnings as taxable dividends. The personal holding company tax is equal to 20% of the undistributed personal holding company income.

[ii] Definition. A corporation is a personal holding company if: (i) at least 60% of its adjusted ordinary gross income (as defined in Section 543(b)(2)) for a taxable year is personal holding company income, and (ii) at any time during the last half of the taxable year, more than 50% in value of the corporation’s stock is owned, directly or indirectly, by or for not more than five individuals.⁶³

[iii] PHC Income. Personal holding company income generally includes dividends, interest, royalties (including mineral, oil and gas royalties and copyright royalties), annuities, rents, produced film rents, compensation for use of corporate

⁶³ Section 542(a).

property by shareholders, personal service contract income, and income from estates and trusts.⁶⁴ In general, undistributed personal holding company income means “taxable income” (as adjusted by the items set forth in Section 545(b)), less the dividends paid deduction (as defined in Section 561).⁶⁵ Adjustments to taxable income generally include negative adjustments for federal income taxes, certain net operating losses, and net capital gains less the attributable taxes.

[2] Taxation of Gain Upon Sale of Assets of Corporation.

The maximum marginal combined rate for a C corporation selling its assets is the same as the maximum double tax on earnings of a C corporation which are distributed to its shareholders (36.8% or 39.8% if the 3.8% Net Investment Tax is applicable). Again, in some states such as Florida, a corporate income tax (5.5% in Florida) is imposed on C corporations but not on S Corporations, partnerships, LLCs or sole proprietorships, which will increase the maximum marginal double tax on the sale of assets (e.g., to approximately 43.11% in Florida). This should be contrasted with the sale of assets by an S corporation, partnership or LLC taxed as a partnership, or a sole proprietorship, where typically the bulk of the sales price is allocated to capital assets (such as goodwill), so that the maximum marginal rate to which the gain on the sale of the assets will be subject will either be 20% (the maximum capital gains tax), or, if the taxpayer does not materially participate in the trade or business carried on by the entity, 23.8% with the addition of the Net Investment Tax.

[a] Avoidance of Double Tax by Allocation to Personal Goodwill. C corporations have used a strategy of allocating the bulk of any sales proceeds to personal goodwill in order to avoid the double tax normally incurred on the sale of assets by a C corporation. Several recent cases suggest that the personal goodwill strategy may not always be successful.

[i] *Muskat v. Commissioner*

In *Muskat v. Commissioner*,⁶⁶ the First Circuit Court of Appeals rejected taxpayer’s refund suit based on the taxpayer’s claim that payments contractually delineated as payments for taxpayer’s covenant not to compete and originally reported by the taxpayer as ordinary income, actually were payments for taxpayer’s personal goodwill, taxable as capital gain.

Irwin Muskat (TP) was the CEO of JacPac Foods, Ltd., a family business. In 1993, an agreement was reached between JacPac and a subsidiary of Corporate Brand Foods America, Inc. (CBFA) for purchase of JacPac’s assets for approximately \$45,000,000 plus assumption of JacPac’s liabilities. As part of the sale, TP entered into an employment agreement, a noncompetition agreement and a subscription agreement (under which he invested \$2,000,000 in the purchaser). Under the noncompetition agreement, the purchaser agreed to pay TP \$3,955,599 for a covenant not to compete over a 13 year period.

⁶⁴ Section 543(a).

⁶⁵ Section 545(a).

⁶⁶ 103 AFTR2d 2009-666 (1st Cir. 2009).

The first installment of \$1,000,000 was paid at closing with the remainder payable over the 13 years. These payments survived TP's death.

TP received the first installment in 1998 and reported the payment as ordinary income on his 1998 federal income tax return and paid self-employment taxes on the income. In 2002 however, TP filed an amended return for 1998 reclassifying the \$1,000,000 payment as capital gain and seeking a refund of \$203,434, which included \$21,479 of self-employment tax. After the IRS denied TP's refund claim, he filed suit in the federal district court. The District Court denied TP's refund claim on the ground that he failed to present strong proof that the parties intended the payment to be a payment for TP's personal goodwill and denied TP's self-employment tax claim on the ground that it lacked jurisdiction over that claim because that claim was not part of TP's administrative refund claim.

Initially, the court reaffirmed the application of the "strong proof" rule in the First Circuit. Under this rule, when parties to a transaction have executed a written contract providing for allocation of sums to particular items and one party thereafter seeks to alter the written allocation, for tax purposes, the proponent must present "strong proof" that, at the time of execution of the contract, the contracting parties actually intended the payments to be compensation for something else.

The court found that TP did not produce strong proof that the contracting parties intended the challenged payment to be compensation for TP's personal goodwill. First, the court clarified that "strong proof" means that a taxpayer's evidence must approach "clear and convincing" evidence required to reform a written contract on the ground of mutual mistake. The court found that the district court did not clearly err in holding that TP failed to adduce such strong proof. In this respect, the trial testimony revealed no discussion of TP's personal goodwill during the negotiations and none of the transaction documents, including early drafts of those documents, mentioned TP's personal goodwill. Further, the court found it significant that the noncompetition agreement referenced protection of JacPac's goodwill (purchased by purchaser for \$16,000,000, which made it extremely unlikely that the contracting parties intended the payments under the noncompetition agreement to serve as *de facto* compensation for TP's personal goodwill.

The court rejected TP's argument that survivability of the noncompetition payments mandated a conclusion that the payments were for something other than refraining from competition. The court stated that other courts have classified agreements that contain survivability provisions as valid noncompetition agreements for tax purposes.

The court also rejected TP's argument that the terms of his employment and subscription agreement were so lucrative that they eliminated any realistic possibility that, at an advanced age, TP would compete with the purchaser. The court responded that proof that a written allocation does not have economic reality, does not in of itself, constitute strong proof that the parties intended some other allocation. Further, the court found that there was evidence that the noncompetition provisions were grounded in economic reality, including the fact that CBFA representatives testified that the noncompetition agreement

was to prevent the possibility that TP would use his relationships with customers, suppliers and distributors to pursue competitive opportunities.

Finally, the court upheld the district court's rejection of TP's self-employment tax claim on the ground that it lacked subject matter jurisdiction over the claim. In this respect the court agreed that TP had substantially varied the legal theory and factual basis of his self-employment refund claim made to the IRS. TP's refund claim to the IRS was based on the argument that he had incorrectly characterized the claim as ordinary income and not capital gain. However, at trial, TP shifted gears and argued that sums paid in consideration of a covenant not to compete are not deemed to have been earned in the conduct of a trade or business and, thus, are not subject to self-employment tax. The court concurred with the district court that the taxpayer's refund claim filed with the IRS did not properly raise the revised self-employment tax claim and thus, was not within the subject matter jurisdiction of the court to address.

[ii] *Howard v. United States*

In *Howard v. United States*,⁶⁷ the Ninth Circuit Court of Appeals affirmed the district court's denial of the taxpayer's motion for a summary judgment and granting of the government's motion for summary judgment in finding that goodwill in connection with the sale of a dental practice was corporate goodwill rather than personal goodwill.

Under the facts of the case, the taxpayer incorporated his practice as the sole shareholder, officer and director in 1980, and also entered into an employment agreement and a covenant not to compete with the corporation. The covenant not to compete provided that for so long as the taxpayer held any stock and for a period of three years thereafter, he would not engage in any business which was competitive to that of the corporation within 50 miles of Spokane, Washington. In 2002, the taxpayer and his corporation sold the practice to another personal service corporation. In the Asset Purchase Agreement, the taxpayer was allocated \$549,900 for his "personal goodwill" and \$16,000 for consideration regarding a covenant not to compete with the acquiring personal service corporation. The selling corporation itself received \$47,100 for its assets.

Following an audit by the IRS, the IRS recharacterized the sale of goodwill as a corporate asset and treated the amount received by the taxpayer from the sale to the acquiring personal service corporation as a dividend from the selling professional service corporation to the taxpayer. The government argued that the goodwill was corporate goodwill versus personal goodwill for three main reasons. First, the goodwill at issue was a corporate asset because the taxpayer was an employee of the corporation and had a covenant not to compete with the corporation. Second, the corporation earned the income and correspondingly earned the goodwill. Third, attributing the goodwill to the taxpayer would not comport with the economic reality of the taxpayer's relationship with his personal service corporation.

⁶⁷ 108 AFTR2d 2011-5993 (9th Cir. 2011).

The government, citing *Furrer v. Commissioner*,⁶⁸ *Martin Ice Cream v. Commissioner*,⁶⁹ *Norwalk v. Commissioner*,⁷⁰ and *MacDonald v. Commissioner*,⁷¹ found that the goodwill was an asset of the corporation and not of the taxpayer personally primarily because of the contractual obligation of the taxpayer under his Employment Agreement to continue to work for and not to compete against his corporation. In granting summary judgment in favor of the government, the court found no merit in the taxpayer's argument that Washington state dissolution case law supported the proposition that professional goodwill is a community property right in dissolution cases, and as such, is of a personal nature.

[iii] *Kennedy v. Commissioner*

In *Kennedy v. Commissioner*,⁷² the Tax Court held that payments received by a shareholder of an employee benefits consulting company which was a C corporation did not constitute payments for personal goodwill, and consequently, were taxable as ordinary income.

James Kennedy was the sole shareholder of an employee benefits consulting firm taxed as a C corporation for federal income tax purposes. Kennedy was approached by another company that proposed to acquire the assets of Mr. Kennedy's corporation. Early in the negotiations, the parties basically agreed that the purchase price should be 150% of the projected annual income to be generated from Mr. Kennedy's corporation with certain adjustments (approximately \$660,000). Late in the negotiations, Mr. Kennedy's attorney consulted with a tax advisor who informed him that if the transaction was structured as an asset purchase, then the payment would be taxed twice, once at the corporate level and again at the shareholder level when distributed to Mr. Kennedy. On the other hand, if the transaction were instead structured as a purchase of the corporation's stock, there would be only one level of tax on which Mr. Kennedy would pay capital gain rates, but this would be disadvantageous to the purchaser because the purchaser would not be able to claim any deductions with respect to the purchase of the stock, and as such, would likely not agree to such an arrangement.

The tax advisor alternatively suggested that Mr. Kennedy take the position that he owned the personal goodwill of the business, and that he enter into an Agreement for Assignment of Know-How and Goodwill, an Asset Purchase Agreement and a Consulting Services Agreement. Only \$10,000 of the purchase price was allocated to the assets of the C corporation, with the remaining amounts being allocated 75% to the sale of Mr. Kennedy's personal goodwill and the remaining 25% being allocated to the Consulting Services Agreement.

⁶⁸ 566 F.2d 1115 (9th Cir. 1977).

⁶⁹ 110 TC 189 (1998).

⁷⁰ TC Memo. 1998-279.

⁷¹ 3 TC 720 (1944).

⁷² TC Memo. 2010-206.

The taxpayer argued that under *Martin Ice Cream Company v. Commissioner*, 110 TC 189 (1998), the court was compelled to conclude that Mr. Kennedy owned personal goodwill and that the payments he received from the purchaser were to purchase personal goodwill since Mr. Kennedy did **not** have a non-compete agreement with his corporation.

The Tax Court, despite the fact that Mr. Kennedy had no employment agreement or non-compete agreement with his corporation, held that the amounts paid were consideration for services rather than goodwill because there was no economic reality to the contractual allocation of payments to personal goodwill. Specifically, the court found that the allocation of 75% of the total consideration paid by the purchaser to personal goodwill was a “tax-motivated afterthought” that occurred late in the negotiations.

[3] The Cost of “Escaping” C Corporation Status.

There has already been substantial discussion that a number of S corporations, LLCs and sole proprietorships may convert to C corporation status as a result of the flat 21% tax rate imposed on C corporations. However, the owners of C corporations may not be able to “escape” the shareholder-level tax because of reasonable compensation arguments, the accumulated earnings tax or the personal holding company tax, as discussed above. Additionally, in the event Congress subsequently raises the corporate tax rate (although deemed a “permanent change”), taxpayers may find themselves “trapped” in C status. Once in the C corporation regime, there are number of “prohibitions” and “toll charges” on entities that want to convert back from a C corporation to a pass through entity or sole proprietorship.

If a C corporation converts to a partnership or a sole proprietorship, the conversion will be treated as a taxable liquidation. Where an S corporation has revoked its S election to become a C corporation, Section 1362(g) generally prohibits the corporation from reelecting S status for a period of five years. Even where a C corporation is allowed to convert to S corporation status, a number of unfavorable rules may apply to the S corporation which has converted from C corporation status, including the application of the LIFO recapture tax under Section 1363(d), the imposition of the tax on excess passive investment income imposed under Section 1375 for S corporations having subchapter C earnings and profits, the possible termination of the corporation’s S election (where it has excess passive investment income and subchapter C earnings and profits for three consecutive taxable years) under Section 1362(d), the less favorable distribution rules applicable to S corporations having subchapter C earnings and profits versus S corporations having no subchapter C corporation earnings and profits and the possible loss of net operating losses under Section 172. Most importantly, the so-called built in gains tax under Section 1374 is imposed on C corporations which have converted to S corporation status (which effectively imposes a double tax to the extent of any built-in gain of such corporation at the time of conversion), if the assets of the corporation are sold or otherwise disposed of within the five (5) year period following the corporation’s conversion to S status.

[4] Built-In Gain Tax Hurdle.

Because of its nature, the greatest exposure facing a corporation upon conversion to S corporation status is the imposition of the built-in gains tax under IRC Section 1374. This

can be especially disadvantageous for a cash-basis taxpayer having accounts receivable converting from C to S status where the collection of such accounts receivable following conversion to S status will be treated as built-in gain subject to the built-in gains tax. A brief discussion of the mechanics of the built-in gains tax will ensue and will be followed by an examination of the special problems facing the cash-basis service corporation converting to S corporation status.

[a] General Built-In Gain Tax Rules. IRC Section 1374 imposes a corporate-level tax on the built-in gains of S corporations that were previously C corporations. IRC Section 1374 as originally enacted applies to built-in gains recognized by a corporation during the five-year period following such corporation's conversion to S status. The recognition period is the five-calendar year period, and not the five-tax year period, beginning on the first day the corporation is an S corporation or the day an S corporation acquires assets under IRC Section 1374(d)(8) in a carryover basis transaction.⁷³ The tax rate is presently 21% (the highest rate of tax imposed under IRC Section 11(b)) of the S corporation's "net recognized built-in gain."⁷⁴

The American Recovery and Reinvestment Act of 2009 (the "2009 Act"),⁷⁵ was signed into law by President Obama on February 17, 2009. Section 1261 of the 2009 Act amends IRC Section 1374 of the Code to provide for reduction of the recognition period during which corporations that converted from C corporation status to S corporation status are subject to the so-called built in gain tax from 10 years to 7 years under certain circumstances. IRC Section 1374 was further amended by the Small Business Jobs Act of 2010, H.R. 5297 (the "2010 Act"). Specifically, IRC Section 1374(d)(7)(B), *as amended by* the 2009 Act and the 2010 Act reads as follows:

[b] Special Rules for 2009, 2010 and 2011. *No tax shall be imposed on the net recognized built-in gain of an S corporation—(i) in the case of any taxable year beginning in 2009 or 2010, if the 7th taxable year in the recognition period preceded such taxable year, or (ii) in the case of any taxable year beginning in 2011, if the 5th year in the recognition period preceded such taxable year.*

While the statutory language itself is short, it raises a number of questions that will need to be clarified regarding its scope and application.⁷⁶

Some or all of these questions may have been answered by the 2012 Act. The 2012 Act again provides for a temporarily shortened recognition period and also provides a special rule for installment sales of built-gain assets during 2012 and 2013. For tax years beginning in 2012 and 2013, the recognition period is a five calendar year period. Consequently, if the S corporation acquired the built-in gain asset at least five calendar years before disposing of the assets in 2012 or 2013, IRC Section 1374 will not apply to the disposition. Additionally, new IRC Section 1374(d)(7)(E) provides that if an S corporation sells an asset and reports the income from the sale using the installment method under IRC Section 453, the treatment of all payments received will

⁷³ IRC § 1374(d)(7)(A) and Treas Reg § 1.1374-1(d).

⁷⁴ RC § 1374(b)(1).

⁷⁵ PL 111-5, 123 Stat 115 (Feb 17, 2009).

⁷⁶ See Klein and Looney, "American Recovery and Reinvestment Act of 2009 Provides for Temporary Reduction of Built-In Gain Recognition Period—Clarification Still Needed," 11 BET 53 (May/June 2009).

be governed by the provisions of IRC Section 1374(d)(7) applicable to the tax year in which such sale was made. Consequently, this paragraph seems to clarify that if a disposition qualified for any of the special rules applicable to 2009, 2010, 2011, 2012 or 2013, the fact that sales proceeds are received in later years (which are within the original 10-year recognition period), the built-in gain tax proposed under IRC Section 1374 will not be imposed on such disposition. This is contrary to the general rule applicable to installment sales within the original 10-year recognition period. On December 19, 2014, President Obama signed H.R. 5771, the “Tax Increase Prevention Act of 2014” into law, which extends the reduced five-year recognition period for dispositions made in 2014.

On December 18, 2015, President Obama signed the Protecting Americans from Tax Hikes Act of 2015, which made permanent for 2015 and all years thereafter the shortened five-year recognition period under the built-in gains tax imposed under IRC Section 1374. As such, a corporation which converts from C status to S status will only be subject to the built-in gains tax if it sells its assets prior to the expiration of the five-year period following the date of its conversion to S corporation status. For those few C corporations that have hesitated in the past to convert from C status to S status because of the ten-year recognition period, this reduction to a five-year recognition period should cause more of such corporations to convert from C to S status.

[c] NUBIG Limitation. IRC Section 1374(c)(2) provides that the net recognized built-in gain taken into account under IRC Section 1374 for any tax year may not exceed the NUBIG of all the corporation’s assets less the built-in gains recognized by the corporation in prior years during the recognition period. IRC Section 1374(d)(1) provides that NUBIG is the amount by which the fair market value of all the corporation’s assets as of the beginning of its first tax year as an S corporation exceeds the corporation’s aggregate adjusted tax bases in such assets at such time. Treasury Regulation Section 1.1374-3(a) provides a more expansive definition of NUBIG as the total of the following amounts:

- 1) The amount that would be the amount realized if on the first day of the recognition period the corporation sold all of its assets at fair market value to an unrelated party which assumed all of its liabilities; decreased by
- 2) Any liability of the corporation that would be included in the amount realized but only if the corporation would be allowed a deduction on payment of such liability; decreased by
- 3) The aggregate adjusted bases of the corporation’s assets on the first day of the recognition period; increased or decreased by
- 4) The corporation’s IRC Section 481 adjustments on the first day of the recognition period; and increased by
- 5) Any recognized built-in loss that would not be allowed under IRC Section 382, 383 or 384.

Pursuant to the NUBIG limitation, the maximum amount of built-in gain subject to tax under IRC Section 1374 is generally limited to the amount of pre-C to S conversion

appreciation in the corporation's assets and does not include any post-C to S conversion appreciation in such assets.

IRC Section 1374(d)(5)(C) also provides that a corporation's NUBIG is to be properly adjusted for amounts which would be treated as built-in gains under IRC Section 1374(d)(5)(A) or as built-in losses under IRC Section 1374(d)(5)(B). These built-in gain and loss items are included in the computation of NUBIG without regard to when or whether such items are actually recognized during the recognition period.

[d] Taxable-Income Limitation. In addition to the limitation placed on the aggregate amount of net built-in gains that may be recognized by an S corporation under the NUBIG limitation, the taxable-income limitation limits the amount of net built-in gains recognized by an S corporation on an annual basis. Because a corporation's taxable income may serve as the base for the built-in gains tax, the maximum amount of net built-in gains (built-in gains less built-in losses) that must be recognized by an S corporation in a particular tax year within the BIG Period is limited to the amount of the corporation's taxable income for such year (the taxable-income limitation).⁷⁷

Any recognized built-in gain that is not subject to the built-in gains tax because of the taxable income limitation must be carried forward and is subject to the built-in gains tax in the S corporation's succeeding tax years to the extent that it subsequently has other taxable income (that is not already subject to the built-in gains tax) for any tax year within the BIG Period. IRC Section 1374(d)(2)(B), *as amended by* IRC Section 1006(f)(5) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).⁷⁸ This modification reduced potential manipulation of timing post-conversion losses to avoid the built-in gains tax on the corporation's NUBIG, and applies only to corporations filing S elections on or after March 31, 1988.

[e] Built-In Income And Built-In Deduction Items. An S corporation's recognized built-in gain includes gain recognized from the "disposition" of any asset.⁷⁹ The legislative history of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) clarified that the "disposition of any asset" includes not only sales and exchanges, but also other income recognition events that effectively dispose of, or relinquish, the taxpayer's right to receive income.⁸⁰ Specifically, any item of income that is properly taken into account during the recognition period but which is "attributable" to periods prior to the date of the corporation's conversion to S status will be treated as a recognized built-in gain for the tax year in which it is properly taken into account.⁸¹ This type of item is generally referred to as a "built-in income item." Similarly, any amount which is allowable as a deduction during the recognition period but which is "attributable" to a period prior to the date of the corporation's conversion to S status will be treated as a recognized built-in loss for the tax year for which it is allowable.⁸² This type of item is generally referred to as a "built-in deduction item." In determining whether an item

⁷⁷ IRC § 1374(d)(2)(A)(ii) and Treas Reg § 1.1374-2(a)(2).

⁷⁸ Pub L No 100-647, 102 Stat 3342 (1988).

⁷⁹ IRC § 1374(d)(3).

⁸⁰ H R Rep No 795, 100th Cong, 2d Sess 63 (1988). See also Ann 86-128, 1986-51 IRB 5.

⁸¹ RC § 1374(d)(5)(A).

⁸² RC § 1374(d)(5)(B).

constitutes a built-in income or built-in deduction item under IRC Section 1374(d)(5)(A) and (B), the focus is therefore on whether such item is “attributable” to a period prior to the date of the corporation’s conversion to S status.

The IRS adopted an “accrual method rule” in determining whether an income item or a deduction item is attributable to a period prior to the date of the corporation’s conversion to S status. Specifically, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been included in gross income before the beginning of the recognition period by a taxpayer using the accrual method of accounting.⁸³ The most common example of a built-in income item subject to the built-in gains tax is the collection of accounts receivable by a cash-basis taxpayer. Likewise, any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period by a taxpayer using the accrual method of accounting.⁸⁴ The most common example of a built-in deduction item is the payment of accounts payable by a cash-basis taxpayer. Consequently, the benchmark for whether an item constitutes a built-in income or built-in deduction item under IRC Section 1374(d)(5), is whether such item would have been includable in income, or allowed as a deduction, prior to the corporation’s conversion to S status if the corporation had been an accrual basis taxpayer.

In determining whether an item would have been includable in income, or allowed as a deduction, prior to the corporation’s conversion to S status if the corporation had been an accrual basis taxpayer, the regulations generally provide that all rules applicable to an accrual basis taxpayer apply, specifically including IRC Section 267(a)(2) (relating to the timing of deductions by an accrual basis payor with respect to a cash basis payee that is a related party), and IRC Section 404(a)(5) (relating to the timing of deductions for deferred compensation).

IRC Section 267(a)(2) generally prohibits an accrual basis taxpayer from deducting an item payable to a cash basis payee until the amount is includable in the cash basis payee’s income if the payor and payee are related within the meaning of IRC Section 267(b).

Similarly, IRC Section 404(a)(5) generally prohibits a corporation from taking a deduction for any amounts deferred under a non-qualified deferred compensation plan, until such amounts are includable in the employee’s gross income.

Many commentators objected to the IRS’s application of IRC Section 267(a)(2) and 404(a)(5) to preclude treatment of an item as a built-in deduction under IRC Section 1374(d)(5)(B). Specifically, the House Report which accompanied TAMRA, provides the following:

As an example of these built-in gain and loss provisions, in the case of a cash basis personal service corporation that converts to S status and that has receivables at the time of the conversion, the receivables, when received, are built-in gain items. At the same time, built-in losses would include otherwise deductible

⁸³ Treas Reg § 1.1374-4(b)(1).

⁸⁴ Treas Reg § 1.1374-4(b)(2).

compensation paid after the conversion to the persons who performed the services that produced the receivables, to the extent such compensation is attributable to such pre-conversion services. To the extent such built-in loss items offset the built-in gains from the receivables, there would be no amount subject to the built-in gains tax.⁸⁵

In determining whether an item would be deductible by an accrual basis taxpayer for purposes of the built-in gains tax, however, the regulations modify the rules generally applicable to accrual basis taxpayers in three respects. First, any amounts properly deducted in the recognition period under IRC Section 267(a)(2), relating to payments to related parties, will be treated as recognized built-in loss to the extent that the following requirements are met:

- 1) All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and
- 2) The amount is paid in the first two and one-half months of the recognition period or is paid to a related party owning (under the attribution rules of IRC Section 267) less than 5% (by voting power and value) of the corporation's stock, both as of the beginning of the recognition period and when the amount is paid.⁸⁶

Additionally, any amount properly deducted in the recognition period under IRC Section 404(a)(5), relating to payments for deferred compensation, will be treated as recognized built-in loss to the extent that the following requirements are met:

- 1) All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and
- 2) The amount is not paid to a related party to which IRC Section 267(a)(2) applies.⁸⁷

The regulations also provide that in determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer, IRC Section 461(h)(2)(C) (which provides that economic performance does not occur for tort liabilities or worker's compensation liabilities until payment has been made), and Treasury Regulation Section 1.461-4(g) (which provides that economic performance does not occur for liabilities arising out of breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts and taxes until payment is made), do not apply.⁸⁸ Thus, to constitute a built-in deduction item within the meaning of IRC Section 1374(d)(5)(B), only the all events test (and not the economic performance test) needs to be satisfied

⁸⁵ HR Rep No 100-795, 100th Cong, 2d Sess 63–64.

⁸⁶ Treas Reg § 1.1374-4(c)(1).

⁸⁷ Treas Reg § 1.1374-4(c)(2).

⁸⁸ Treas Reg § 1.1374-4(b)(2).

with respect to the liabilities referred to in IRC Section 461(h)(2)(C) and Treasury Regulation Section 1.461-4(g).

Treasury Regulation Sections 1.446-1(c)(1)(ii) and 1.451-1(a), provide that accrual method taxpayers recognize income for the tax year in which the following two requirements are met:

- 1) All of the events have occurred that fix the right to receive such income; and
- 2) The amount thereof can be determined with reasonable accuracy.

Similarly, Treasury Regulation Sections 1.446-1(c)(1)(ii) and 1.461-1(a)(2) provide that under the accrual method of accounting, deductions are allowable for the tax year in which:

- 1) All of the events have occurred that establish the fact of the liability giving rise to such deduction; and
- 2) The amount thereof can be determined with reasonable accuracy.

Under IRC Section 461(h)(1), the “all events” test is not considered to be met any earlier than when economic performance with respect to such item occurs. In circumstances involving services or property provided to a taxpayer, economic performance is deemed to occur under IRC Section 461(h)(2)(A) when the person provides such services or provides such property to the taxpayer. In circumstances where the liability of a taxpayer requires the taxpayer to provide services or property to another person, economic performance is deemed to occur under IRC Section 461(h)(2)(B) as the taxpayer provides such property or services.

[f] Effect of Classification of Item as Built-in Income or Built-In Deduction Item. An item that is classified as a built-in income item will be treated as a recognized built-in gain when taken into account by the S corporation during the BIG Period, and thus, potentially be subject to the built-in gains tax imposed under IRC Section 1374.⁸⁹ A built-in income item also has the effect of increasing the corporation’s NUBIG.⁹⁰ Likewise, an item that is classified as a built-in deduction item will be treated as a recognized built-in loss when allowed as a deduction to the S corporation during the recognition period, and thus, will be available to offset any built-in gains recognized by the S corporation during such tax year.⁹¹ A built-in deduction item also has the effect of decreasing the corporation’s NUBIG under IRC Section 1374(d)(5)(C).

Even if an item does not constitute a built-in loss item within the meaning of IRC Section 1374(d)(5)(B), it still may potentially affect a corporation’s NUBIG. For example, an accrued bonus payable to a C corporation’s sole shareholder-employee that is not paid by the corporation within the first two and one-half months following the date of its conversion to S status would not constitute a built-in deduction item under IRC Section 1374(d)(5)(B) since, under both IRC Sections 267(a)(2) and 404(a)(5), such amount would not have been deductible by the

⁸⁹ IRC § 1374(d)(5)(A).

⁹⁰ IRC § 1374(d)(5)(C).

⁹¹ IRC § 1374(d)(5)(B).

corporation prior to the date of its conversion if it were an accrual basis taxpayer. The accrued bonus would, however, still serve to reduce the corporation's NUBIG limitation since Treasury Regulation Section 1.1374-3(a)(2) provides that NUBIG is decreased by the amount of any liability of the corporation to the extent the corporation would be allowed a deduction on payment of such liability. In other words, the accrual method rule does not apply in determining whether a liability decreases a corporation's NUBIG.

Example (1):

Assume a cash-basis corporation owns two buildings (Building "A" and "Building "B"), each of which has a built-in gain (excess of fair market value over basis as of the date of conversion to S status) of \$100. Additionally, assume that prior to the corporation's conversion to S status, the corporation accrued a bonus to its sole shareholder-employee of \$50. In its initial S year, the corporation sells Building "A" generating a recognized built-in gain of \$100, pays the \$50 accrued bonus to its shareholder-employee following the first two and one-half months of such year, and has other taxable income of \$100.

Because the accrued bonus was not paid within the first two and one-half months following the corporation's conversion to S status, the accrued bonus will not constitute a recognized built-in deduction item under IRC Section 1374(d)(5)(B). As such, the corporation's pre-limitation amount (the amount which would be its taxable income if only recognized built-in gains and recognized built-in losses were taken into account) will be \$100. If the accrued bonus had been treated as a built-in deduction item, however, the corporation's pre-limitation amount would only have been \$50 (\$100 recognized built-in gain on the sale of Building "A" less \$50 recognized built-in loss on payment of the bonus). The accrued bonus will, however, decrease the corporation's NUBIG to \$150 (\$100 built-in gain on Building "A" plus \$100 built-in gain on Building "B" less \$50 liability for accrued bonus). Thus, if Building "B" is sold during the BIG Period and results in a recognized built-in gain of the full \$100, only \$50 will be subject to the built-in gains tax under IRC Section 1374, and the only adverse consequence of the accrued bonus not being treated as a built-in deduction item would be the acceleration of the corporation's built-in gains (\$100 gain recognized on the disposition of Building "A" rather than \$50). This example demonstrates that the effect of an item not being classified as a built-in deduction under IRC Section 1374(d)(5)(B), but which nevertheless reduces NUBIG, will be greatest where the corporation has several assets with built-in gain, only some of which are sold during the BIG Period. In such case, the corporation will pay more built-in gains tax than it otherwise would have paid if the item had been treated as a built-in deduction item and had been available to offset the recognized built-in gains of other assets. If all of the built-in gain assets are sold during the BIG Period, the only effect of an item not being classified as a built-in deduction item will be the acceleration of the built-in gains tax applicable to the corporation's assets. Finally, if none of the built-in gain assets are sold by the S corporation during the BIG Period, there will be no adverse effect from an item not being classified as a built-in deduction.

Although not as clear as in the case of a liability not qualifying as a built-in deduction item, an item that does not constitute a built-in income item because it would not have been recognized by the corporation prior to the date of its conversion to S status if the corporation had been on the accrual method of accounting, could possibly still increase the corporation's NUBIG limitation if such item was treated as an asset of the corporation on the date of conversion and the item had an ascertainable fair market value in excess of the corporation's basis in such item on the date of conversion. Possible examples of such items include an account receivable subject to a substantial doubt as to collectibility and a contingent or potential claim against a third party. The collection of an item that does not constitute a built-in income item under IRC Section 1374(d)(5)(A) would not trigger application of the built-in gains tax since the collection of such an item would not constitute a recognized built-in gain. Assuming that such an income item increased the corporation's NUBIG limitation, however, the corporation's overall exposure to the built-in gains tax might be increased to the extent the corporation has other built-in gain assets.

Example (2):

Assume that a cash-basis corporation owns Building "A", which has a built-in gain of \$100, and Building "B", which has a built-in loss of \$100. Additionally, the corporation has an account receivable in the face amount of \$100 with respect to which there is sufficient doubt as to its collectibility so as to preclude the corporation (had it been an accrual basis taxpayer) from including the receivable in its income prior to the date of its conversion to S status. Further assume that the IRS can somehow show that the account receivable had some value (assume \$20) as of the date of the corporation's conversion to S status, so that the corporation's NUBIG is increased to \$20.⁹²

In the event the corporation collects the full \$100 account receivable in its first tax year as an S corporation, such amount would not constitute a recognized built-in gain subject to the built-in gains tax under IRC Section 1374 since the item did not constitute a built-in income item under IRC Section 1374(d)(5)(A). If, however, the corporation subsequently sells Building "A" with a built-in gain of \$100 during the BIG Period, the corporation would have a net recognized built-in gain of \$20 (the Corporation's NUBIG limitation) on which the built-in gains tax would be imposed. If, alternatively, the account receivable had no effect on the corporation's NUBIG, the corporation would not have been subject to the built-in gains tax on the disposition of Building "A" since its NUBIG would have been zero. This example illustrates that an item which does not constitute a built-in income item under IRC Section 1374(d)(5)(A), but which nevertheless increases a corporation's NUBIG, will have its greatest impact if the corporation has other built-in gain assets

⁹² If the receivable actually had an ascertainable fair market value of \$20, then the receivable arguably might also constitute a built-in income item to the extent of \$20. Bifurcating a single asset in this manner, however, seems inappropriate and not supported by IRC § 1374 (or the regulations promulgated under IRC § 1374).

that are disposed of during the recognition period that are not offset by corresponding dispositions of built-in loss assets during the same tax year.

[g] General Accounts Receivable Planning Opportunities. Because the accounts receivable of a cash-basis corporation are included in determining a corporation's NUBIG, and the collection of such receivables is treated as a recognized built-in gain under IRC Section 1374, the cash-basis corporation, and particularly the cash-basis service corporation, is potentially subject to a substantial tax liability under IRC Section 1374 (a double tax of approximately 50.23%). Consequently, it is imperative that the cash-basis service corporation converting from C corporation status to S corporation status consider all available planning opportunities to minimize the impact of the built-in gains tax with respect to its accounts receivable.

[h] Zeroing Out of Taxable Income. Since the base of the built-in gain tax is limited to a corporation's taxable income, one method of avoiding the built-in gain tax would be to zero out the corporation's taxable income for the entire 5-year built-in gain period. Such a strategy seems inadvisable in that it could very well subject the S corporation to the same unreasonable compensation arguments to which it would have been subject had it remained a C corporation. An S corporation would be susceptible to an unreasonable compensation argument in this context since the result of recharacterizing amounts paid as compensation to the shareholder-physicians as distributions would be to increase the corporation's taxable income above zero, and thus, subject it to the built-in gain tax.

[i] Bonus Accrual Method. Due to the pass-through nature of an S corporation, the collection of accounts receivable by a cash-basis corporation that has converted from C corporation status to S corporation status, absent proper planning, will result in a forced double taxation on such receivables. As discussed above, one common method of avoiding the built-in-gain tax on the accounts receivable of a cash basis taxpayer is to accrue bonuses (in an amount equal to its receivables) to its shareholder-employees in its last tax year as a C corporation and pay such bonuses to its shareholder-employees in its first tax year as an S corporation. Although there are a number of open issues with regard to this strategy, Private Letter Ruling 200925005 confirms that this strategy does work.

In Private Letter Ruling 200925005, the IRS ruled that the payment of certain salary expenses and other outstanding costs relating to the production of the outstanding accounts receivable of the corporation at the time of its conversion to S status would constitute built-in deduction items, specifically including the payment of compensation to shareholder-employees of the corporation within the first two and one-half months following the corporation's conversion to S corporation status.

Under the facts of the ruling, the taxpayer is a cash basis C corporation with a calendar tax year. The corporation is a personal service corporation which is wholly-owned by a number of professionals. The corporation bills its clients for the services performed by the professionals and when invoices are paid, the corporation pays salaries and wages to the professionals. Additionally, the corporation has other employees, such as non-shareholder clerical staff and non-shareholder professionals to which it pays wages.

The taxpayer will elect to be an S corporation and will have built-in gain from its outstanding accounts receivable. The taxpayer requested the letter ruling to determine whether certain salary expenses and other outstanding costs relating to the production of the outstanding accounts receivable as of the date of the corporation's conversion to S status will qualify as built-in losses under IRC Section 1374, and specifically, whether the amounts paid to its shareholder-employees within the first two and one-half months of the recognition period under IRC Section 1374 of salary and wage expenses that are related to the production of accounts receivable that are outstanding as of the effective date of the S election will constitute built-in deduction items under IRC Section 1374(d)(5)(B).

The post-conversion collection of accounts receivable of a cash-basis corporation, particularly the cash-basis service corporation, is potentially subject to a substantial tax liability for the built-in gain tax imposed under IRC Section 1374. Due to the pass-through nature of an S corporation, the collection of accounts receivable by a cash-basis corporation that has converted from C corporation status to S corporation status, absent proper planning, will result in a forced double taxation on such receivables of approximately 50.23 percent.⁹³ Consequently, it is imperative that the cash-basis service corporation converting from C corporation status to S corporation status consider all available planning opportunities to minimize the impact of the built-in gain tax with respect to its accounts receivable.

Since built-in deduction items (such as accounts payable of cash-basis corporations) are taken into account in determining NUBIG of an S corporation under IRC Section 1374(d)(5)(C), and the payment of such amounts is treated as a recognized built-in loss that may be matched against built-in income items (such as a cash-basis corporation's accounts receivable), a common method that has been employed by practitioners to avoid the built-in gain tax imposed on the accounts receivable of a cash basis service corporation is to accrue bonuses (in an amount equal to its collectible receivables) to its shareholder-employees in its last tax year as a C corporation and pay such bonuses to its shareholder-employees in its first tax year as an S corporation. Even though such accrued bonuses may or may not be characterized as built-in deduction items (depending on whether they are paid in the first two and one-half months following conversion), the effect of accruing such bonuses nevertheless may be either to eliminate the potential application of the built-in gain tax altogether by reducing the corporation's NUBIG to zero, or alternatively, if the corporation has goodwill or other appreciated assets, to at least minimize recognition of any built-in gains by reducing the corporation's NUBIG by the amount

⁹³ Assuming \$100 of accounts receivable, the built-in gain tax would be \$21 ($\$100 \times 21\%$), and the shareholder-level tax (assuming the maximum marginal individual tax rate of 37%) would be \$29.23 ($\$79 \times 37\%$). Thus, total taxes on the \$100 of accounts receivable would be \$50.23 ($\$21 + \29.23), resulting in an effective federal tax rate of 50.23%. In addition, state corporate income taxes may be imposed on the corporate level gain. The 50.23% potential double tax on S corporations under both Section 1374 and the sting tax imposed on passive investment income under IRC § 1375 should be revised. The purpose of the built-in gain tax was expressly to avoid the repeal of the general utilities doctrine by way of a C corporation converting to S corporation status. It was meant to impose a tax on the S corporation and its shareholders in the same amount as would be taxed if the corporation had remained a C corporation and engaged in the proposed transaction. Because C corporation shareholders are now subject to a 20% tax rate on dividends, that same rate should be used for both the built-in gain tax imposed under IRC § 1374 and the tax on excess passive investment income imposed under IRC § 1375 in order to reach results equivalent to those that would be reached if the corporation had remained a C corporation. Using the current 37% ordinary income rates for S corporation shareholders results in the S corporation shareholders being taxed at a higher rate than had they remained a C corporation and engaged in the same transaction. Such a result is clearly inequitable.

of such accrued bonuses. There are a number of open issues regarding the mechanics of accruing such bonuses. These open issues include:

- whether such bonuses should be paid within the first two and one-half months so as to constitute built-in deduction items that offset the built-in income items (receivables), or whether such bonuses may be paid at any time during the corporation's first taxable year as an S corporation based on the position that the accrued bonuses reduce the corporation's NUBIG to zero;
- if the corporation intends to pay such bonuses in cash within the first two and one-half months and funds must be borrowed to pay such bonuses, whether the corporation or the shareholder-employees should borrow such funds;
- whether such bonuses could be paid by simply having the corporation distribute the accounts receivable attributable to the accrued bonuses within the first two and one-half months following conversion to S corporation status (as opposed to paying such bonuses out in cash);
- whether the regular salaries of the shareholder-employees should be "suspended" in order to enable the corporation to pay such bonuses;
- assessment of the effect of such bonuses on any buy-out provision in the event a shareholder-employee's employment is terminated after receipt of the bonus but prior to any loans funding such bonus being repaid;
- whether the employment agreements of the shareholder-employees should be amended to provide compensation for nonbillable services to support compensation paid in "C" years as well as accrual of the bonus;
- documentation of such accrued bonuses in the minutes of the board of directors as compensation for past services; and
- whether the corporation should continue zeroing out its taxable income for some period of time in order to support compensation amounts paid in prior "C" years as well as to provide a "back-up" for the bonus accrual strategy.

Although Private Letter Ruling 200925005 certainly does not answer all of these open questions, it certainly makes it clear that the built-in gain tax on accounts receivable can be avoided by the converted corporation paying out compensation related to such accounts receivable to its shareholder-employees within the first two and one-half months of the corporation's first tax year as an S corporation, which is the method that has been most commonly employed by practitioners in order to avoid imposition of the built-in gain tax on the accounts receivable of a cash basis service corporation.

The IRS expressly concludes in the ruling that the taxpayer's payments to its shareholder-employee of salary and wages relating to the production of accounts receivable on the effective date of the S election, if paid in the first two and one-half months of the recognition period, qualify as built-in loss items under IRC Section 1374(d)(5)(B). Additionally, the IRS found

that the taxpayer's payments to its non-shareholder employees of salary and wages related to the production of outstanding accounts receivable on the effective date of the S election, if paid at any time during the recognition period, will qualify as built-in loss items under IRC Section 1374(d)(5)(B). Finally, the IRS concluded that the taxpayer's payments of other unpaid payable expenses and accounts payable related to the production of the accounts receivable outstanding on the effective date of the S election, if paid at any time during the recognition period, would qualify as built-in loss items under IRC Section 1374(d)(5)(B).⁹⁴

[j] Acceleration of Accounts Receivable. Alternatively, in order to avoid forced double taxation on its receivables, a service corporation converting from C to S corporation status may choose to accelerate its receivables income and recognize such income prior to conversion to S corporation status. In this manner, the corporation may be able to defer (possibly indefinitely) shareholder-level tax on its receivables until the earnings and profits generated by the collection of such receivables are distributed to the corporation's shareholders. The recognition of receivables income by a corporation prior to its conversion to S corporation status will have the added benefit of decreasing its overall NUBIG. The pre-conversion recognition of receivables income may be achieved in at least three ways.

1) First, the corporation may simply assign and sell its accounts receivable prior to its conversion to S corporation status to a third party.

2) Second, the corporation may sell its accounts receivable to its shareholder-employees prior to its conversion to S corporation status. Additionally, in each of the first two alternatives, the sale of the receivables could be combined with the payment of a bonus in an amount equal to the sales proceeds in order to avoid payment of a corporate level tax on the corporation's sale of its receivables.

3) Finally, the corporation could, in order to avoid a pre-conversion C corporation tax on the sale of its accounts receivable, simply "bonus" its accounts receivable to its shareholder-employees. The pre-conversion recognition of receivables income by a service corporation, when combined with the payment of a corresponding bonus to its shareholder-employees, should also limit any attempts by the IRS to recharacterize payments to the corporation's shareholder-employees as dividend distributions under unreasonable compensation arguments to the corporation's last tax year as a C corporation.

[k] Examples. The examples set forth below examine tax planning alternatives available with respect to the accounts receivable of a cash-basis service corporation converting to S corporation status.

⁹⁴ It is interesting to note that Priv Ltr Rul 200925005 did not specifically state that any type of special bonus had to be accrued prior to the last day of the corporation's last tax year as a C corporation or require any written evidence of such accrual in the corporate minutes or other documentation. Rather, the IRS simply concluded that the payment of salary and wages to the shareholder-employees of the corporation which related to the production of the accounts receivable on the effective date of the S election would qualify as built-in loss items if paid in the first two and one-half months of the recognition period. To be certain, the authors would recommend that such bonus be accrued prior to the last tax year as a C corporation and evidenced at least in the Board of Director minutes of the corporation.

Example (1): *No Planning.* Doctors R Us, a professional corporation using the cash receipts and disbursements method of accounting, has taxable income (pre-salary and bonus to its four shareholder-employees) of \$1,000,000. The corporation is planning to pay total salaries and bonuses to its four shareholder-employees of \$1,000,000, resulting in taxable income to the corporation of zero. The corporation also has \$200,000 of accounts receivable as of December 31, 2018, which will be collected and give rise to income in 2019. The corporation desires to elect S corporation status effective January 1, 2019. If the corporation takes no action to affirmatively plan for its receivables and has no other built-in gain or built-in loss items, it potentially will be subject to a tax of \$42,000 under IRC Section 1374 on the collection of the \$200,000 of receivables in 2019 (21% of \$200,000). The \$200,000 of income recognized on the collection of the receivables, reduced under IRC Section 1366(f)(2) by the \$42,000 corporate level tax imposed under IRC Section 1374, will pass through to, and be taken into account by, the individual shareholder-employees of the corporation under IRC Section 1366 in 2019. Consequently, assuming a maximum marginal tax rate of 37% for individuals, the shareholder-employees will be subject to a tax of \$58,460 (37% of \$158,000). The aggregate tax paid by both the corporation and the individual shareholders of the corporation on the \$200,000 of receivables will therefore be \$100,460 (\$42,000 corporate level tax under IRC Section 1374 plus \$58,460 tax imposed on the individual shareholder-employees), resulting in an aggregate tax rate of approximately 50.23%

Example (2): *Accrual of Bonus.* Now assume that the corporation accrues an additional bonus to its four shareholder-employees in 2018 of \$200,000, an amount equal to its receivables. Under IRC Section 1374(d)(1), the corporation should avoid application of the built-in gains tax altogether because its NUBIG will be zero (even if the accrued bonus does not constitute a built-in deduction item under IRC Section 1374(d)(5) because of the limitations of IRC Section 267(a)(2) and/or IRC Section 404(a)(5)). As such, when the receivables are collected by the corporation in 2018, they will be subject to a single level of tax at the shareholder level of \$74,000 (37% of \$200,000). If the accrued bonus is paid within the first two-and one-half (2-1/2) months of the corporation's first taxable year as an S corporation, it will constitute a built-in deduction item that will offset the built-in income item dollar for dollar, again resulting in a single level of tax at the shareholder level of \$74,000 (assuming no deduction under section 199A). This same result should also occur if the accounts receivable themselves (rather than cash) are bonused out to the shareholder-employees in 2018.

Example (3): *Sale of Receivables to Third Party.* Now assume that instead of accruing a bonus in 2018, the corporation sells the receivables to a third party (for their face value). Also assume that the corporation continues its policy of reducing its taxable income to zero except for the \$200,000 recognized on the sale of its receivables. In this situation, the corporation will be subject to a tax of \$42,000 on the sale of its receivables to the third party (21% of \$200,000). In turn, the earnings and profits of the corporation will be increased by \$158,000, the difference between the \$200,000 received on the sale of the receivables and the \$42,000 of taxes paid

with respect to the sale of the receivables. The shareholder-employees will not, however, be taxed on the \$158,000 of earnings and profits until such earnings and profits are distributed to them.

Although the corporate level tax of \$42,000 is accelerated and recognized in 2018 rather than in 2019, any tax payable at the shareholder level may be deferred for a number of years and, in fact, may never be recognized by the shareholders if the distributions made by the corporation never exceed its accumulated adjustments account following its conversion to S corporation status.

Example (4): *Sale of Receivables to Third Party and Payment of Bonus.* Assume the same facts as in Example 3, above, except that in addition to selling the receivables to a third party, the corporation distributes the additional \$200,000 collected on the sale of its receivables to its four shareholder-employees as an additional bonus, thus reducing the corporation's taxable income to zero. The corporation will not be subject to the built-in gains tax imposed under IRC Section 1374 since it will no longer own any receivables, and additionally will not be subject to any tax in 2018 since it will have no taxable income. The shareholders will be subject, however, to a tax of \$74,000 in 2019, determined by multiplying the additional \$200,000 bonus by the highest marginal individual income tax rate of 37% (assuming no deduction is available under Section 199A).

The sole difference between this example and the straight accrual of a bonus alternative found in Example 2, above, is that the tax of \$74,000 is paid in 2018 in this case whereas the tax of \$74,000 is paid in 2019 in the case of a bonus accrued in 2018. This method has an additional advantage of not exposing the corporation to an unreasonable compensation argument beyond its last tax year as a C corporation since it will not be subject to IRC Section 1374, and as such, will have no reason to pay high amounts of compensation to its shareholder-employees in order to zero out its income.

Example (5): *Sale of Receivables to Shareholder-Employees.* Assume the same facts as in Example 4, above, except that the corporation sells the receivables to its shareholder-employees for \$200,000. Assuming that the shareholder-employees have \$200,000 to pay the corporation for the receivables (or will execute promissory notes to the corporation for the receivables), the corporation will recognize a corporate level tax of \$42,000 in 2018.

As the shareholder-employees collect the receivables in 2019, they will recognize no gain since they will have a cost basis in the receivables under IRC Section 1012 equal to \$200,000. Again, until some future point in time when the earnings and profits of \$158,000 (\$200,000 of sales proceeds minus \$42,000 of tax) is distributed to such shareholder-employees, any shareholder level tax will be deferred. This is the same result as achieved in Example 3, above, where the receivables were sold to a third party. Since it may be impossible for a corporation to find a third party willing to buy its receivables, it may be forced to sell the receivables to its

shareholders if it desires to dispose of its receivables prior to its conversion to S corporation status.

Example (6): *Sale of Receivables to Shareholder-Employees and Payment of Bonus.* Assume the same facts as in Example 5, above, where the corporation sold the receivables to its shareholder-employees, but assume as in Example 4, above, that the corporation accrues an additional bonus of \$200,000 to its shareholder-employees. In actuality, the only money that will change hands on the sale of the receivables will be withholding taxes since the shareholders will be receiving a bonus equal to the amount which they are paying for the receivables of the corporation (less applicable withholding taxes).

Just as in Example 4, above, if this strategy is successful, the receivables will be subject to a single level of tax at the shareholder level equal to \$74,000 (37% of \$200,000) in 2018. As the receivables are collected by the shareholders in 2019, they will recognize no income since they will have a cost basis in the receivables under IRC Section 1012 of \$200,000.

Example (7): *Bonus of Receivables.* Assume the same facts as in Example 6, above, except that the corporation simply distributes the \$200,000 of receivables proportionately to the shareholder-employees generating the receivables as a bonus. Under the assignment of income doctrine, the corporation should recognize \$200,000 of income on the distribution of its receivables to its shareholder-employees, but will receive a corresponding compensation deduction for the \$200,000 bonus paid to them. The shareholders will therefore recognize \$200,000 of income in 2018, and be subject to a tax of \$74,000 (37% of \$200,000).

Once again, the shareholder-employees will have a IRC Section 1012 tax-cost basis in the receivables, and as such, will recognize no income in 2019 when they collect the receivables.

[1] Summary of Accounts Receivable Planning Alternatives. These examples demonstrate that the accrual of a bonus in an amount equal to the receivables of a cash-basis service corporation in its final C year, produces the lowest amount of tax and the greatest amount of deferral on the entire amount of tax due (provided the corporation has no other built-in gain items). Alternatively, the sale of the corporation's receivables prior to its conversion to S corporation status will accelerate the corporate level tax due on the receivables, but may result in an indefinite deferral of the shareholder level tax on the earnings and profits generated by the sale of the receivables. The sale of receivables in a cash-basis service corporation's last C year with a corresponding bonus in the amount of its receivables or the bonus of its receivables will result in a single level of tax and a one year acceleration of income in comparison to the bonus accrual alternative. The alternatives involving the sale or bonus of the cash-basis service corporation's receivables in its last C year also have the added benefit of limiting any unreasonable compensation arguments to its last year as a C corporation, rather than exposing the corporation to such an argument in years following its conversion to S corporation status when the corporation may be subject to the built-in gains tax imposed under IRC Section 1374.

Consequently, the tax practitioner must analyze the specific facts and circumstances of each situation, including the total compensation package otherwise being paid to the shareholder-employees of the corporation in its last year as a C corporation, in order to determine the optimal planning alternative regarding the cash-basis service corporation's receivables. In no event, however, should the cash-basis service corporation merely convert to S corporation status without engaging in any planning to minimize the built-in gains tax which will be imposed under IRC Section 1374 on such corporation's receivables.

§1.18 **Conclusion**

As discussed above, the rules applicable to the 20% of QBI Deduction for pass-throughs and sole proprietorships are complex and should be carefully considered in the selection of the type of entity to use. Because of the anomalies of Section 199A, the use of different types of pass-through entities, or a sole proprietorship, may result in different deductions under Section 199A even under identical facts.

A great deal of thought should be given before a business decides to convert from a pass-through entity to a C corporation due to the difficulty in getting out of "C" corporation status, and the "toll charges" imposed on converting from "C" corporation status, especially the built-in gains tax imposed under Section 1374 discussed in detail above.

Unless the taxpayer or tax practitioner has a crystal ball predicting future changes in tax laws, revenues, payroll, equipment purchases and the timing of the sale of the business, it may be very hard to recommend that a business convert to "C" corporation status. However, there will certainly be some situations in which a C corporation will make sense. Obviously, one of the biggest factors as to whether a "C" corporation makes sense at all is how much of the earnings are expected to be distributed to the shareholders. If the owner or owners frequently take profits out of the business or the business will be sold in the foreseeable future, it makes the most sense to stay a pass-through entity or sole proprietorship. Conversely, if the owners are reinvesting most of the earnings of the business (back into non-deductible expenditures), cannot take advantage of the Section 199A deduction and/or are not planning on selling their business in the foreseeable future, a "C" corporation may be the better vehicle to conduct the business. Concepts of the time value of money clearly come into play in making this determination.

Chapter 2

Current IRS Enforcement Objectives, Ways in Which IRS Detects and Pursues These Objectives, and Taxpayer Defense Alternatives

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OREGON TAX INSTITUTE



Current IRS Enforcement Objectives, Ways in which IRS Detects and Pursues these Objectives and Taxpayer Defense Alternatives

SPEAKER:

Dennis Perez

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Multnomah Athletic Club | June 6, 2019 | 8:00 a.m. – 5:15 p.m.

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LARGE BUSINESS & INTERNATIONAL CAMPAIGNS

Since January 31, 2017, LB&I has approved approximately 50 compliance campaigns. The latest LB&I announcements were on May 21, 2018 and October 30, 2018, which identified 11 additional campaigns:

- Internet Capitalization for Self-Constructed Assets
- Forms 3520/3520-A Non-Compliance and Penalties
- Forms 1042/1042-S Compliance
- Nonresident Tax Treaty Exemptions
- Nonresident Alien Schedule A and other Deductions
- Nonresident Alien Tax Credits
- Individual Foreign Tax Credit Phase II
- Offshore Service Providers
- FATCA Filing Accuracy
- 1120F Delinquent Returns
- Work Opportunity Tax Credit

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LARGE BUSINESS & INTERNATIONAL CAMPAIGNS (cont.)

Other Notable Campaigns:

- OVDP Declines and Withdrawals
- Micro Captive Insurance
- Swiss Bank Program Data Mining

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CAMPAIGN APPROACH

- Identify areas of greatest non-compliance through:
 - Data Analytics
 - Feedback from Field
 - Feedback from tax community
- Deploy resources to those areas
- Transparent to taxpayers
- Focus on mid-market companies

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DEFINITION OF A CAPTIVE

- Basic Definition
 - A captive is an insurance company that insures the risks of its shareholders or persons closely related to its shareholders.
- Types of Captive Structures
 - Parent-Subsidiary Captive Arrangements
 - Brother-Sister Captive Arrangements
 - Group Captives
 - Micro-captives

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TAX TREATMENT OF CAPTIVES

- Insureds
 - Deduction for insurance premiums as business expenses
- Captive
 - Taxed under Subchapter L – Earned and incurred
 - Section 831(b) Election – Micro-captives taxed only on investment income; must meet requirements including premium cap of \$1.2 million (\$2.2 million beginning in 2017)
 - Annual premiums received within the \$1.2 million (or \$2.2 million) cap are excluded from income
 - Section 953(d) Election – Insurance company CFC treated as a domestic corporation

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IRS SCRUTINY: THE DIRTY DOZEN LIST

Beginning in 2015, the IRS included on its “Dirty Dozen” list of tax scams, what it believes are certain abusive micro-captive insurance arrangements (see IR-2017-31):

- *In abusive structures ... “coverages may insure implausible risks, fail to match genuine business needs or duplicate the taxpayer’s commercial coverages.”*
- *“Premium amounts may be unsupported by underwriting or actuarial analysis, may be geared to a desired deduction amount or may be significantly higher than premiums for comparable commercial coverage.”*
- *“[Abusive] captives may invest in illiquid or speculative assets or loans or otherwise transfer capital to or for the benefit of the insured, the captive’s owners or other related persons or entities. Captives may also be formed to advance inter-generational wealth transfer objectives and avoid estate and gift taxes. Promoters, reinsurers and captive insurance managers may share common ownership interests that result in conflicts of interest.”*

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IRS NOTICE 2016-66

On November 1, 2016, the IRS issued Notice 2016-66, which identifies certain transactions relating to small captive insurance companies as “transactions of interest,” making it a category of reportable transaction.

A transaction of interest is defined as a transaction that is the same as or substantially similar to a transaction identified by the IRS as a transaction of interest by notice, regulation, or other published guidance. Treas. Reg. § 1.6011-4(b)(6).

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CAPTIVES DEFINED AS TRANSACTIONS OF INTEREST

A captive is a transaction of interest if:

- A person owns, directly or indirectly, an interest in an insured entity;
- The captive enters into an insurance arrangement to assume risks of the insured;
- The captive makes an election under Section 831(b) to exclude premium income and to be taxed only on investment income;
- The owner of insured, the insured, or a related person owns directly or indirectly at least 20% of the vote or value of the captive; and
- The captive either:
 - Has liabilities for covered losses and expenses in an amount less than 70% of total premiums earned; AND/OR
 - Uses its premium income to provide financing to related parties in a transaction nontaxable to the recipient.

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WHO MUST REPORT UNDER NOTICE 2016-16?

Participants identified in Notice 2016-66 are required to report under Treas. Reg. § 1.6011-4.

- The insured(s);
- Certain owners of the insured(s);
- The Captive; and
- Intermediary company (if any).

Material advisors are required to report under the rules of Section 6111 and Treas. Reg. § 301.6111-3.

IRS AUDITS OF CAPTIVES

- Focus of inquiry
 - Is the product insurance?
 - Does the captive look and operate like an insurance company?
 - Is there an arms-length relationship between the captive and the insured(s)?
 - Are the insurance policies relevant to the insured's business?
 - Terms of coverage
 - Price of premiums
 - Actuarial Analysis
 - Penalties Considered

Avrahami v. Commissioner, 149 T.C. No. 7, August 21, 2017 (Judge Holmes)

- H & W owned jewelry and real estate businesses via pass-through entities. W formed Feedback, a St. Kitts company, to act as a captive insurance company for their businesses. H & W claimed deductions under § 162 on their 2009 and 2010 tax returns for amounts paid by their entities to Feedback and to Pan Am, an offshore third-party insurance company that reinsured a portion of its risk with Feedback, which the IRS disallowed.
- Annual insurance premiums paid by H & W's businesses rose from \$150,000 to \$1.3 million after Feedback was formed. Feedback accumulated a surplus of \$3.8 million, of which \$1.7 million migrated back to H & W via loans and loan repayments.
- For a company to be an insurance company, the company must 1) involve risk shifting, 2) involve risk distribution, 3) involve insurance risk, and 4) meet commonly accepted notions of insurance. Factors considered by the Court included the fact only 3 to 4 companies were insured; the total risk exposure was low; the premiums paid were not reasonable; no claims were paid until after the IRS audit started; Feedback did not comply with St. Kitts insurance regulations; and a real insurance company would not make such loans and loan repayments with its premiums.
- The Tax Court held that neither Feedback nor Pan Am were valid insurance companies. As a result, the court disallowed the taxpayers' deduction for premiums paid and invalidated Feedback's elections under § 831(b) (to be treated as a small insurance company) and § 953(d) (to be taxed as a domestic corporation).

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Reserve Mechanical Corp. v. Commissioner, TC Memo 2018-86, June 18, 2018 (Judge Kerrigan)

- Reserve Mechanical Corp was a captive insurance corporation incorporated in Anguilla. Reserve was a wholly-owned subsidiary of Peak Casualty Holdings, LLC, which was owned by two U.S. citizens, Mr. Zumbaum and Mr. Weikel. Mr. Zumbaum and Mr. Weikel also together owned an S corporation in Osburn, Idaho, that provided and serviced equipment used in underground mining.
- Relying on *Avrahami*, the Tax Court concluded that the captive arrangement did not have adequate risk distribution, did not involve bona fide insurance agreements, involved a circular flow of funds, and had premiums that were not negotiated at arm's length or actuarially determined. The Tax Court further concluded that the company's activities related to those policies were not those of a bona fide insurance company.
- As a result, the Tax Court upheld the IRS's determination that (1) Reserve's transactions were not insurance transactions in the commonly accepted sense, and thus, taxpayer did not qualify for insurance company exemption from income tax; (2) Reserve was not eligible to make an election to be treated as a domestic corporation; and (3) payments that Reserve received were subject to the 30% withholding tax as fixed or determinable annual or periodical (FDAP) income received by a foreign corporation from sources within the United States.

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Syzygy Ins. Co. v. Commissioner, TC Memo 2019-034, April 10, 2019 (Judge Ruwe)

- Syzygy is a microcaptive insurance company established by officers of Highland Tank, an S corp family business engaged in manufacturing of above-ground and below-ground steel tanks.
- Tax Court held that amounts paid to Syzygy were not insurance premiums for tax purposes, and as a result, (1) Syzygy's § 831(b) election was invalid; (2) the premiums weren't excludible from Syzygy's gross income; and (3) the S corporation officers weren't entitled to passthrough business deductions for the premiums paid.
- Key factors in the Tax Court's decision included: Syzygy did not accomplish sufficient risk distribution through fronting carriers, which were also not bona fide insurance companies; Syzygy was not operated as an insurance company; facts indicated the policies were not valid and binding, taking into consideration the related-party transaction and the policies' late issuances, ambiguities, and conflicting terms; and the premiums were unreasonable.

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OFFSHORE NONCOMPLIANCE

The U.S. Government has implemented and followed a number of procedures aimed at discovering American taxpayers with undeclared accounts and acting against them. The current and expanding information disclosure regime includes a combination of the following disclosure methods to obtain information about foreign financial accounts, whether in secrecy jurisdictions or otherwise:

1. Whistleblowers and informants.
2. Criminal investigations of financial institutions and account holders.
3. Civil summons processes.
4. Requests under tax treaty or mutual information exchange agreements.
5. The voluntary disclosure of thousands of Americans seeking to avoid criminal prosecution and obtain reduced civil penalties, and their continuing tax compliance.
6. FATCA and related legislative and regulatory developments.

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OFFSHORE NONCOMPLIANCE (cont.)

Report of Foreign Bank and Financial Accounts – FBAR

- U.S. law also requires the filing of a separate information return, FinCEN Form 114, known as an “FBAR,” by April 15th following each calendar year. The form is not filed with a tax return, but is filed electronically via FinCEN’s BSA E-Filing System.
- A non-willful failure to file an FBAR can be penalized up to \$10,000, but a willful failure to file can result in a civil penalty of as much as 50% of the value of the foreign account, with no cap for each violation, per year. 31 U.S.C. § 5321(a)(5).
- In both *United States v. Williams*, 110 AFTR 2d 2012-5298 (4th Cir. 2012), and *United States v. McBride*, No. 2:09-cv-00378 (D. Utah 2012), the government successfully established that the taxpayer’s failure to comply with the FBAR obligations was willful for purposes of the civil penalty.
- In both cases, the government’s burden of proof on all questions before the court, including the question of whether the taxpayer’s failure to comply with the FBAR obligations was “willful,” was held to be “a preponderance of the evidence.”

OFFSHORE NONCOMPLIANCE (cont.)

- Taken together, both decisions appear to have adopted a standard of “reckless disregard,” “constructive knowledge,” or “willful blindness” as a basis to establish willfulness for FBAR penalty purposes. “Reckless disregard” means that the individual was aware of the failure to file the FBAR and nonetheless ignored the obligation to file the form; “constructive knowledge” allows the government to impute knowledge of FBAR filing requirements to taxpayers without proving that the taxpayer had actual knowledge.
- IRS guidance issued in May 2015 indicates that the IRS will, in most cases, not assess a penalty greater than 50% of the aggregate high balance during the years open under the statute of limitations. The IRS guidance noted that the Service could seek 100% of the balance in egregious cases, and of course has the statutory right to seek more.

OFFSHORE NONCOMPLIANCE (cont.)

Forms 3520, 3520-A and 5471

- If a U.S. transferor of property to a foreign trust, or a U.S. recipient of a distribution from such a trust, fails to timely file a Form 3520 to report these transactions, the IRS may impose a penalty equal to 35% of the gross value of the property transferred to or received from the trust.
- If a U.S. donee fails to timely file a Form 3520 to report the receipt of a large foreign gift, or files the form incorrectly or incompletely, such donee may be subject to a penalty equal to 5%, not to exceed 25%, of the value of the gift or bequest received in the relevant year.
- If a foreign grantor trust fails to timely file a Form 3520-A, or fails to furnish all of the required information, the U.S. owner may be subject to a penalty equal to 5% of the gross value of the portion of the trust's assets treated as owned by the U.S. person at the close of the taxable year.

OFFSHORE NONCOMPLIANCE (cont.)

- The failure to timely file a complete and correct Form 3520 or Form 3520-A may result in an additional penalty of \$10,000 per 30-day period for failing to comply within 90 days of notification by the IRS that the information return has not been filed. The total penalty for failure to report a trust transfer, however, cannot exceed the amount of the property transferred.
- Depending on the type of foreign corporation involved, and the company's relationship to the U.S. shareholder, there are varying penalties that may be imposed on the failure to file a Form 5471. Generally, the penalty is \$10,000 per failure to file, but additional penalties can be imposed if the form is not filed after notice by the IRS.

IRS CRIMINAL INVESTIGATION

Title 26 Tax Crimes – 26 U.S.C. § 7201, 7206(1)

- Employment Tax
- International Tax Fraud
- Abusive Tax Schemes
- Refund Crimes – QRP, RPP and ID theft
- Cybercrimes (including Virtual Currency)
- Frivolous Arguments Program – Non-filers
- Political/Public Corruption
- Counterterrorism/Terrorist Financing
- Money Laundering/Bank Secrecy Act (BSA)
- Organized Crime Drug Enforcement Task Force (OCDETF)
- High Intensity Drug Trafficking Area (HIDTA)

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FY STATISTICS

	FY 2016	FY 2017	FY 2018
Investigations Initiated	3,395	3,019	2,886
Prosecution Recommendations	2,744	2,251	2,130
Informations/Indictments	2,761	2,294	2,011
Conviction Rate	92.1%	91.5%	91.7%
Total Sentenced	2,699	2,549	2,111
Percent to Prison	79.9%	80.1%	82%
Average Months to Serve	41	42	45

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EMPLOYMENT TAX STATISTICS

	FY 2016	FY 2017	FY 2018
Investigations Initiated	137	162	207
Prosecution Recommendations	77	59	81
Informations/Indictments	71	60	64
Sentenced	87	77	48
Incarceration Rate	70.1%	77.9%	77%
Average Months to Serve	14	21	21

FATCA OVERVIEW

FATCA is a federal law enacted in 2010 that requires foreign financial institutions to identify their U.S. customers and report information (FATCA Information) about financial accounts held by U.S. taxpayers either directly or through a foreign entity. FATCA's primary aim is to prevent U.S. taxpayers from using foreign accounts to facilitate the commission of federal tax offenses.

LOYAL BANK LTD FATCA PROSECUTION

Adrian Baron, the former Chief Business Officer and former Chief Executive Officer of Loyal Bank Ltd, an offshore bank with offices in Budapest, Hungary and Saint Vincent and the Grenadines, pleaded guilty to conspiring to defraud the United States by failing to comply with the Foreign Account Tax Compliance Act (FATCA).

June 2017 – IRS Undercover Agent met with Baron, explained that he was involved in stock manipulation schemes and wanted to open several bank accounts at Loyal Bank. Although he was the beneficial owner of the accounts, he did not want to appear on any of the bank documents.

July 2017 – UCA met with Baron again to describe his scheme and that he wanted to circumvent FATCA reporting.

August 2017 – Multiple accounts were opened at Loyal Bank and no information was requested by Loyal Bank for FATCA purposes.

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JOINT CHIEFS OF GLOBAL TAX ENFORCEMENT aka J5

Australian Criminal Intelligence Commission (ACIC) and Australian Taxation Office (ATO)

Canada Revenue Agency (CRA)

The Netherlands – Fiscale Inlichtingen-en Opsporingsdienst (FIOD)

The United Kingdom – HM Revenue & Customs (HMRC)

Internal Revenue Service Criminal Investigation (IRS-CI)

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THE J5 IS DEDICATED TO COMBATTING TRANSNATIONAL TAX CRIME, COMMITTED TO:

Develop shared strategies to gather information and intelligence that will strengthen operational cooperation in matters of mutual interest, and target those who seek to commit transnational tax crimes, cybercrime and launder the proceeds of crime.

Drive strategies and procedures to conduct joint investigations and disrupt the activity of those who commit transnational tax crime, cybercrime and enable money laundering.

Collaborate on effective communications that reinforce that J5 is working together to tackle transnational tax crime, cybercrime and money laundering.

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INTERNATIONAL TAX ENFORCEMENT GROUP (ITEG)

Dedicated to developing significant international tax investigations, building on the NCIU efforts, utilizing data analytics from BSA, FATCA, OVDP, Swiss Bank investigations, Whistleblowers including the Panama Papers and Paradise Papers.

Attaches will be located in Barbados, Bogota, Frankfurt, Europol (at the Hague), Hong Kong, London, Mexico City, Ottawa, Panama City and Sydney and the Netherlands.

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NATIONALLY COORDINATED INVESTIGATION UNIT (NCIU)

NCIU will be responsible for overseeing all IRS field offices, and coordinating major investigations at a national level.

Initially focused on Employment Tax, International Tax Enforcement, Microcap Stock Fraud (coordinating with the SEC), and fuel excise tax.

Unit will report to CI Executives in HQ and will identify national areas of non-compliance.

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STREAMLINED DOMESTIC OFFSHORE PROCEDURES

Terms:

- U.S. taxpayers (U.S. citizens, lawful permanent residents, and those meeting the substantial presence test of IRC section 7701(b)(3)) must:
 - For each of the most recent 3 years for which the U.S. tax return due date (or properly applied for extended due date) has passed (the “covered tax return period”), file amended tax returns, together with all required information returns (e.g., Forms 3520, 3520-A, 5471, 5472, 8938, 926, and 8621);
 - For each of the most recent 6 years for which the FBAR due date has passed (the “covered FBAR period”), file any delinquent FBARs (FinCEN Form 114, previously Form TD F 90-22.1);
 - Pay a 5% Title 26 miscellaneous offshore penalty; and
 - Submit certification of non-willfulness.

A taxpayer who is eligible and who complies with all of the instructions will be subject only to the 5% Title 26 miscellaneous offshore penalty and will not be subject to accuracy-related penalties, information return penalties, or FBAR penalties. Even if returns properly filed under these procedures are subsequently selected for audit under existing audit selection processes, the taxpayer will not be subject to accuracy-related penalties with respect to amounts reported on those returns, or to information return penalties or FBAR penalties, unless the examination results in a determination that the original return was fraudulent and/or that the FBAR violation was willful.

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STREAMLINED DOMESTIC OFFSHORE PROCEDURES (cont.)

Offshore Penalty

- **Includes:**
 - A foreign financial asset is subject to the 5-percent offshore penalty in a given year in the covered FBAR period if the asset should have been, but was not, reported on an FBAR for that year.
 - A foreign financial asset is subject to the 5-percent offshore penalty in a given year in the covered tax return period if the asset should have been, but was not, reported on a Form 8938 for that year.
 - A foreign financial asset is also subject to the 5-percent offshore penalty in a given year in the covered tax return period if the asset was properly reported for that year, but gross income in respect of the asset was not reported in that year.
- **Does not include:**
 - Any asset (tax compliant or non-compliant) that was not the kind of asset reportable on either FBAR or Form 8938.
 - Assets in which the taxpayer had no financial interest, such as an employer's account over which the taxpayer had only signature authority, or portions of assets in which the taxpayer had no personal financial interest.

STREAMLINED FOREIGN OFFSHORE PROCEDURES

Terms:

- Same as Streamlined Domestic Offshore Procedures, but must also meet the non-residency requirement.
 - Non-Residency Requirement: Individual U.S. citizens or lawful permanent residents, or estates of U.S. citizens or lawful permanent residents, meet the applicable non-residency requirement if, **in any one or more of the most recent three years** for which the U.S. tax return due date (or properly applied for extended due date) has passed, the individual did not have a U.S. abode and the individual was physically outside the United States for at least 330 full days.
- There is **no** 5% Miscellaneous Offshore Penalty under the Streamlined Foreign Offshore Procedures.

DELINQUENT FBAR SUBMISSION PROCEDURES

What are the eligibility requirements:

- Taxpayers have not filed required FBARs.
- Taxpayers do not need to use either OVDP or the SFOP to file delinquent or amended tax returns to report and pay additional tax.
- Taxpayers are not under a civil examination or a criminal investigation by the IRS, and have not already been contacted by the IRS about the delinquent FBARs.

How does one file the FBARs?

- File the delinquent FBAR electronically and include a statement explaining why you are filing the FBARs late (recall that the FBAR can only be filed electronically)

What is the benefit?

- The IRS **will not impose a penalty** for the failure to file the delinquent FBARs if the taxpayer properly reported on his U.S. tax returns, and paid all tax on, the income from the foreign financial accounts reported on the delinquent FBARS. What about de minimis unreported income?
- FBARs will not be automatically subject to audit but may be selected for audit through the existing audit selection processes that are in place for any tax or information returns.

DELINQUENT INFORMATION RETURN SUBMISSION PROCEDURES

What are the eligibility requirements?

- Same as Delinquent FBAR Submission Procedures but also must have **reasonable cause** for not timely filing the information returns.
- Unlike the procedures described in OVDP FAQ 18, penalties may be imposed under the Delinquent International Information Return Submission Procedures if the Service does not accept the explanation of reasonable cause.
- Taxpayers who have unreported income or unpaid tax are not precluded from filing delinquent international information returns.

What is required in the reasonable cause statement?

- A reasonable cause statement must be attached to each delinquent information return filed for which reasonable cause is being requested. If a reasonable cause statement is not attached to each delinquent information return filed, penalties may be assessed.
- The longstanding authorities regarding what constitutes reasonable cause continue to apply, and existing procedures concerning establishing reasonable cause, including requirements to provide a statement of facts made under the penalties of perjury, continue to apply.
- As part of the reasonable cause statement, taxpayers **must certify** that any entity for which the information returns are being filed was not engaged in tax evasion.

OTHER OPTIONS

Quiet Disclosure

- File amended returns and FBARs outside of any formal voluntary disclosure program. Generally tailor the filing of the delinquent returns and FBARs to the applicable statute of limitations.
- IRS has consistently announced that they are looking for quiet disclosures. The implication is the potential penalties will be applied harshly. Of course, if the taxpayer has a good willfulness defense or reasonable cause, then this is still a viable option, but the willfulness defense and reasonable cause should be thoroughly vetted.

Prospective Compliance

- Taxpayer complies with his obligations moving forward.
- Generally the easiest option but the taxpayer will generally have unlimited exposure on the tax return side and the FBAR civil penalties will remain for 6 years. Criminal exposure for the tax return and the FBAR will remain for 5 years.

Do Nothing

- IRS has said about 100 times to not do this.
- Not a viable option and may be an excellent indicator to walk away from the client.

PROCEDURES IN NOVEMBER 2018 GUIDANCE

- Once Criminal Investigation preliminarily accepts submissions, it will forward cases to a civil compliance unit in Austin for distribution to the appropriate civil examination unit.
- All voluntary disclosures will be assigned for examination and follow standard examination procedures.
- The IRS expects the majority of cases to be resolved by agreement.

FRAMEWORK IN NOVEMBER 2018 GUIDANCE

- Voluntary disclosures will generally include a 6 year disclosure period.
- Taxpayers must submit all required returns and reports for the disclosure period.
- Taxpayer cooperation is required.
- Examiners will use the interim guidance in considering penalties.

FRAMEWORK IN NOVEMBER 2018 GUIDANCE (cont.)

Fraud Penalties will be asserted as follows:

- Civil fraud penalty will apply to one year with the highest tax liability.
- Examiners may apply civil fraud penalty to more than one year, up to all six years, based on facts and circumstances, for example, if there is no agreement to tax liability.
- Examiners may apply civil fraud penalty beyond six years if taxpayer fails to cooperate and resolve examination by agreement.

FRAMEWORK IN NOVEMBER 2018 GUIDANCE (cont.)

Other Penalties will be asserted as follows:

- Willful FBAR penalties will be asserted in accordance with existing IRS penalty guidelines under IRM 4.26.16 and 4.26.17
- Penalties for failure to file information returns will be at examiner's discretion
- Penalties related to excise taxes, employments taxes, estate and gift tax, etc. will be based on facts and circumstances with examiners coordinating with subject matter experts

FRAMEWORK IN NOVEMBER 2018 GUIDANCE (cont.)

Taxpayers may:

- Request imposition of accuracy related penalties instead of civil fraud penalties or non-willful FBAR penalties instead of willful penalties. Given the objective of the voluntary disclosure practice, granting requests for the imposition of lesser penalties is expected to be exceptional. The taxpayer must present convincing evidence to justify the reduction.
- Request an appeal with the Office of Appeals.

Thank You

Dennis Perez
Hochman Salkin Toscher Perez P.C.

FY2018 Statistics

	FY 2017	FY 2018
Investigations Initiated	3019	2886
Prosecution Recommendations	2251	2130
Informations/Indictments	2294	2011
Conviction Rate	91.5%	91.7%
Total Sentenced	2549	2111
Percent to Prison	80.1%	82%
Average Months to Serve	42	45

- ▶ THERE WERE 66,873 CASES REPORTED TO THE UNITED STATES SENTENCING COMMISSION IN FISCAL YEAR 2017.
- ▶ OF THESE CASES, 584 INVOLVED TAX FRAUD.¹
- ▶ THESE OFFENDERS WERE SENTENCED UNDER SECTIONS 2T1.1 AND 2T1.4 OF THE U.S. SENTENCING COMMISSION'S *GUIDELINES MANUAL*.

Quick Facts



Tax Fraud Offenses¹



Top Five Districts Tax Fraud Offenders FY 2017
Northern District of Illinois (N=35)
Northern District of California (N=31)
Eastern District of California (N=29)
Central District of California (N=25)
Eastern District of New York (N=23)



In fiscal year 2017, there were 584 tax fraud offenders, who accounted for 0.9% of all offenders sentenced under the guidelines.² The number of tax fraud offenders has decreased slightly during the last five years.

Offender and Offense Characteristics

- In fiscal year 2017, approximately two-thirds of tax fraud offenders were men (69.4%).
- More than half were White (52.4%) followed by Black (30.8%), Hispanic (10.3%), and Other Races (6.5%).
- The average age of these offenders at sentencing was 52 years.
- Most tax fraud offenders were United States citizens (93.8%).
- The majority of tax fraud offenders had little or no prior criminal history (80.5% of these offenders were assigned to Criminal History Category I).
- The median tax loss for these offenses was \$277,576.³
 - ◆ 87.2% of tax offenses involved tax losses of \$1.5 million or less.
 - ◆ 19.8% of tax offenses involved tax losses of \$100,000 or less.
- Sentences for tax fraud offenders were increased for:
 - ◆ 12.5% of offenders for using sophisticated means to execute or conceal the offense;
 - ◆ 8.4% of offenders for having a leadership or supervisory role in the offense;
 - ◆ 3.8% of offenders for abusing a public position of trust or using a special skill; and
 - ◆ 8.7% of offenders for obstructing or impeding the administration of justice.
- Sentences for tax fraud offenders were decreased for:
 - ◆ 2.4% of offenders because they were a minor or minimal participant in the offense.

Punishment

- More than half of tax fraud offenders were sentenced to imprisonment only (59.1%).
- The average sentence length for tax fraud offenders was 17 months.

¹ Tax fraud offenses include cases with complete guideline application information in which the offender was sentenced under §2T1.1 (Tax Evasion; Willful Failure to File Return, Supply Information, or Pay Tax; Fraudulent or False Returns, Statements, or Other Documents) or §2T1.4 (Aiding, Assisting, Procuring, Counseling, or Advising Tax Fraud) using a *Guidelines Manual* in effect on November 1, 2001 or later.

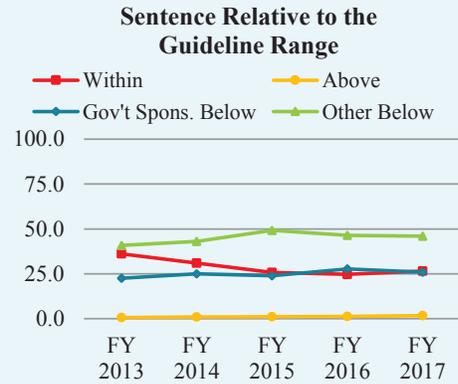
² Of the 66,873 offenders sentenced in fiscal year 2017, 4,956 were excluded from this analysis due to incomplete guideline application information.

Quick Facts

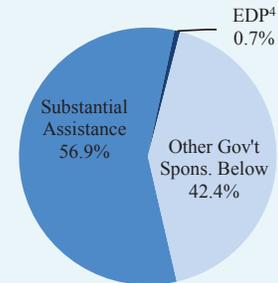
Tax Fraud Offenses

Sentences Relative to the Guideline Range

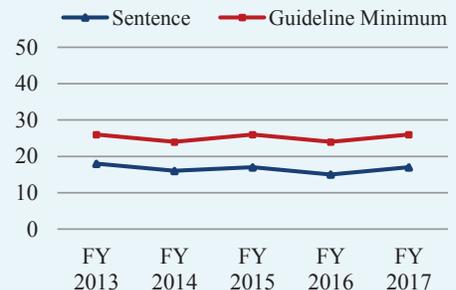
- During the past five years, the rate of within range sentences for tax fraud offenders has decreased (from 36.1% in fiscal year 2013 to 26.5% in fiscal year 2017).
- In each of the past five years, approximately one-quarter of tax fraud offenders received a sentence below the guideline range because the government sponsored the below range sentence.
 - ◆ Substantial assistance departures were granted in approximately 15 to 17 percent of tax fraud cases in each of the past five years.
 - ◇ These offenders received an average reduction of 67.3% in their sentence during the five-year time period (which corresponds to an average reduction of 17 months).
 - ◆ Other government sponsored departures were granted in approximately seven to thirteen percent of tax fraud cases in each of the past five years.
 - ◇ These offenders received an average reduction of 68.1% in their sentence during the five-year time period (which corresponds to an average reduction of 13 months).
- The rate of non-government sponsored below range sentences increased during the past five years (from 40.8% of tax fraud cases in fiscal year 2013 to 45.9% in fiscal year 2017).
 - ◆ Reductions for non-government sponsored below range sentences were smaller than in cases in which the government sponsored a below range sentence, with an average reduction of 59.0% during the five-year time period (which corresponds to an average reduction of 12 months).
- Both the average guideline minimum and average sentence have varied slightly for the past five years.
 - ◆ The average guideline minimum ranged between 24 months and 26 months during that time period;
 - ◆ The average sentence ranged between 15 months and 18 months during that time period.



Government Sponsored Below Range Sentences FY 2017



Average Sentence and Average Guideline Minimum (in months)



³ The Tax Table was amended effective November 1, 2015.

⁴ "Early Disposition Program (or EDP) departures" are departures where the government sought a sentence below the guideline range because the defendant participated in the government's Early Disposition Program, through which cases are resolved in an expedited manner. See USSG §5K3.1.

SOURCE: United States Sentencing Commission Datafiles, 2013 through 2017, USSCFY13-USSCFY17.

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DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

November 20, 2018

Control Number: LB&I-09-1118-014
Expiration Date: 11/20/2020
Affected IRM: 9.5

MEMORANDUM FOR DIVISION COMMISSIONERS
CHIEF, CRIMINAL INVESTIGATION

FROM: Kirsten B. Wielobob /s/ Kirsten B. Wielobob
Deputy Commissioner for Services and Enforcement

SUBJECT: Updated Voluntary Disclosure Practice

This memorandum addresses the process for all voluntary disclosures (domestic and offshore) following the closing of the Offshore Voluntary Disclosure Program (2014 OVDP) on September 28, 2018.

Background and Overview of Updated Procedures

The 2014 OVDP began as a modified version of the OVDP launched in 2012, which followed voluntary disclosure programs offered in 2011 and 2009. These programs were designed for taxpayers with exposure to potential criminal liability or substantial civil penalties due to a willful failure to report foreign financial assets and pay all tax due in respect of those assets. They provided taxpayers with such exposure potential protection from criminal liability and terms for resolving their civil tax and penalty obligations. Taxpayers with unfiled returns or unreported income who had no exposure to criminal liability or substantial civil penalties due to willful noncompliance could come into compliance using the Streamlined Filing Compliance Procedures (SFCP), the delinquent FBAR submission procedures, or the delinquent international information return submission procedures. Although they could be discontinued at any time, these other programs are still available.

Voluntary disclosure is a long-standing practice of the IRS to provide taxpayers with criminal exposure a means to come into compliance with the law and potentially avoid criminal prosecution. See I.R.M. 9.5.11.9. This memorandum updates that voluntary disclosure practice. Taxpayers who did not commit any tax or tax related crimes and do not need the voluntary disclosure practice to seek protection from potential criminal prosecution can continue to correct past mistakes using the procedures mentioned

above or by filing an amended or past due tax return. When these returns are examined, examiners will follow existing law and guidance governing audits of the issues.

Procedures in this memo will be effective for all voluntary disclosures received after the closing of the 2014 OVDP on September 28, 2018. All offshore voluntary disclosures conforming to the requirements of “Closing the 2014 Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers” FAQ 3 received or postmarked by September 28, 2018 will be handled under the procedures of the 2014 OVDP. For all other voluntary disclosures (non-offshore) received on or before September 28, 2018, the Service has the discretion to apply the procedures outlined in this memorandum. The objective of the voluntary disclosure practice is to provide taxpayers concerned that their conduct is willful or fraudulent, and that may rise to the level of tax and tax-related criminal acts, with a means to come into compliance with the law and potentially avoid criminal prosecution.

Proper penalty consideration is important in these cases. A timely voluntary disclosure may mitigate exposure to civil penalties. Civil penalty mitigation occurs by focusing on a specific disclosure period and the application of examiner discretion based on all relevant facts and circumstances including prompt and full cooperation (see IRM 9.5.11.9.4) during the civil examination of a voluntary disclosure. Managers must ensure that penalties are applied consistently, fully developed, and documented in all cases.

The terms outlined in this memorandum are only applicable to taxpayers that make timely voluntary disclosures and who fully cooperate with the Service.

Criminal Investigation Procedures

Criminal Investigation (CI) will screen all voluntary disclosure requests whether domestic, offshore, or other to determine if a taxpayer is eligible to make a voluntary disclosure. To accomplish this, CI will require all taxpayers wishing to make a voluntary disclosure to submit a preclearance request on a forthcoming revision of Form 14457. IRM 9.5.11.9 will continue to serve as the basis for determining taxpayer eligibility.

Taxpayers must request preclearance from CI via fax or mail.

Fax: (267) - 466-1115

Or

Mail: IRS Criminal Investigation
Attn.: Voluntary Disclosure Coordinator
2970 Market St.
1-D04-100
Philadelphia, PA 19104

For all cases where CI grants preclearance, taxpayers must then promptly submit to CI all required voluntary disclosure documents using a forthcoming revision of Form 14457. This form will require information related to taxpayer noncompliance, including a narrative providing the facts and circumstances, assets, entities, related parties and any professional advisors involved in the noncompliance. Once CI has received and preliminarily accepted the taxpayer's voluntary disclosure, CI will notify the taxpayer of preliminary acceptance by letter and simultaneously forward the voluntary disclosure letter and attachments to the LB&I Austin unit for case preparation before examination. CI will not process tax returns or payments.

Civil Processing

Once the LB&I Austin unit receives information from CI, LB&I will route the case as appropriate. The IRS will not require taxpayers to provide additional documents to the LB&I Austin unit. If a taxpayer or representative wishes to make a payment prior to case assignment with an examiner, payments may be remitted to the LB&I Austin unit. The LB&I Austin unit will establish the most recent tax year covered by the voluntary disclosure for examination. Then, the LB&I Austin unit will forward cases for case building and field assignment to the appropriate Business Operating Division and Exam function for civil examination. Civil examiners receiving the disclosure will establish any additional controls necessary on IRS systems.

Case Development

All voluntary disclosures handled by examination will follow standard examination procedures. Examiners must develop cases, use appropriate information gathering tools, and determine proper tax liabilities and applicable penalties. Under the voluntary disclosure practice, taxpayers are required to promptly and fully cooperate during civil examinations. In general, the Service expects that voluntary disclosures will be resolved by agreement with full payment of all taxes, interest, and penalties for the disclosure period. In the event a taxpayer fails to cooperate with the civil examination, the examiner may request that CI revoke preliminary acceptance. See I.R.M. 9.5.11.9.4 (discussing cooperation).

Civil Resolution Framework

For all voluntary disclosures received after September 28, 2018, the Service will apply the civil resolution framework outlined below. At the Service's discretion, this civil resolution framework may extend to non-offshore voluntary disclosures that have not been resolved but were received on or before September 28, 2018.

Examiners are authorized to resolve tax and tax related noncompliance of taxpayers who make voluntary disclosures in the following manner:

- a) In general, voluntary disclosures will include a six-year disclosure period. The disclosure period will require examinations of the most recent six tax years. Disclosure and examination periods may vary as described below:
 - i. In voluntary disclosures not resolved by agreement, the examiner has discretion to expand the scope to include the full duration of the noncompliance and may assert maximum penalties under the law with the approval of management.
 - ii. In cases where noncompliance involves fewer than the most recent six tax years, the voluntary disclosure must correct noncompliance for all tax periods involved.
 - iii. With the IRS' review and consent, cooperative taxpayers may be allowed to expand the disclosure period. Taxpayers may wish to include additional tax years in the disclosure period for various reasons (e.g., correcting tax issues with other governments that require additional tax periods, correcting tax issues before a sale or acquisition of an entity, correcting tax issues relating to unreported taxable gifts in prior tax periods).
- b) Taxpayers must submit all required returns and reports for the disclosure period.
- c) Examiners will determine applicable taxes, interest, and penalties under existing law and procedures. Penalties will be asserted as follows:
 - i. Except as set forth below, the civil penalty under I.R.C. § 6663 for fraud or the civil penalty under I.R.C. § 6651(f) for the fraudulent failure to file income tax returns will apply to the one tax year with the highest tax liability. For purposes of this memorandum, both penalties are referred to as the civil fraud penalty.
 - ii. In limited circumstances, examiners may apply the civil fraud penalty to more than one year in the six-year scope (up to all six years) based on the facts and circumstances of the case, for example, if there is no agreement as to the tax liability.
 - iii. Examiners may apply the civil fraud penalty beyond six years if the taxpayer fails to cooperate and resolve the examination by agreement.

- iv. Willful FBAR penalties will be asserted in accordance with existing IRS penalty guidelines under IRM 4.26.16 and 4.26.17.
 - v. A taxpayer is not precluded from requesting the imposition of accuracy related penalties under I.R.C. § 6662 instead of civil fraud penalties or non-willful FBAR penalties instead of willful penalties. Given the objective of the voluntary disclosure practice, granting requests for the imposition of lesser penalties is expected to be exceptional. Where the facts and the law support the assertion of a civil fraud or willful FBAR penalty, a taxpayer must present convincing evidence to justify why the civil fraud penalty should not be imposed.
 - vi. Penalties for the failure to file information returns will not be automatically imposed. Examiner discretion will take into account the application of other penalties (such as civil fraud penalty and willful FBAR penalty) and resolve the examination by agreement.
 - vii. Penalties relating to excise taxes, employment taxes, estate and gift tax, etc. will be handled based upon the facts and circumstances with examiners coordinating with appropriate subject matter experts.
 - viii. Taxpayers retain the right to request an appeal with the Office of Appeals.
- d) The Service will provide procedures for civil examiners to request revocation of preliminary acceptance when taxpayers fail to cooperate with civil disposition of cases.
- e) All impacted IRM sections will be updated within two years of the date of this memorandum.

If you have any questions about this memorandum, please contact Scott Roberts, Team Manager at the LB&I Austin unit at (737) 800-7616 or Christine Stone, LB&I WIIC IPN Technical Specialist at (781) 876-1186.

cc: IRS.gov

Chapter 2—Current IRS Enforcement Objectives

Form 14457 (March 2019)	Department of the Treasury—Internal Revenue Service Voluntary Disclosure Practice Preclearance Request and Application	OMB Number 1545-2241
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Note: Use Part I of this form to make a preclearance request to determine whether you are eligible to use the voluntary disclosure practice. Only submit Part 1 of this form for preclearance. If you receive preclearance, proceed with submitting Part II to request preliminary acceptance. Submitting the information requested in Part I of this form does not guarantee acceptance. **All answers and attachments must be in English.**

Mailing Address: Internal Revenue Service
 Attn.: Voluntary Disclosure Coordinator
 2970 Market Street
 1-D04-100
 Philadelphia, PA 19104

Fax Number: 267-466-1115

Part I - Preclearance Request (Mail or FAX Part I Only to Above)

1. Part I submission date	2. Person submitting disclosure <i>(check box that applies)</i> <input type="checkbox"/> Individual(s) <input type="checkbox"/> Partnership <input type="checkbox"/> Corporation <input type="checkbox"/> Trust <input type="checkbox"/> Executor
---------------------------	--

3. Disclosure special features *(check all that apply)*

<input type="checkbox"/> Domestic Issues	<input type="checkbox"/> Estate & Gift Issues	<input type="checkbox"/> Virtual Currency Issues
<input type="checkbox"/> Offshore Issues	<input type="checkbox"/> Employment Tax Issues	<input type="checkbox"/> Other Issues <i>(briefly describe)</i>

Briefly describe issue

4a. Taxpayer name	b. Identification number (SSN/ITIN/EIN)	c. Date of birth
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d. Telephone number	e. Number, street, and room or suite number
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f. City or town	g. State or province	h. ZIP/Foreign postal code	i. Country
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j. Occupation	k. Passport information <i>(list all passport numbers and countries)</i>
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5a. Spouse name <i>(if joint disclosure)</i>	b. Identification number (SSN/ITIN)	c. Date of birth
--	-------------------------------------	------------------

d. Telephone number	e. Number, street, and room or suite number <i>(complete 5d through 5i if different than 4d through 4i)</i>
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f. City or town	g. State or province	h. ZIP/Foreign postal code	i. Country
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j. Occupation	k. Passport information <i>(list all passport numbers and countries)</i>
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6a Representative's name <i>(attach Form 2848, if applicable)</i>	<input type="checkbox"/> Check if no representative	b. Telephone number
---	---	---------------------

c. FAX number	d. Number, street, and room or suite number
---------------	---

e. City or town	f. State or province	g. ZIP/Foreign postal code	h. Country
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7. List any entities (corporations, partnerships, etc.) for which you are making a disclosure, include EIN if applicable. Further identification information for these entities will be required in Part II of this application

8. Do you believe that the IRS has obtained information concerning your tax liability Yes No

If "Yes," specify

Chapter 2—Current IRS Enforcement Objectives

9. Disclose if you, your spouse or any related entities are currently under audit or criminal investigation by the Internal Revenue Service or any other law enforcement authority and if any income is sourced from an illegal activity

	Taxpayer		Spouse			Related Entities		
	Yes	No	Yes	No	N/A	Yes	No	N/A
a. Has the IRS notified you, your spouse or any related entities that it intends to commence an examination or criminal investigation	<input type="checkbox"/>							
b. Are you, your spouse or any related entities under criminal investigation by the Internal Revenue Service	<input type="checkbox"/>							
c. Are you, your spouse or any related entities under criminal investigation by any law enforcement authority	<input type="checkbox"/>							
d. Do you, your spouse or any related entities have income sourced from an illegal activity	<input type="checkbox"/>							

If "Yes" to any, explain

10. Schedule of financial accounts

- List **ALL** noncompliant financial accounts you owned or controlled or were the beneficial owner of, either directly or indirectly.
 - The listings must cover the entire disclosure period as outlined in the [Updated Voluntary Disclosure Practice Memorandum](#) dated November 20, 2018.
 - This includes opened and closed accounts which held unreported funds during the disclosure period.
 - This includes accounts held through entities you owned or controlled or were the beneficial owner of, either directly or indirectly. **Note:** The entities will be further identified in Part II of this application.
- Disclose all account numbers held at each financial institution.
 - Organize the account numbers in order of who held the account. Jointly held accounts should be identified as such and only listed once.
 - Account holders must match the disclosing taxpayer(s) from Lines 4 and 5, or an entity on Line 7 that will be subsequently disclosed in more detail in Part II after pre-clearance is received
 - If an account is closed, mark it with a "(CL)" after the account number.
 - Detailed Example: John Smith – 2023245454534, 342345845454 (CL), 3423423434343
 Jane Smith – 3423233443232, 523124523123
 Joint (John and Jane Smith) – 23124523163,23453232326
 ABC Ltd – 3433423343344
- Click "Add Financial Account" button below for additional financial institutions.

Financial Institution 1

Financial institution name *(complete bank legal name, including all suffixes (e.g., Inc., A.G., S.A., etc.), DBAs and pseudonyms)*

Telephone number	Number, street, and room or suite number		
City or town	State or province	ZIP/Foreign postal code	Country

Accounts numbers

Important:

Catalog Number 61637F

www.irs.gov

Form **14457** (Rev. 3-2019)

Chapter 2—Current IRS Enforcement Objectives

- **CI will provide a case control number that is required to submit Part II.**
- **Only submit Part II and attachments after preclearance is received.**
- **Do not send returns and/or remit payments with this form. No returns or payments will be accepted by IRS-Criminal Investigation.**
- **Complete all fields. If you cannot complete a field, attach a statement explaining why.**
- **Wait for contact from IRS examiner who will request additional documentation.**

Part II - Voluntary Disclosure (Mail or FAX Part II to Address or FAX Number on Page 1)

Taxpayer name	Identification number	Telephone number
Spouse name (if joint disclosure)	Identification number	Telephone number
Representative's name (attach Form 2848, if applicable)	<input type="checkbox"/> Check if no representative	Telephone number
1. Part II submission date	2. Case control number (required from preclearance approval)	

3. Identify the source of funds (check all that apply and explain below)

- U.S. source
 Foreign source
 Illegal source
 Gift/Inheritance
 Virtual Currency
 Other

4. During the disclosure period, have you taken a position that you were a bona fide resident of a U.S. territory (e.g., American Samoa, the Commonwealth of the Northern Mariana Islands, Guam, Puerto Rico, or the U.S. Virgin Islands) or did you file an income tax return with a U.S. territory Yes No

If "Yes," list the territory and tax years

5. Provide estimated total annual **unreported income** during the disclosure period (for fields 5 and 6, input all amounts in U.S. Dollars using year-end exchange rates AND provide the most recent 6 years unless the noncompliance was for a shorter period)

Tax year	Unreported income	Tax year	Unreported income	Tax year	Unreported income
Tax year	Unreported income	Tax year	Unreported income	Tax year	Unreported income

6. Provide estimated annual range of the highest aggregate value of your offshore holdings (**Offshore Issues Only**)

Tax year	Highest aggregate account/Asset value	Tax year	Highest aggregate account/Asset value
Tax year	Highest aggregate account/Asset value	Tax year	Highest aggregate account/Asset value
Tax year	Highest aggregate account/Asset value	Tax year	Highest aggregate account/Asset value

7. Offshore issues only (check appropriate boxes)

	Taxpayer		Spouse	
	Yes	No	Yes	No
a. Has anyone, including a foreign government or a foreign financial institution, advised you that your offshore account records, which are the subject of this voluntary disclosure, were susceptible to being turned over to the U.S. Government pursuant to an official request	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
b. If 7a is "Yes," did you or anyone on your behalf submit documents in opposition	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
c. If 7b is "Yes," were copies of those documents provided to the Attorney General of the United States as required by 18 USC §3506	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Chapter 2—Current IRS Enforcement Objectives

8. Schedule of entities

- List **ALL** entities you owned or controlled or were the beneficial owner of, either directly or indirectly for which you reported noncompliant financial accounts in the Part I preclearance request.
- The listings must cover the entire disclosure period as outlined in the [Updated Voluntary Disclosure Practice Memorandum](#) dated November 20, 2018.
- Click “Add Entity” button below for additional entities.

Entity 1

Entity name (including all DBAs and pseudonyms)		Identification number	Country of incorporation
Telephone number	Number, street, and room or suite number		
City or town	State or province	ZIP/Foreign postal code	Country

9. Narrative (Your narrative must truthfully and fully explain your noncompliance from inception to the present. Organize the narrative with the following headings: (1) Noncompliance, (2) Taxpayer Background and (3) Professional Advisors. “Noncompliance” must include a complete and thorough discussion of all Title 26 and Title 31 failures to report income, pay tax, and submit all required information returns and reports. Address the source of all unreported income. Explain the use of nominees, alter egos, and any other methods used to conceal your noncompliance. Completely identify all entities involved in your noncompliance. “Taxpayer Background” must include all aspects of personal and professional history. “Professional Advisors” must include complete details on attorneys, accountants, financial planners, private bankers, etc. that rendered services to you from the inception of the noncompliance to the present, regardless of their connection to or knowledge of your noncompliance. If your disclosure involves offshore issues, provide a complete story about your foreign financial assets. The field below will automatically expand to accommodate your narrative.)

Note: You must provide specific facts on this form or on a signed attachment providing a complete story about your tax fraud and willful noncompliance. Any submission that does not contain a narrative statement of facts will be considered incomplete.

By signing this document, I certify that I am willing to continue to cooperate with the Internal Revenue Service, including in assessing my income tax liabilities and making good faith arrangements to pay all taxes, interest, and penalties associated with this voluntary disclosure.

Under penalties of perjury, I declare that I have examined this document and accompanying schedules and statements and to the best of my knowledge and belief, they are true, correct, and complete.

Signature of taxpayer	Name (print/type)	Date
Signature of taxpayer's spouse	Name (print/type)	Date

Signature must be original (must be mailed), preferably in blue ink. Photocopied, facsimile, or electronic signatures are not acceptable. The power of attorney may not sign the voluntary disclosure letter on behalf of the taxpayers.

IRS reserves the right to make further contacts with the taxpayer to clarify his/her submission.

Privacy Act and Paperwork Reduction Act Notice

We ask for the information on this foreign account or asset statement to carry out the Internal Revenue laws of the United States. Our authority to ask for information is sections 6001, 6109, 7801, 7803 and the regulations thereunder. This information will be used to determine and collect the correct amount of tax under the terms of the offshore voluntary disclosure program. You are not required to apply for participation in the offshore voluntary disclosure program. However, if you choose to apply you are required to provide all the information requested on the offshore voluntary disclosure letter.

You are not required to provide the information requested on a document that is subject to the Paperwork Reduction Act unless the document displays a valid OMB control number. Books or records relating to a document or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103. Section 6103, however, allows or requires the Internal Revenue Service to disclose or give this information to others as described in the Internal Revenue Code. For example, we may disclose this information to the Department of Justice to enforce the tax laws, both civil and criminal, and to cities, states, the District of Columbia, and U.S. commonwealths or possessions to carry out their tax laws. We may also disclose this information to other countries under a tax treaty, to federal and state agencies to enforce federal nontax criminal laws, or to federal law enforcement and intelligence agencies to combat terrorism. Failure to provide this information may delay or prevent processing your application. Providing false information may subject you to penalties.

The time needed to complete and submit the foreign account or asset statement will vary depending on individual circumstances. The estimated average time is: 2 hour.

If you have comments concerning the accuracy of this time estimate or suggestions for making the foreign account or asset statement simpler, we would be happy to hear from you. Comments should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224.

Chapter 3

Presentation Slides: A Whole New World: State Tax Post-TCJA and *Wayfair*

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Washington, D.C.

KATHLEEN QUINN

McDermott Will & Emery LLP
Washington, D.C.

A WHOLE NEW WORLD: STATE TAX POST-TCJA AND *WAYFAIR*



Oregon State Bar: Oregon Tax Institute

June 6, 2019

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**McDermott
Will & Emery**

AGENDA

- State Responses to the Tax Cuts and Jobs Act
 - IRC Section 965 Transition Tax
 - GILTI and FDII
 - Domestic Provisions
- State Responses to Wayfair

STATE RESPONSES TO THE TAX CUTS AND JOBS ACT

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STATE CONFORMITY WITH FEDERAL TAX LAW (GENERAL)

- Most states start with some version of federal taxable income as the starting point for state taxable income.
- Additions to and subtractions from federal taxable income are made to reflect differences between federal and state tax policies.
 - States often decouple from federal provisions that the states regard as subsidies (e.g., accelerated depreciation).
 - If a state statute requires conformity to federal taxable income, the state revenue department cannot decouple from a federal provision that it does not like. IBM Corp. v. Director, 26 N.J. Tax 102 (2011).

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IRC SECTION 965 TRANSITION TAX

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FEDERAL TAXATION OF DEEMED REPATRIATED FOREIGN EARNINGS

- **IRC §965(a) provides for a one-time mandatory deemed repatriation of 30 years of accumulated foreign earnings.**
 - The IRC §965 provisions were effective beginning in 2017.
 - IRC §965(c) reduces the federal tax rate on repatriated earnings to 15.5% for earnings of cash and cash equivalents and 8% for all other earnings.
 - For 2017, the transition tax was reported on a new federal form created specifically for the one-time deemed repatriation and was not reported as part of the regular federal taxable income.
 - But see treatment for 2018 – seemingly on Form 1120
 - The transition tax can be paid in installments over eight years.

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REPATRIATION TRANSITION TAX: DETERMINING THE STATE AND LOCAL IMPACT

Overview of Issues

- Impact of date of IRC conformity (see, for example, Arizona – adopts current IRC for 2017, but not yet for 2018)
- Assuming the state conforms to the IRC post TCJA, is income included in federal income under IRC 965 included in the state tax base?
 - Deemed repatriated foreign earnings are included in income under the Subpart F provisions, IRC 951(a), but are not technically defined as "Subpart F" income under IRC section 952
 - Under this structure, such foreign earnings may not necessarily be excluded in states that do not tax subpart F income
- State tax policy reasons for inclusion/exclusion of 965 income

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REPATRIATION TRANSITION TAX: DETERMINING THE STATE AND LOCAL IMPACT

Overview of Issues (cont.)

- Application of the IRC § 965(c) deduction (intended to lower the federal tax rate).
 - IRC § 965(c) deduction is not a "special deduction" so should be allowed in most states that tax foreign earnings deemed retreated under IRC 965
 - Interplay with applicable dividend-received deductions
- Apportionment considerations
 - Potential inclusion of 965 income
 - Is there "factor relief" for the U.S. shareholder?
 - If there is no statutory factor relief, such relief may nevertheless be required by the U.S. Constitution?
 - How would factor relief work? Remember, the 965 inclusion is of deemed repatriated earnings from the past 30+ years.

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REPATRIATION TRANSITION TAX: DETERMINING THE STATE AND LOCAL IMPACT

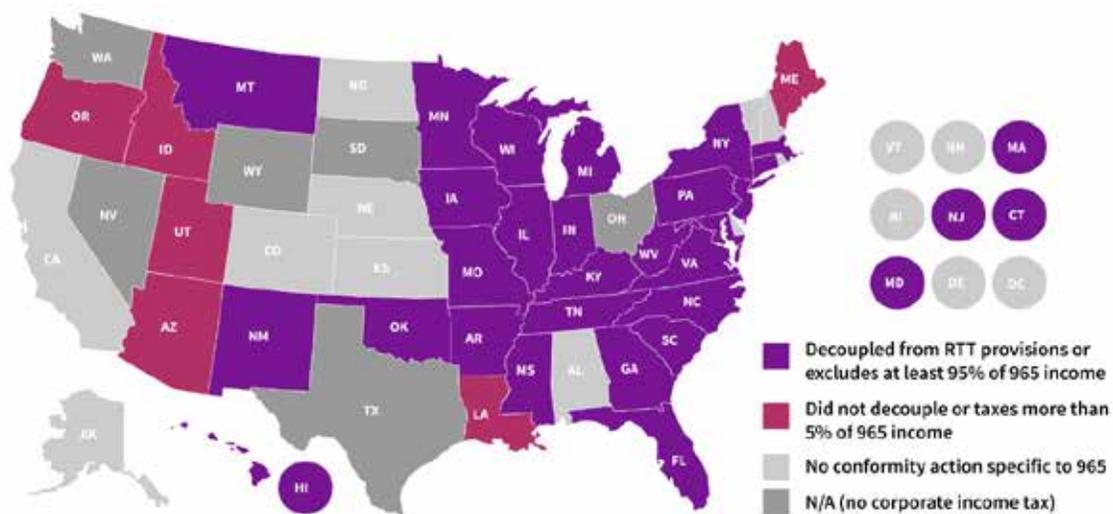
Where to look for guidance on these issues:

- Is state law clear, or in need of statutory or administrative clarification?
- Are there any lurking constitutional questions, say with respect to *Kraft General Foods, Inc. v. Iowa Dep't of Revenue*, 505 U.S. 71 (1992)?

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Which states decoupled from the TCJA's **Repatriation Transition Tax** provisions?



Nebraska's Department of Revenue has issued guidance providing that 965 income is taxed, but such guidance is inconsistent with Nebraska's statute. The New Mexico Department of Revenue issued guidance providing that 965 income is excluded only for separate company filers. The Arizona and Minnesota legislatures issued gubernatorial approval on May 26, 2018.

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REPATRIATION TRANSITION TAX: FLORIDA

- The Florida Legislature updated conformity to the IRC to January 1, 2018
- The Department's Guidance
 - Since 965 income is not reported on lines 1-10 of the Federal 1120, it does not “flow into” federal taxable income for most corporations and is, thus, excluded from the tax base
 - Is this rational is correct?
- Florida's dividends-received deduction:
 - “There shall be subtracted from such taxable income any amount to the extent included therein the following... all amounts included in taxable income under s. 78 or s. 951 of the Internal Revenue Code. However, as to any amount subtracted under this subparagraph there shall be added to such taxable income all expenses deducted on the taxpayer's return for the taxable year which are attributable, directly or indirectly, to such subtracted amount.” Fla. Stat. § 220.13(1)(b)(2).
- The Department's guidance suggests that the dividends-received deduction would apply to 965 income if it was included in federal taxable income.

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REPATRIATION TRANSITION TAX: NEW YORK

- Part KK of Chapter 59 of the Laws of 2018
 - Exemption for Subpart F income expanded to include deemed repatriated income as a new type of exempt income, whether or not the deferred foreign income corporation is unitary
 - Existing interest attribution applies
 - Direct and indirect, or election to reduce exempt income by 40%
- Penalty relief

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REPATRIATION TRANSITION TAX: OREGON

- Oregon SB 1529
 - Provides that the gross, not the net, repatriation amount is included in the tax base, with such gross amount subject to the dividends-received deduction of 70 or 80 percent, depending upon level of ownership.
 - Ensures that taxpayers don't receive double deduction.
 - Oregon had adopted tax haven legislation. ORS 317.716. As a result, Oregon may already have taxed some of the income now deemed repatriated. To alleviate any double taxation, the bill allows a credit for taxes attributable to this income. The credit is limited to the lesser of the tax attributed to the repatriated income or the tax on the income included under ORS 317.716.

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REPATRIATION TRANSITION TAX: CONNECTICUT

- The Department of Revenue Services has issued guidance providing that the IRC 965 Income is considered a dividend for purposes of Connecticut's 100% dividend received deduction.
 - The guidance also provides that the 965(c) is disallowed.
- The Connecticut statute provides that expenses related to dividends are disallowed and that expenses related to dividends equals 5% of the dividends; thus, Connecticut effectively includes 5% of gross 965 income in the state tax base.
- Massachusetts has very similar treatment.

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REPATRIATION TRANSITION TAX: NEW JERSEY

- Under New Jersey law, the gross 965 income should be eligible for a 95% dividend-received deduction if the foreign subsidiary is at least 80% owned by the taxpayer.
- The gross 965 income should be eligible for a 50% deduction if the foreign subsidiary is at least 50% owned by the taxpayer.
- The New Jersey statute provides that the 965(c) deduction is disallowed.

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REPATRIATION TRANSITION TAX: NEBRASKA

- Nebraska has a dividends-received deduction for “dividends received or deemed to be received” from foreign corporations.
- The Nebraska Department of Revenue issued guidance providing that 965 Income is not a deemed dividend for purposes of this deduction.
- Is the Department’s position correct?
 - The Department has historically excluded Subpart F income as a deemed dividend in the return instructions.
 - 965 Income is treated very similar to a dividend for federal income tax purposes.
 - If 965 Income is not a deemed dividend, what is?

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GILTI AND FDII

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GILTI (GLOBAL INTANGIBLE LOW-TAXED INCOME)

- Purpose: to discourage U.S. companies from retaining business operations in low-tax foreign countries or, alternatively, from moving such operations there.
- Federal rule:
 - U.S. shareholders must include in income certain income of controlled foreign corporations that is taxed abroad at a rate lower than the U.S. tax rate and that exceeds a 10% return on the CFCs' tangible property. IRC § 951A.
 - U.S. shareholder that is a C-corporation can deduct 50% (or 37.5% after 2025) of its GILTI (thereby reducing the effective tax rate). IRC § 250(a)(1)(B).
 - Partial foreign tax credit allowed to lessen tax imposed on GILTI in an effort to tax only income generated in low-tax jurisdictions.

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GILTI: DETERMINING THE STATE AND LOCAL IMPACT

Overview of Issues

- Impact of date of IRC conformity
- Assuming the state conforms to the IRC post TCJA, is GILTI included in state income?
 - Note: new IRC § 951A has been included in the subpart F provisions of the Code and GILTI is treated as Subpart F income under certain provisions of the Code but GILTI is technically not Subpart F income
 - For example, GILTI is not determined with respect to a CFC's earnings & profits (i.e., unlike Subpart F income)
 - Under this structure, GILTI is not necessarily excluded in states that do not tax Subpart F income
- State tax policy reasons for inclusion/exclusion of GILTI

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GILTI: DETERMINING THE STATE AND LOCAL IMPACT

Overview of Issues (cont.)

- Application of the IRC § 250 federal deduction (intended to lower the federal tax rate)
- Apportionment considerations
 - Potential inclusion of GILTI
 - Net of 250 deduction?
 - Subsequent of any state dividend-received deduction?
 - Is there “factor relief” for the U.S. shareholder?
 - If there is no statutory factor relief, such relief may nevertheless be required by the U.S. Constitution?
 - How would factor relief work?

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GILTI: DETERMINING THE STATE AND LOCAL IMPACT

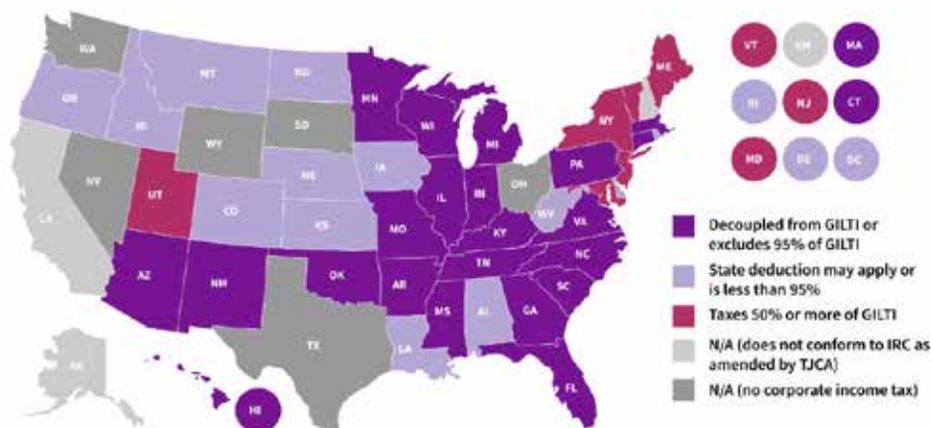
Where to look for guidance on these issues:

- Is state law clear, or in need of statutory or administrative clarification?
- Is there a possibility that state law may be changed (i.e., a reconsideration of prior policy)?
- Are there any lurking constitutional questions, say with respect to *Kraft General Foods, Inc. v. Iowa Dep't of Revenue*, 505 U.S. 71 (1992)?

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Which states decoupled from the TCJA's **Global Intangible Low-Taxed Income (GILTI)** provisions?



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STATE TAXES AFTER REFORM
PARTNERSHIP

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GILTI: GEORGIA

- Georgia H.B. 918 (Enacted on March 2, 2018)
 - This conformity bill did not provide for an exclusion from the tax base for GILTI, although the IRC § 250 deduction was allowed. In addition, the bill provided that the Georgia DRD did not apply to GILTI.
- Georgia SB 328 (Enacted on March 26, 2018)
 - Due to pressure from the business community, this bill provided that GILTI was treated as Subpart F income and excluded from the tax base.

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GILTI: WISCONSIN

- Wisconsin Act 231
 - Specifically decouples with GILTI provisions of the Tax Cuts and Jobs Act (P.L. 115-97).
 - Accordingly, neither the GILTI addition nor the deduction are included in the starting point for computing the Wisconsin tax base.

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GILTI: KENTUCKY

- Tech. Advice Memo (KY-TAM-18-02)
 - Kentucky does not tax dividend income, including Subpart F
 - GILTI “treated similarly to Subpart F income” for federal purposes
 - GILTI is, therefore, non-taxable for Kentucky purposes
 - 250 deduction is not allowed
 - Provides for add back of related expenses

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GILTI: NEW JERSEY

- A. 4495 (Oct. 4, 2018)
 - Under legislation passed in October 2018, New Jersey includes GILTI in the state tax base and allows the IRC section 250 deduction, essentially taxing 50% of GILTI.
- Tax Bulletin TB-85(R)
 - GILTI is not treated as a dividend or deemed dividend, and therefore not subject to the state’s dividends received deduction
 - The allocation factor for computing the tax on net GILTI is equal to a ratio of:
 - (1) New Jersey’s gross domestic product (GDP) over
 - (2) the total GDP of every US state (and DC) in which the taxpayer has economic nexus

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GILTI: OREGON

- TBD
 - The Oregon Senate Finance & Revenue Committee has released two draft bills concerning the state’s taxation of GILTI.
 - With respect to GILTI, both drafts are the same and both would treat GILTI as a dividend for purposes of the 70-80% DRD and provide an addback for the GILTI deduction.
 - Factor relief is unclear.

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FDII DEDUCTION (DEDUCTION FOR FOREIGN DERIVED INTANGIBLE INCOME)

Purpose: to incentivize U.S. companies to keep business operations and assets in the U.S.

- Domestic corporations get a deduction from income for 37.5 percent of their foreign derived intangible income.
- This is a special deduction under the IRC.

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FDII: DETERMINING THE STATE AND LOCAL IMPACT

Overview of Issues

- Impact of date of IRC conformity
- Assuming the state conforms to the IRC post TCJA, is the FDII deduction included in state income?
 - Does the state conform to federal taxable income, before or after special deductions?
 - The FDII deduction is included in the computation of federal taxable income so if a state's starting point is federal taxable income, as defined in IRC sec. 63, the FDII deduction should be allowed absent a specific modification.
 - Look at the statutes, not only the forms!
- If a state excludes GILTI from the tax base, that does not mean that the FDII deduction is automatically disallowed. FDII and GILTI are different!

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FDII: NEW JERSEY

- Tax Bulletin TB-85(R)
 - FDII is allocated to New Jersey in the same manner as GILTI.
 - The allocation factor for computing the tax on FDII is equal to a ratio of:
 - (1) New Jersey's gross domestic product (GDP) over
 - (2) the total GDP of every US state (and DC) in which the taxpayer has economic nexus
- Does this allocation make sense?
 - FDII is not a new category of income in the New Jersey tax base.
 - Should FDII be allocated any differently than domestic sales?
 - Constitutional issues.

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DOMESTIC PROVISIONS

- 163(j) Limitations
- Other Notable Domestic Provisions

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INTEREST DEDUCTION LIMITATION

- **IRC §163(j) provides a new limitation on a taxpayer's ability to deduct interest expense**
 - A taxpayer generally cannot deduct business interest expense for a taxable year to the extent that such interest exceeds the sum of (a) the taxpayer's business interest income, and (b) 30% of the taxpayer's adjusted taxable income (ATI) for such taxable year.
 - Business interest expense means any interest paid or accrued on indebtedness properly allocable to a trade or business and business interest income means any interest includible in the gross income of the taxpayer which is properly allocable to a trade or business.
 - ATI means the taxable income of the taxpayer computed without regard to (1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, (2) any business interest expense or business interest income, (3) any NOL deduction under Section 172, (4) any deduction allowable under Section 199A, (5) for taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.

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INTEREST DEDUCTION LIMITATION: STATE ISSUES

- Purpose of federal rule: to prevent double tax benefit when coupled with expensing.
- If states do not adopt the federal expensing regime, arguably they should not limit interest deductions.

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INTEREST DEDUCTION LIMITATION: STATE ISSUES

- In most states, the corporate income tax base is based on a taxpayer's federal taxable income.
- Interaction with related-party addback provisions.
- Will state allow indefinite carryforward of disallowed interest expense?

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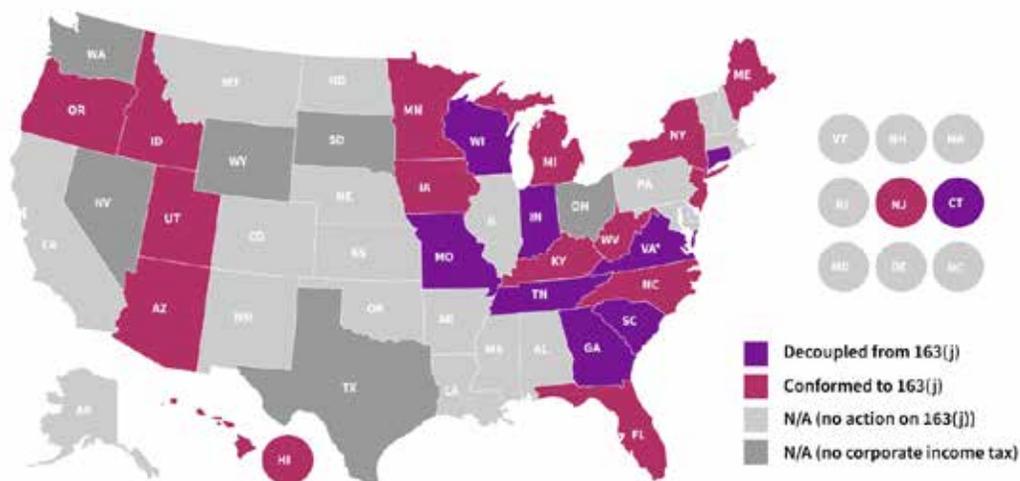
INTEREST DEDUCTION LIMITATION: STATE ISSUES

- In separate return states, a different computation will be needed to determine the interest limitation for each corporate taxpayer that files within the state.
- In combined-filing states the state combined group may not be the same as the federal consolidated group, thus resulting in the need for additional interest expense limitation computations to adjust for differences between the federal and state groups.
- Approaches:
 - Separate computation at state level
 - Allocation of federal limitation among members of the consolidated group – but based on what?
- Pennsylvania and New Jersey issued guidance

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Which states conformed to the TCJA's **interest expense limitation** provisions?



Virginia allows owners to prorate deduction for the amount of interest expense allowed at the federal level. The Arizona, Minnesota and Missouri legislation awaits gubernatorial approval as of May 28, 2018.

STATE TAXES AFTER REFORM
PARTNERSHIP

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OTHER NOTABLE DOMESTIC PROVISIONS

- **IRC Sec. 118** -- requires contributions of capital to be included in gross income if made as a “contribution to construction” or by “a customer or potential customer,” from “governmental entities” and “civic groups” (other than contributions “made by a shareholder as such”), with limited grandfather exception
- **Expensing provisions** -- Current bonus depreciation percentage under IRC §168(k) is increased from 50% to 100% for property acquired and placed in service after September 27, 2017, and before December 31, 2022. The 100% expensing is phased down by 20 percentage points per calendar year beginning in 2023.

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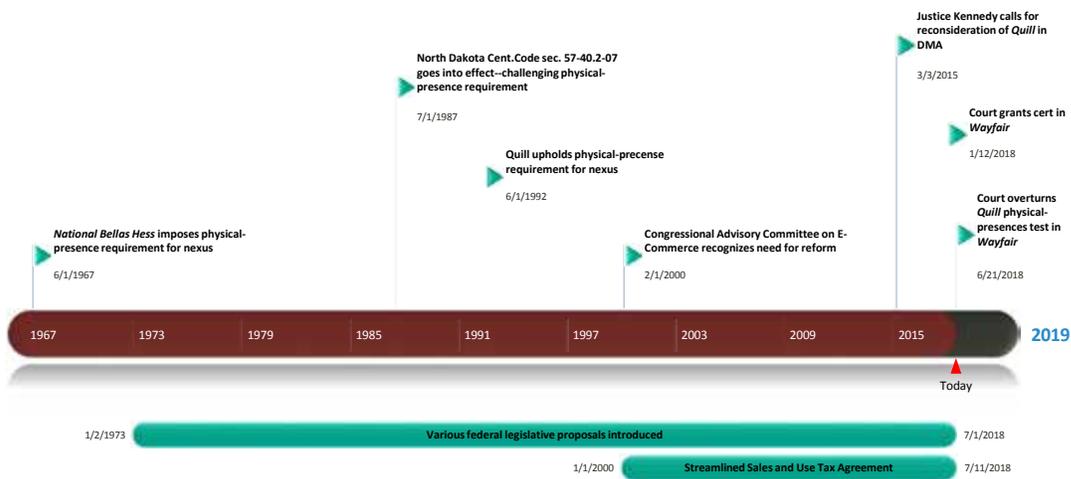
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STATE REPOSSES TO SOUTH DAKOTA *V. WAYFAIR*

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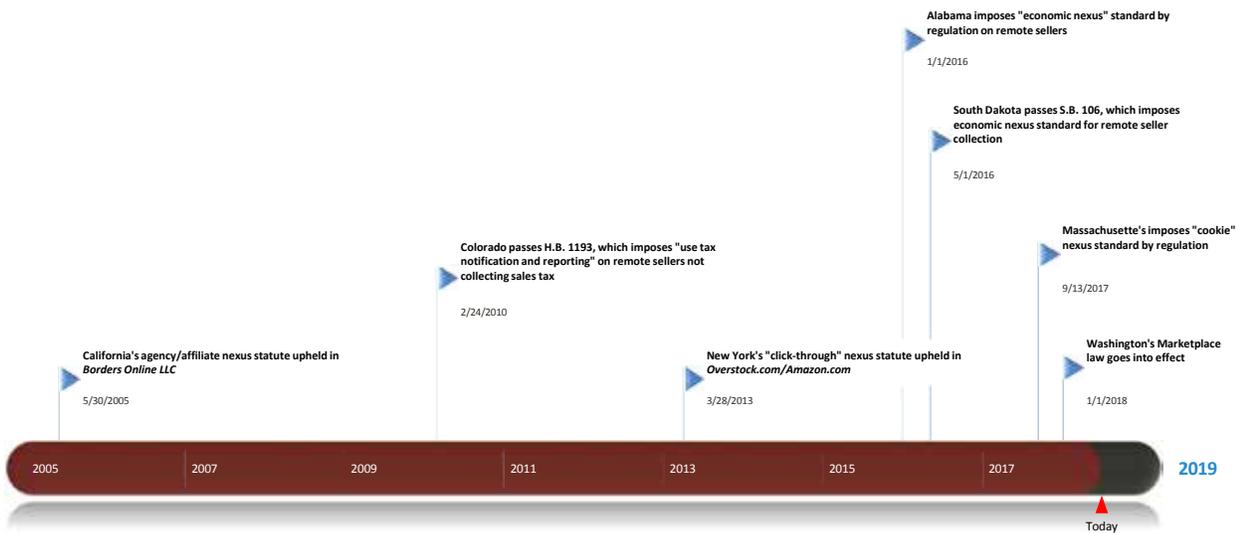
NATIONAL BELLAS HESS TO WAYFAIR



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STATES TAKE THINGS INTO THEIR OWN HANDS...



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SOUTH DAKOTA V. WAYFAIR

Background

- South Dakota adopted an economic nexus standard for sales and use tax purposes
 - Any seller with sales exceeding an annual threshold of **\$100,000 or 200 or more separate transactions** in South Dakota was required to collect and remit effective May 1, 2016
 - Physical presence was not required

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SOUTH DAKOTA V. WAYFAIR

On June 21, 2018, the Court ruled in a 5-4 decision to overturn the *Quill* physical presence standard for sales tax nexus

- The Court concluded that the physical presence rule set forth in *Quill* is overruled because it was “unsound and incorrect”
- The Court said that the physical presence rule “has been the target of criticism over many years from many quarters”
 - “***Quill* is flawed on its own terms.** First, the physical presence rule is not a necessary interpretation of the requirement that a state tax must be applied to an activity with a substantial nexus with the taxing state. Second, *Quill* creates rather than resolves market distortions. Third, *Quill* imposes the sort of arbitrary, formalistic distinction that the Court’s modern Commerce Clause precedents disavow” (emphasis added)

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SOUTH DAKOTA V. WAYFAIR

- Instead of *Quill*'s physical presence rule, the appropriate test is whether the taxpayer “avails itself of the substantial privilege of carrying on business” in a jurisdiction
- The taxpayers had substantial nexus with South Dakota
 - The taxpayers at issue, large retailers with extensive virtual presence, clearly availed themselves of the substantial privilege of carrying on business in South Dakota
- The case was remanded to South Dakota to determine whether South Dakota's law was otherwise consistent with the Commerce Clause

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SOUTH DAKOTA V. WAYFAIR

- South Dakota's law included several features that appear designed to prevent discrimination or undue burdens upon interstate commerce
 - No retroactivity
 - Member of Streamlined Sales and Use Tax Agreement
 - Minimum threshold
- Other Commerce Clause precedents will protect against any undue burden on interstate commerce
 - *Pike* balancing test – is the burden imposed on interstate commerce clearly excessive in relation to the putative local benefits
 - Retroactive liability creates a double-taxation risk
 - Small sellers can still argue there is a burden or the presence is *de minimis*

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STATE RESPONSES TO *WAYFAIR*

- Most states have already taken legislative and regulatory action adopting nexus standards aimed at remote retailers
- States with laws on their books can immediately begin requiring remote sellers to register and collect tax on sales to in-state customers
 - Will they give companies lead time to adopt new systems and procedures? Most have.
- Will states offer amnesty/voluntary disclosure programs for remote retailers?

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POST-*WAYFAIR* RAMIFICATIONS

Winners

- States
- Localities (?)
- Bricks and mortar retailers
- Software compliance companies
- Foreign sellers (?)

Losers

- Online retailers
- Start-ups
- Marketplace providers
- Foreign sellers (?)
- Service providers

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PLANNING FOR SELLERS - LOCALITIES

- The *Wayfair* decision did not address enforcement by localities.
- The majority decision specifically referenced South Dakota's membership in the Streamlined Sales and Use Tax Agreement as one of the reasons the imposition was not an undue burden.
- One of SST's key features is a 'one-stop shop' for registration, return filing, and audits of sellers. SST members do not have local enforcement or compliance requirements for sales and use taxes.
 - Louisiana, which has extensive local enforcement, stated that it was reviewing its options to enable single-state administration by January 1, 2019.
 - Colorado Sales and Use Tax Simplification Task Force actively considering potential simplification efforts for 2019 legislation.

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STATE RESPONSE – SIMPLIFICATION

- For those states that are not members of the Streamlined Sales and Use Tax Agreement, the NCSL SALT Task Force recommended the following simplifications:
 - Simplification of registration for sellers
 - Establish, centralize and simplify a process for sellers to use Certified Software Providers for compliance
 - Provide publicly available taxability and exemption tables and update regularly
 - Provide a publicly available rate and boundary database and update regularly

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MARKETPLACE PROVIDER LAWS

- Requires “marketplace providers” to collect tax on sales made by third party sellers or comply with notice requirements
- States have specific definitions of “marketplace providers”
 - Washington: “Marketplace facilitator” means a person that:
 - (i) Contracts with sellers to facilitate for consideration, regardless of whether deducted as fees from the transaction, the sale of the seller’s products through a marketplace owned or operated by the person;
 - (ii) Engages directly or indirectly, through one or more affiliated persons, in transmitting or otherwise communicating the offer or acceptance between the buyer and seller. For purposes of this subsection, mere advertising does not constitute transmitting or otherwise communicating the offer or acceptance between the buyer and seller; and
 - (iii) Engages directly or indirectly, through one or more affiliated persons, in any of the following activities with respect to the seller’s products: (A) Payment processing services; (B) Fulfillment or storage services; (C) Listing products for sale; (D) Setting prices; (E) Branding sales as those of the marketplace facilitator; (F) Taking orders; or (G) Providing customer service or accepting or assisting with returns or exchanges.

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STATES WITH MARKETPLACE PROVIDER LAWS

As of May 22, 2019, the following states enacted a marketplace provider law:

- Alabama – eff. January 1, 2019
- Arkansas – eff. July 1, 2019
- California – eff. October 1, 2019
- Connecticut – eff. December 1, 2018
- District of Columbia – eff. April 1, 2019
- Hawaii – eff. January 1, 2020
- Idaho – eff. June 1, 2019
- Indiana – eff. July 1, 2019
- Iowa – eff. January 1, 2019
- Kentucky – eff. July 1, 2019
- Minnesota – eff. October 1, 2018
- Nebraska – eff. April 1, 2019
- New Jersey – eff. November 1, 2018
- New Mexico – eff. July 1, 2019
- New York – eff. June 1, 2019
- North Dakota – eff. October 1, 2019
- Oklahoma – eff. July 1, 2018
- Pennsylvania – eff. April 1, 2018
- Rhode Island – eff. June 27, 2019
- South Carolina – eff. April 26, 2019
- South Dakota – eff. March 1, 2019
- Utah – eff. October 1, 2019
- Virginia – eff. July 1, 2019
- Washington – eff. January 1, 2018
- West Virginia – eff. July 1, 2019
- Wyoming – eff. July 1, 2019

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NON-SALES TAX ISSUES

- Corporate Income Tax
 - Could this expand concept of water’s-edge?
 - Foreign company with no sales in a state but with substantial business activities – such as with an affiliate or a third-party supplier
 - Benefit or harm?
- Personal Income Tax Withholding

Chapter 4

Estate Planning and Administration After the Tax Cuts and Jobs Act

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I. TAX REFORM PROVIDES SIGNIFICANT CHANGES FOR ESTATE PLANNERS

An Act To Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, Enacted December 22, 2017 (“TCJA”)

A. Effective Date and Sunset

Most provisions in the TCJA became effective January 1, 2018. Except with respect to the change in the calculation of inflation adjustments, many of the changes to business taxes and other changes, discussed below, many of the provisions of the TCJA will sunset on January 1, 2026 and the law in effect on December 31, 2017 will become effective again, unless legislation is enacted altering this sunset.

B. New Basic Exclusion Amounts for Estate and Gift Taxes and New Generation-Skipping Transfer Exemption

For estate and gift tax purposes, the TCJA increased the basic exclusion amount under Internal Revenue Code (“IRC”) § 2010(c)(3) to \$10 million as adjusted for inflation with a 2010 base year (the same base year under prior law). Thus, the basic exclusion amount for 2019 for gift and estate tax purposes, and the generation-skipping transfer (“GST”) exemption amount under IRC § 2631(c), is \$11.4 million. Rev. Proc. 2018-57, 2018-49 I.R.B. 827 (November 15, 2018).

Under the current applicable exclusion amount, the number of decedent’s estates subject to federal estate tax may only reach a few thousand, and taxpayers have the ability to make larger gifts during their lives free of gift tax. Fox, Henry & Kaufman, “Confronting the Challenges of Tax Reform: What Happened to the Certainty of Death and Taxes?” ALI-CLE and ACTEC (January 11, 2018).

IRC § 2001(g)(2), enacted as part of the TCJA, states that regulations shall be issued to address “clawback,” *i.e.*, dealing with what occurs if a decedent used the increased basic exclusion amount for gifts made while the TCJA was in effect and died after the sunset of the TCJA.

The transfer tax rates were not changed by the TCJA.

C. Inflation Adjustments

All provisions in the Code that provide amounts subject to indexing for inflation will utilize the chained consumer price index for all urban consumers (“C-CPI-U” or “Chained Consumer Price Index”). IRC § 1(f)(6); TCJA § 11002. This inflation adjustment method is a permanent change to the Code. The use of the Chained Consumer Price Index will result in slower growth of inflation and a slower increase in basic exclusion amount than the prior method, the Consumer Price Index for all Urban Consumers, or CPI-U. Fox, *supra*. It will also cause more taxpayers to be in higher tax brackets over time. Akers, “Selected Highlights of TCJA and Estate Planning Considerations,” <http://www.bessemertrust.com/portal/site/Advisor> (January 12, 2018).

D. Income Taxation of Individuals, Trusts and Estates

1. New Tax Rates. The TCJA modified the tax brackets for married individuals filing a joint return and surviving spouses, heads of household, single individuals and married individuals filing separate returns. IRC § 1. The brackets for married individuals filing a joint return and surviving spouses and single filers are provided below:

Married Individuals Filing a Joint Return and Surviving Spouses

<u>If taxable income is:</u>	<u>The tax is:</u>
Not over \$19,400	10% of taxable income
Over \$19,400 but not over \$78,950	\$1,940 plus 12% of the excess over \$19,400
Over \$78,950 but not over \$168,400	\$9,086 plus 22% of the excess over \$78,950
Over \$168,400 but not over \$321,450	\$28,765 plus 24% of the excess over \$168,400
Over \$321,450 but not over \$408,200	\$65,497 plus 32% of the excess over \$321,450
Over \$408,200 but not over \$612,350	\$93,257 plus 35% of the excess over \$408,200
Over \$612,350	\$164,709.50 plus 37% of the excess over \$612,350

Single Individuals

<u>If taxable income is:</u>	<u>The tax is:</u>
Not over \$9,700	10% of taxable income
Over \$9,700 but not over \$39,475	\$970 plus 12% of the excess over \$9,700
Over \$39,475 but not over \$84,200	\$4,543 plus 22% of the excess over \$39,475
Over \$84,200 but not over \$160,725	\$14,382.50 plus 24% of the excess over \$84,200
Over \$160,725 but not over \$204,100	\$32,748.50 plus 32% of the excess over \$160,725
Over \$204,100 but not over \$510,300	\$46,628.50 plus 35% of the excess over \$204,100
Over \$510,300	\$153,798.50 plus 37% of the excess over \$510,300

Rev. Proc. 2018-57, 2018-49 I.R.B. 827 (November 15, 2018).

The tax brackets for trusts and estates under the TCJA are as follows:

<u>If taxable income is:</u>	<u>The tax is:</u>
Not over \$2,600	10% of taxable income
Over \$2,600 but not over \$9,300	\$260 plus 24% of the excess over \$2,600
Over \$9,300 but not over \$12,750	\$1,868 plus 35% of the excess over \$9,300
Over \$12,750	\$3,075.50 plus 37% of the excess over \$12,750

Rev. Proc. 2018-57, 2018-49 I.R.B. 827 (November 15, 2018).

The tax brackets for capital gains (IRC § 1(j)(5)) and dividends (IRC §§ 1(h)(11), 301) are the same as under prior law except for very slight modifications to the bracket ceilings. The net investment income tax under IRC § 1411 remains intact.

The thresholds for each income tax bracket will be indexed for inflation using C-CPI-U in tax years beginning after December 31, 2018.

2. Standard Deduction. The TCJA (as supplemented by Rev. Proc. 2018-57) increased the standard deduction to \$24,400 for taxpayers filing jointly or for a surviving spouse, \$18,350 for head of household and \$12,200 for single filers. Taxpayers who are blind or 65 years of age or older are eligible for an increased standard deduction as under prior law. IRC § 63(c)(2), (f). For 2019, the additional amount is \$1,300, except that the additional amount is \$1,650 for individuals who are also unmarried and not a surviving spouse. Rev. Proc. 2018-57, 2018-49 I.R.B. 827 (November 15, 2018). The amount of the standard deduction is indexed for inflation using the C-CPI-U in tax years beginning after 2018.

3. Personal Exemption. The personal exemption has been suspended. IRC § 151(d); TCJA § 11041. The suspension of the personal exemption does not affect the exemption for trusts and estates, except that a qualified disability trust, which under prior law was entitled to the personal exemption of an individual. The TCJA allows a deduction for a qualified disability trust of \$4,150 (\$4,200 in 2019) during the years that the personal exemption is suspended. This deduction for qualified disability trusts is indexed for inflation. IRC § 642(b)(2)(C)(iii).

4. Miscellaneous Itemized Deductions. Miscellaneous itemized deductions subject to the 2% floor under IRC § 67(a)-(b) are suspended. IRC § 67(g).

Because many states base their income tax calculation on federal taxable income, the elimination of many itemized deductions due to IRC § 67(g) will increase state income taxes for many individuals, trusts and estates as well. Akers, *supra*.

Note that this does not include expenses of an estate or trust not subject to the 2% floor under IRC § 67(e). Expenses of an estate or trust are not subject to the 2% floor if such expenses would not have been incurred if the property were not held in a trust or estate. Thus, executor and trustee fees and attorney's fees related to trust and estate administration should continue to be deductible. Fox, *supra*. The IRS plans to issue regulations to this effect. Notice 2018-61, 2018-31 I.R.B. 278 (July 13, 2018).

IRC § 642(h)(2) states that on termination of an estate or trust any deductions (other than the estate or trust exemption and other than the charitable deduction) for the estate or trust in excess of gross income are allowable as deductions to the beneficiaries. This deduction is eliminated due the suspension of miscellaneous itemized deductions for individuals under IRC § 67(g). However, the IRS has announced that it is considering whether this deduction should continue to be a miscellaneous itemized deduction. Notice 2018-61, 2018-31 I.R.B. 278 (July 13, 2018). Beneficiaries may still claim a trust or estate's net operating losses or capital loss carryovers upon trust or estate termination under IRC § 642(h)(1). Akers, *supra*.

The income tax deduction for estate tax attributable to income in respect of a decedent under IRC § 691(c) was not altered by the TCJA. Akers, *supra*.

5. Pease Limitation. The limitation on otherwise allowable itemized deductions that applied to certain high-income taxpayers, often referred to as the "Pease" limitation, has been suspended. IRC § 68; TCJA § 11046. Because the TCJA suspended many itemized deductions, this suspension of the Pease limitation may be meaningful only to taxpayers who have substantial charitable or home mortgage interest deductions. Akers, *supra*.

6. State and Local Taxes. The deduction for state, local and foreign real property taxes; state and local personal property taxes; and state, local and foreign income taxes (referred to as "SALT" deductions) is now limited to \$10,000 per taxable year (\$5,000 for a married taxpayer filing a separate return). These cap amounts are not indexed for inflation.

Deductions for state and local real property taxes; state and local personal property taxes; and foreign income taxes incurred in connection with trade or business or from an activity described in IRC § 212 (*i.e.*, investment activities) are not subject to this cap. The deduction for foreign real property taxes is suspended. IRC § 164(b)(6).

7. Alimony and Separate Maintenance; Trusts for Divorced Spouse. The TCJA eliminated the above-the-line deduction for alimony and separate maintenance payments under IRC § 215. In addition, the TCJA eliminated IRC §§ 61(a)(8) and 71, which required payees of alimony and separate maintenance to include such payments in gross income.

The TCJA repealed IRC § 682, which provided that if one spouse created a grantor trust for the benefit of the other spouse and the spouses divorced, thereafter the trust income would not be taxed to the grantor spouse to the extent of any income that the donee-spouse is entitled to receive.

These changes are effective for divorce decrees and separation agreements entered into after 2018. Thus, taxpayers seeking a divorce during 2018 may wish to ensure that the divorce is finalized before the end of the calendar year. Akers, *supra*. Modifications entered into after

2018 are subject to the TCJA if the modification expressly states that this provision of TCJA applies. TCJA § 11051(c)(2). No sunset applies to the repeal of the above provisions regarding alimony and separate maintenance payments and IRC § 682.

The IRS intends to issue regulations regarding the application of IRC § 682 before its repeal is effective. Notice 2018-37, 2018-18 I.R.B. 521 (April 30, 2018). In the Notice, the IRS requested comments on whether guidance is needed regarding the application of IRC §§ 672(e)(1)(A), 674(d), and 677 following a divorce or separation in light of the repeal of IRC § 682.

IRC § 672(e)(1)(A) provides that the grantor of a trust shall be treated as holding any power or interest in such trust held by any individual who was the spouse of the grantor at the time of the creation of such power or interest. IRC § 674(a) provides, in general, that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the trust assets is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. However, IRC § 674(d) provides that IRC § 674(a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a Trustee or Trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, if such power is limited by a reasonably definite external standard that is set forth in the trust instrument. IRC § 677(a) provides that the grantor of a trust shall be treated as the owner of any portion of a trust, whether or not the grantor is treated as such owner under IRC § 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse, or held or accumulated for future distribution to the grantor or the grantor's spouse. In light of the repeal of IRC § 682, IRC §§ 672(e)(1)(A), 674(a) and 677(a) may have the effect of triggering grantor trust status due to the non-grantor spouse's powers over a trust even after the spouses divorce.

8. Charitable Contributions. The TCJA enhanced the deduction for charitable contributions of cash to public charities, private operating foundations, supporting organizations and other entities described in IRC § 170(b)(1)(A) by raising the limit that can be contributed in any one year to 60% of a taxpayer's contribution base (generally, adjusted gross income) from 50%. IRC § 170(b)(1)(G)(i).

The TCJA permanently removed the deduction relating to purchases of tickets to college sporting events. Contributions that are linked to the right to purchase such tickets will no longer be considered charitable donations. IRC § 170(l).

The TCJA also eliminated the alternative rule for substantiating gifts to donee organizations. Previously, donors who made donations of \$250 or more to donee organizations did not need a contemporaneous written acknowledgment from the donee organization if the donee organization filed a return with the required information. This change is effective for taxable years beginning after 2016. IRC § 170(f)(8).

9. Unearned Income of Children (the "Kiddie Tax"). The unearned income of children under 18 years of age (up to 23 years of age in certain circumstances) is now

subject to the same ordinary income and capital gain tax brackets that are applied to trust and estate income. IRC § 1(j)(4).

10. Life Settlements of Life Insurance Policies. For purposes of life settlements of life insurance policies, the TCJA provides that a taxpayer's basis in a life insurance policy is not reduced by the cost of insurance. This provision reverses the IRS's position, stated in Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, that a taxpayer's basis does include such charges.

New reporting requirements are imposed for life settlements. IRC § 6050Y. The IRS has announced that it will issue guidance on these reporting requirements. Notice 2018-41, 2018-20 I.R.B. 584. Also, the transfer for value rules are excluded from life settlements. IRC § 101(a)(2). These provisions do not sunset after 2025.

11. Retirement Assets. Prior law allowed individuals who converted a traditional IRA to a Roth IRA to reverse the conversion, move the assets back to the traditional IRA (the "recharacterized traditional IRA") and avoid the income tax from a conversion if the conversion was reversed before the extended due date of the taxpayer's individual income tax return for the year of the conversion. While continuing to allow the conversion to a Roth IRA, the TCJA removed the ability to recharacterize the conversion. This provision does not sunset after 2025. IRC § 408A(d)(6)(B)(iii).

12. ABLE Accounts. An ABLE account is a tax-favored savings program to meet the qualified disability expenses of the beneficiary of the account. Once the overall limitation on contributions is reached for a calendar year (\$15,000 for 2018), the TCJA provides that the designated beneficiary of the ABLE account may contribute an additional amount to the ABLE account. The designated beneficiary's contribution cannot exceed the lesser of the federal poverty line for one-person household or the designated beneficiary's compensation for the year. Contributions to an ABLE account may be claimed as a saver's credit on the designated beneficiary's income tax return. The designated beneficiary, or the designated beneficiary's representative, must maintain adequate records of any additional contribution by the designated beneficiary. IRC §§ 529A, 25B. The IRS recently issued Notice 2018-62, 2018-34 I.R.B. 316 (August 20, 2018), stating that it intends to issue proposed regulations to clarify recent law changes to the limits on contributions to ABLE accounts provided in IRC § 529A(b)(2).

13. 529 Plans. The TCJA permits owners of IRC § 529 accounts to rollover funds from such accounts to ABLE accounts, but only if the designated beneficiary (or member of the beneficiary's family) of the IRC § 529 account owns the ABLE account. The amount rolled over is counted against the contribution limit that applies to the ABLE account for the year of the rollover. IRC § 529(c)(3)(C)(i)(III).

In addition, the TCJA expanded the definition of "qualified higher education expense" to include up to \$10,000 of the cost of enrollment or attendance at an elementary or secondary public, private, or religious school. This expansion of qualified higher education expense does not sunset. IRC § 529(c)(7), (e)(3)(A).

E. Alternative Minimum Tax

The corporate alternative minimum tax (“AMT”) has been repealed. IRC § 55(a). The TCJA increased the exemption amounts applicable to individuals for AMT purposes. The AMT exemption amounts for unmarried individuals was increased from \$54,300 to \$70,300 (\$71,700 for 2019). The AMT exemption amounts for married individuals filing joint returns was increased to \$109,400 (\$111,700 for 2019). IRC § 55(d). The exemption for estates and trusts is \$25,000. IRC § 55(d)(1); Rev. Proc. 2018-57, 2018-49 I.R.B. 827 (November 15, 2018).

The TCJA increased the amount by which the AMT begins to phase out. For married individuals filing joint returns, the phase out begins at \$1,020,600 as opposed to \$160,900 under prior law. For unmarried individuals, the phase out begins at \$510,300 as opposed to \$120,700 under prior law. IRC § 55(d); Rev. Proc. 2018-57, 2018-49 I.R.B. 827 (November 15, 2018). For estates and trusts, the phase-out begins at \$83,500. Rev. Proc. 2018-57, 2018-49 I.R.B. 827 (November 15, 2018).

F. Tax Exempt Organizations

The TCJA imposes an excise tax on highly compensated employees of tax-exempt organizations. The excise tax is imposed at a rate of 21% of compensation in excess of \$1 million paid to any of the organization’s five highest-paid employees. The excise tax is paid by the organization and not the covered employee(s). The excise tax would also apply to certain parachute payments. IRC § 4960.

The TCJA also made changes to the unrelated business income tax (“UBIT”). Under prior law, tax-exempt entities could allocate gains and losses from one trade or business activity against the gains and losses from another trade or business activity for purposes of calculating UBIT. Under the new law, this is no longer possible as unrelated business income must be calculated separately for each activity. The result is that the losses generated by unrelated business income activities computed on a separate basis may not be used to offset the gains of other unrelated business income activities. This rule does not apply to net operating losses that arise in a year before 2018. IRC § 512(a)(6).

G. Taxation of Businesses and Business Interests

1. Corporations. Corporations (subject to tax under Subchapter C of the Code) now pay a flat 21% income tax rate. IRC § 11(b). This rate change is permanent.

The 80% dividend-received deduction has been reduced to 65%. The 70% dividends-received deduction was reduced to 50%. IRC §§ 243, 245, 246, 246A.

2. Net Operating Losses. Net operating loss carryovers are now limited to 80% of taxable income, but such losses be carried forward indefinitely. For most businesses, the loss carryback has been eliminated. IRC § 172.

3. Nonresident Aliens and ESBTs. The TCJA allows a nonresident alien individual to be a potential current beneficiary of an electing small business trust. IRC § 1361(c)(2)(B)(v).

4. Deduction for Qualified Business Income.

a. Introduction. The TCJA enacted new Internal Revenue Code (“IRC”) § 199A, which, in general, creates a deduction for the combined qualified business income received from certain pass-through and disregarded entities. This Section does not apply to taxable years beginning after 2025. IRC § 199A(i).

On August 8, 2018, the IRS issued proposed regulations under IRC § 199A. REG-107892-18, 83 Fed. Reg. 40884 (August 16, 2018). These regulations were finalized on January 18, 2019 and became effective after corrections on February 8, 2019. T.D. 9847. With the final regulations, the IRS issued new proposed regulations to provide guidance regarding previously suspended losses, regulated investment companies, charitable remainder trusts and split-interest trusts. REG-134652-18, 84 Fed. Reg. 3015 (February 8, 2019) (the “Newly Proposed Regulations”).

For individuals, the deduction is available whether the individual claims the standard deduction or itemizes deductions. IRC § 63(b); Joint Explanatory Statement of the Committee of Conference on H.R. 1, 115th Cong. 1st Sess, p. 39 (2017). The deduction does not affect the calculation of adjusted gross income. IRC § 62(a); Akers, “Section 199A – Qualified Business Income Deduction Including Highlights of Final and Newly Proposed Regulations,” at <http://www.bessemer.com> (February 2019).

The deduction is available for individuals, partnerships, S corporations, estates, trusts and any other taxpayer other than a C corporation. IRC § 199A(a). The deduction is applied at the pass-through owner level. IRC § 199A(f)(1); Treas. Reg. § 1.199A-1(e)(1); -6. The deduction does not affect the adjusted basis of a partner’s interest in a partnership, the adjusted basis of a shareholder’s stock in an S corporation or an S Corporation’s accumulated adjustments account. Treas. Reg. § 1.199A-1(e)(1). The deduction is available for up to 20% of the taxpayer’s taxable income (without consideration of IRC § 199A) minus the taxpayer’s net capital gains (IRC § 1(h)). Net capital gain is defined as net capital gain under IRC § 1221(11) and includes qualified dividend income. Treas. Reg. § 1.199A(b)(3). The deduction cannot exceed the combined qualified business income of the taxpayer. IRC § 199A(a), (e)(1).

The deduction is for income tax purposes only. It is not available to reduce self-employment tax under IRC § 1402 or net investment income tax under IRC § 1411. IRC § 199A(f)(3); Treas. Reg. § 1.199A-1(e)(3).

b. Qualified Business Income. In general, qualified business income (“QBI”) means the “deductible amount,” determined under IRC § 199A(b)(2), for each qualified trade or business carried on by the taxpayer, plus 20% of qualified REIT dividends and qualified publicly traded partnership (“PTP”) income. IRC § 199A(b)(1), (c); Treas. Reg. § 1.199A-1(b)(5), -3(b).

The deductible amount is the lesser of: (a) 20% of the taxpayer’s QBI with respect to the qualified trade or business (defined below); or (b) the greater of 50% of the W-2 wages with respect to the qualified trade or business, or the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis immediately after acquisition of all

qualified property (“UBIA”) ((b) is hereinafter referred to as the “Wage/UBIA Test”). IRC § 199A(b)(2); Treas. Reg. § 1.199A-1(d)(2)(iv). The Wage/UBIA Test is applied only if taxable income exceeds the threshold amount, discussed below. IRC § 199A(b)(3)(A); Treas. Reg. § 1.199A-1(c).

Generally, QBI consists of net income from an active trade or business within the United States, less qualified REIT dividends or qualified PTP income. It does not include, among other items, capital gains, dividends, non-business interest, wage income received as an employee, any guaranteed payment described in IRC § 707(c) or payments to a partner for acting in a capacity other than a partner under IRC § 707(a). IRC § 199A(c); Treas. Reg. § 1.199A-3(b).

c. Qualified Trade or Business; Specified Service Trade or Business; Trade or Business of Being an Employee. A qualified trade or business is a trade or business other than: (a) a specified service trade or business (“SSTB”); or (b) the trade or business of being an employee. IRC § 199A(d)(1).

In general, a “trade or business” is defined in accordance with the provisions of IRC § 162(a). Treas. Reg. § 1.199A-1(b)(14). The IRS issued a proposed revenue procedure, Notice 2019-07, 2019-09 I.R.B. 740 (January 18, 2019), to provide a safe harbor permitting a rental real estate enterprise to be treated as a trade or business. A trade or business conducted by a disregarded entity will be treated as conducted by the owner of that entity. Treas. Reg. § 1.199A-1(e)(2).

The exclusion for a SSTB applies only if the taxpayer’s taxable income is above the threshold amount, discussed below. These trades or businesses include those in the fields of law, health, accounting, financial services, actuarial science, performing arts, consulting, athletics, brokerage services, investment management or any business where the principal asset is the reputation or skill of one or more of its employees. Notwithstanding this provision, trades or businesses in the fields of engineering and architecture are considered qualified trades or businesses. Treas. Reg. § 1.199A-5(b).

If the trade or business is a SSTB and taxable income exceeds the phase-in range above the threshold amount, discussed below, none of the QBI, wages or UBIA for purposes of the Wage/UBIA Test will be taken into account in determining the taxpayer’s QBI, even if the item is derived from an activity that is not itself a SSTB. IRC § 199A(d)(2); Treas. Reg. § 1.199A-5(a).

The regulations provide that a trade or business is not considered a SSTB if it has gross receipts of \$25 million or less per taxable year and less than 10% of such gross receipts is attributable to the performance of services in a SSTB. If gross receipts are greater than \$25 million in a taxable year, the trade or business still would not be a SSTB if less than 5% of the gross receipts are attributable to the performance of services of a SSTB. Treas. Reg. § 1.199A-5(c)(1).

The regulations contain anti-abuse rules related to SSTBs. A trade or business, or the portion of a trade or business, that provides property or services to a SSTB also is considered a SSTB if there is 50% or more common ownership with the SSTB receiving such property or

services. These rules are intended to prevent the division of a SSTB into a SSTB and a non-SSTB for the purpose of increasing the IRC § 199A deduction. Treas. Reg. § 1.199A-5(c)(2).

d. Taxpayer With Taxable Income Above Threshold Amount.

The threshold amount for 2019 is \$160,700 of taxable income, or \$321,400 of taxable income for a taxpayer filing a joint return. Rev. Proc. 2018-57, 2018-49 I.R.B. 827 (December 3, 2018). This threshold is indexed for inflation. IRC § 199A(e)(2).

If a taxpayer's taxable income is above the threshold amount, and the Wage/UBIA Test results in an amount that is less than 20% of the QBI, then the deductible amount determined under IRC § 199A(b)(2), discussed above, is reduced by a formula based on the taxable income in excess of the threshold amount. For 2019, if taxable income exceeds \$210,700 (\$421,400 for a taxpayer filing a joint return) the deduction under IRC § 199A is unavailable. IRC § 199A(b)(3); Treas. Reg. § 1.199A-1(d)(2)(iv).

There is a second limitation based on the threshold amount that applies to a SSTB, defined above. If taxable income exceeds the threshold amount, only a certain percentage of items of income, gain, deduction or loss, and the W-2 wages and UBIA shall be used in determining the deductible amount, defined above. The percentage is determined by a formula that reduces the percentage based on the amount by which taxable income exceeds the threshold amount. Once taxable income exceeds the threshold amount by \$50,000 (\$100,000 for taxpayer filing a joint return), the deduction is unavailable for the taxpayer's interest in the SSTB. IRC § 199A(d)(3). The taxpayer's interest in a SSTB may be subject to both the phase-out under IRC § 199A(b)(3) and (d)(3). Treas. Reg. § 1.199A-1(d)(4)(vi), Ex. 6.

For wages to be taken into account, the wages must be properly allocable to QBI of one or more trades or businesses. IRC § 199A(b)(4); Treas. Reg. § 1.199A-2(b). The IRS has issued a revenue procedure, Rev. Proc. 2019-11, 2019-09 I.R.B. 742 (January 18, 2019), which provides three methods for calculating W-2 wages.

e. Qualified Property. Qualified property, which is taken into consideration in applying the Wage/UBIA Test, is tangible property subject to allowance for depreciation under IRC § 167. The depreciable period for such property must not have ended before the close of the tax year. The property must be held by, and available for use in, the qualified trade or business at the close of the taxable year. The property must be used in the production of QBI. IRC § 199A(b)(6); Treas. Reg. § 1.199A-2(c).

To help prevent property transfers with the principal purpose of increasing the IRC § 199A deduction, the regulations contain an anti-abuse rule which provides that property would not be considered qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the IRC § 199A deduction. Treas. Reg. § 1.199A-2(c)(1)(iv).

f. Aggregation. The regulations provide rules allowing a taxpayer with interests in related trades or businesses to combine their QBI, W-2 wages and UBIA for

purposes of applying the Wages/UBIA Test. Aggregation is permitted, but not required. In general, the regulations provide that aggregation is permitted if the trades or businesses are under common control, integrated and provide similar products or services. The regulations provide family attribution rules for determining control. Aggregation is disallowed for SSTBs except as provided above pursuant to Treas. Reg. § 1.199A-5. Treas. Reg. § 1.199A-4.

g. Multiple Owners or Beneficiaries. For entities with multiple owners, each owner is allocated the owner's allocable share of income, losses, basis and other items necessary to calculate the owner's QBI deduction. IRC § 199A(f)(1); Treas. Reg. § 1.199A-6. With respect to a non-grantor trust or estate with multiple beneficiaries, each beneficiary's portion of the trust or estate's QBI, W-2 wages and UBIA is based on the proportion of such beneficiary's portion of distributable net income ("DNI"), with any undistributed DNI used to determine the trust or estate's QBI, W-2 wages and UBIA. Whether a trust or estate exceeds the threshold amount is determined after considering any distribution deduction. Treas. Reg. § 1.199A-6(d).

The regulations also provide that a trust formed with a principal purpose of avoiding, or of using more than one, threshold amount under IRC § 199A will not be respected as a separate trust entity for purposes of determining the threshold amount. Treas. Reg. § 1.199A-6(d)(3)(vii).

The Newly Proposed Regulations provide that separate shares of a trust would be treated as a single trust for purposes of determining whether the taxable income of the trust exceeds the threshold amount. Prop. Reg. § 1.199A-6(d)(3)(iii).

h. Regulations Under IRC § 643(f). IRC § 643(f) provides that, for purposes of subchapter J of the IRC (IRC §§ 641-685), pursuant to regulations, two or more trusts shall be treated as one trust if: (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries; and (2) a principal purpose of such trust is the avoidance of the income tax. For purposes of IRC § 643(f), spouses shall be treated as one person.

The regulations include provisions that implement the rule under IRC § 643(f) by preventing taxpayers from dividing trust assets among multiple trusts so that each trust has income below the threshold amount. Treas. Reg. § 1.643(f)-1.

i. Effective Date of the Final and Newly Proposed Regulations. Most of the regulations apply to taxable years ending after February 8, 2019. *See, e.g.*, Treas. Reg. § 1.199A-1(f)(1). The anti-abuse provisions of the regulations, however, apply retroactively to taxable years ending after December 22, 2017, the date of enactment of the TCJA. *See, e.g.*, Treas. Reg. § 1.199A-5(e)(1). The regulations under IRC § 643(f) apply to taxable years ending after August 16, 2018, the date of publication of the Proposed Regulations in the Federal Register. Treas. Reg. § 1.643(f)-1(b). The Newly Proposed Regulations would apply to taxable years ending after the date the final regulations are published in the Federal Register, but taxpayers may rely on the Newly Proposed Regulations before that date.

5. Charitable Gifts From Electing Small Business Trusts. The TCJA also amends prior law to provide that the charitable contribution deduction allowed for the portion of

an electing small business trust (“ESBT”) holding S corporation stock is determined under the rules applicable to individuals under IRC § 170, and not those applicable to trusts under IRC § 642(c). An ESBT holding S corporation stock is able to avoid the restrictions imposed by IRC § 642(c), including the requirements that the contribution be made pursuant to the trust instrument and be made from gross income. An ESBT may now carry forward excess charitable deductions for five years. However, an ESBT will be subject to the same percentage limitations and substantiation requirements as individuals. The above changes to ESBTs will not sunset.

6. Carried Interests. The TCJA imposes a three-year holding period on carried interests before becoming eligible for long-term capital gain treatment. Carried interests are referred to as “applicable partnership interests” and are defined as an interest held in connection with the performance of substantial services by the taxpayer or related persons in an “applicable retained business.” IRC § 1061(c)(1). An “applicable retained business” consists of activities conducted on a regular, continuous and substantial basis related, in whole or in part, to (1) the raising or returning of capital and (2) either developing, or investing in or disposing of (or identifying for investing or disposition), assets such as securities, commodities, rental or investment real estate or cash or its equivalent. IRC § 1061(c)(2)&(3).

Applicable partnership interests do not include: (a) a partnership interest held by a corporation and (b) capital partnership interests that provide the partner with a right to share in partnership capital based on the amount of capital contributed or the value of such interest included in income under IRC § 83 upon the receipt or vesting of the interest. IRC § 1061(c)(4).

The new provision applies regardless of the application of IRC § 83. IRC § 1061(a).

Treasury is authorized to promulgate regulations necessary to carry out the provisions of these provisions. IRC § 1061(f); Notice 2018-18, 2018-12 I.R.B. 443 (March 19, 2018).

II. ESTATE PLANNING AND ESTATE AND TRUST ADMINISTRATION AFTER TCJA

A. Many Changes Wrought by TCJA Not Permanent

As detailed above, many tax law changes implemented by the TCJA are temporary and, unless new legislation is enacted, will sunset on January 1, 2026. Many planning and administration strategies that make sense under the TCJA will become less efficacious, and could even become deleterious, after December 31, 2025. Accordingly, those who draft estate planning documents may be wise in some cases to include alternative provisions to take effect depending on whether particular provisions of the TCJA remain in effect when the client dies. In addition, estate planners will need to remain attentive to further changes in the tax laws that may impact the TCJA’s sunset provisions and to the necessity to change course in some respects if any provisions of the TCJA in fact sunset on January 1, 2026.

B. Effect of TCJA on Formula Provisions

A very sizable number of estate plans in now in effect (and, perhaps, still being designed) largely revolve around provisions to take effect at the death of the first spouse to die that would cause property having a value equal to the smallest amount necessary to reduce federal estate tax to zero (or a fractional share of such property defined by a numerator equal to such smallest

amount) to pass in a marital deduction disposition with the balance of the decedent's estate to pass in a non-marital deduction disposition. There has always been a legitimate question regarding whether testamentary dispositions of property should be utterly dependent on whether the federal tax law in effect when an estate plan put in place remains in place at a client's death.

The TCJA accentuates this issue. Consider the following example: X has a Will containing a formula provision of the type summarized in the preceding paragraph. X signed his Will ten years ago. X's non-marital deduction disposition is materially different from his marital deduction disposition. (There are innumerable clients across America in this estate planning posture.) When X signed his Will or trust instrument, his net worth was \$5,000,000. Today, X's net worth is \$8,000,000. Ten years ago, in 2009, what we now refer to as the "basic exclusion amount" was \$3,500,000. Today, it is \$11,400,000.

Had X died in 2009, \$1,500,000 would have passed in the marital deduction disposition, and \$3,500,000 would have passed in the non-marital deduction disposition, a result of which X presumably approved. The applicable figures for 2010, based on what X and his advisors could have known in 2008, were \$4,000,000 and \$1,000,000. If X were to die today, his surviving spouse could receive *nothing* under his estate plan (whether outright or in trust).

Clients with formula-based estate plans should carefully consider whether those plans would carry out their present intentions and, if not, take steps promptly to make changes needed to conform their plans to achieve the results they want. Furthermore, estate planning advisors should seriously consider in what circumstances, if any, traditional zero-out-the-tax formula provisions make sense any longer (assuming they ever made sense).

C. Provisions Directing Alternative Dispositions

The scheduled, but not 100% certain, expiration on January 1, 2026 of the portion of the TCJA providing for a \$10,000,000 basic exclusion amount (indexed for inflation) will lead to dramatically different results in terms of how much value can pass, federal estate tax-free, at the death of an individual who survives past December 31, 2025. If the law does not change before January 1, 2026, the basic exclusion amount will decline by several million dollars (likely in the neighborhood of \$6,000,000). Anticipating this possibility, clients and their advisors may wish in some cases to design estate plans providing for one dispositive scheme to take effect if the basic exclusion amount at the client's death is equal to or greater than a specified threshold amount and an alternative dispositive scheme if the basic exclusion amount at the client's death is less than such amount.

D. Clayton QTIPs

1. **Description and Background.** A so-called Clayton QTIP trust is a trust for which a QTIP election at the death of the first spouse to die is eligible to be made and where, to the extent the predeceased spouse's executor does not make the QTIP election, any non-elected property, under the terms of the governing instrument, passes to a separate trust which is not required to have terms identical to the QTIP trust and is not required to meet the definition of a QTIP trust, *i.e.*, a traditional credit shelter-type trust for the concurrent benefit of the surviving spouse and descendants living from time to time.

This planning technique is named after *Estate of Clayton v. Comm'r*, 976 F.2d 1486 (5th Cir. 1992). See also Treas. Reg. § 20.2056(b)-7(d) and 7(h). In *Estate of Clayton*, the decedent's will created a family trust and a marital trust. The will provided that, if the executors failed to make a QTIP election with respect to the marital trust, any non-elected potential QTIP property would pass to the family trust. The will also provided that, to the extent the surviving spouse disclaimed any portion of the marital trust, that portion would pass to a third trust with terms similar to those of the family trust. The surviving spouse, as sole Independent Executrix, made a QTIP election for an undivided .563731 interest in specified bonds, notes and cash. The Commissioner disallowed the marital deduction as to the QTIP portion and issued a notice of deficiency. The Court of Appeals for the Fifth Circuit considered the question of whether the effect of the testamentary provision that caused non-elected potential QTIP property to pass in a non-QTIP disposition rendered all potential QTIP property ineligible to be elected as QTIP property in any event. The Fifth Circuit ruled in favor of the surviving spouse and found that the provisions of the will did not affect the deductibility under IRC § 2056(b)(7) of the value of any potential QTIP property with respect to which a QTIP election was actually made because: (1) the property to which IRC § 2056(b)(7) applied was only the property with respect to which a QTIP election was actually made and not all property with respect to which such an election could be made; and (2) the election related back to the decedent's death.

Both the Tax Court and the IRS acceded to the decision of the Fifth Circuit. See *Estate of Spencer v. Comm'r*, 43 F.3d 226 (6th Cir. 1995) and *Estate of Robertson v. Comm'r*, 15 F.3d 779 (8th Cir. 1994). Treas. Reg. § 20.2056(b)-7(d)(3) provides that an income interest which is contingent on the election of the executor will not fail to be a qualifying income interest life if such an election is actually made.

2. Substantial Post-Death Planning Flexibility. In a typical Clayton QTIP scenario, to the extent a QTIP election is not made with respect to a predeceased spouse's residuary estate, non-elected potential QTIP property passes to a traditional credit shelter-type trust for the concurrent benefit of the surviving spouse and descendants living from time to time. Income from that trust does not have to be paid to the surviving spouse. The trust may provide for wholly discretionary income and principal distributions among multiple current beneficiaries. In addition, the surviving spouse may have a non-general power of appointment over the assets of the trust. The surviving spouse must have a mandatory income interest only in the property with respect to which a QTIP election is made.

An executor generally has up to fifteen months (nine-month due date for filing the decedent's Form 706 plus an automatic six-month extension) after the decedent's death to assess the current situation and determine the appropriate QTIP election approach. The executor determines the amount of marital deduction desired relative to the size of the decedent's entire residuary estate. To the extent the executor refrains from making the QTIP election, the executor effectively shifts the disposition of property from a QTIP disposition to a credit shelter disposition. Treas. Reg. §§ 20.2056(b)-7(d)(3) and -7(h), Ex. 6, explicitly allow this technique to be implemented without disallowing causing forfeiture of the marital deduction.

The flexibility allowed in the Clayton QTIP context provides opportunities for tax savings based on asset characteristics, the age and health of the surviving spouse and the family's goals. An executor may elect portability and may make a QTIP election with respect to 100% of

potential QTIP property thereby facilitating use of the predeceased spouse's GST exemption by means of the "reverse QTIP election" under IRC § 2652(a)(3) *plus* a full basis step up as to the QTIP property at the death of the surviving spouse. On the other hand, an executor may prefer a traditional credit shelter trust approach which will allow for use of the predeceased spouse's GST exemption without "reverse QTIP election" and will in essence trade estate tax-free appreciation of property during the life of the surviving spouse for basis step-up at the surviving spouse's death.

With a broad discretionary credit shelter trust dispositive scheme, income tax planning potential through the making of judicious distributions abounds. In addition, income tax planning options may be enhanced by providing the surviving spouse with a broad non-general lifetime power of appointment over the credit shelter trust.

A similar result may be achieved by using a contingent disclaimer trust plan. In this scenario, at the death of the first spouse to die, the predeceased spouse's residuary estate is directed to be distributed outright to the surviving spouse (instead of a trust with respect to which a QTIP election could be made). If and to the extent the surviving spouse makes a qualified disclaimer (IRC § 2518), disclaimed property would pass to a credit shelter-type trust for the concurrent benefit of the surviving spouse and descendants living from time to time. Note, however, that, if the surviving spouse were to hold a non-general power of appointment not limited by an ascertainable standard, the disclaimer would not be qualified. Treas. Reg. § 25.2518-2(e)(2). Also, the time within which such a qualified disclaimer may be made is nine months after the predeceased spouse's date of death (IRC § 2518(b)) (as compared to the fifteen-month timeframe after the predeceased spouse's date of death within which a QTIP election decision may be made). In addition, the opportunity to make a qualified disclaimer may be inadvertently tainted by an acceptance of benefits by the surviving spouse before the disclaimer is finalized. IRC § 2518(b); Treas. Reg. § 25.2518-2(d)(1).

E. Selected Gifting Considerations

1. **Taking Advantage of Enhanced Basic Exclusion Amount.** At this time, and for the indefinite future, individuals have a greatly enhanced, historically high basic exclusion amount. This large basic exclusion amount is scheduled to evaporate January 1, 2026, and could be taken away by legislation at any time before that date. Thus, clients having significant wealth who wish to maximize their use of what could be a fleeting opportunity to use the basic exclusion amount now in place should consider expeditiously making one or more lifetime taxable gifts that fully absorb such basic exclusion amount. All the usual advantages of making gifts sooner rather than later would be in play, and, in addition, if the current basic exclusion amount is reduced or expires after such gifts have been made, it appears at least possible that gifts made to use the enhanced basic exclusion amount will not trigger additional estate tax at the donor's death. *See* IRC § 2001(g)(2).

2. **"Clawback" Issues.** In writing and passing the TCJA, Congress essentially "punted" on the question of "clawback." As explained above, IRC § 2001(g)(2) instructs the Secretary of the Treasury to issue regulations to address "clawback." Many commentators assume Congress intended "clawback" not occur, *i.e.*, that a decedent who made large lifetime taxable gifts to use the increased basic exclusion amount while the TCJA was in

effect and died after the sunset of the TCJA should not be treated on his or her estate tax return as having made taxable gifts because the increased basic exclusion amount for estate tax purposes had been eliminated. However, IRC § 2001(g)(2) does not instruct the Secretary to eliminate or prevent “clawback,” just to address it.

Even if “clawback” were to apply, an individual who made large lifetime taxable gifts to use the increased basic exclusion amount while the TCJA was in effect would still be in a better transfer tax position than if he or she had not made the gifts, except in a case in which the gifted property (or its proceeds) did not increase in value after the date(s) of the gift(s).

3. **Generating Gift Tax.** Particularly in an era of relatively enormous basic exclusion amounts, the vast majority of our clients who make sizeable lifetime gifts will not want to make such gifts in a manner that will cause gift tax actually to be incurred.

F. Selected Basis Considerations

1. **Watch Basis in Making Gifts.** As always, but particularly when contemplating the making of large gifts and selecting the best assets with which to fund such gifts, the cost basis embedded in the assets being considered as the subject of gifts should not be overlooked. In most cases, the making of gifts using low basis assets will be undesirable.

2. **Formula General Powers of Appointment.** Post-TCJA, not only do many clients anticipate having no estate tax issues, they reasonably believe their children and grandchildren will also have no such issues. Nevertheless, trusts for clients’ children and more remote descendants (at least until they reach designated ages) remain as viable and important as ever.

It is possible to design trusts for clients’ descendants in a manner that will cause the value of the assets in such trusts to be included in their respective gross estates just up to the point beyond which estate tax would be incurred.

IRC § 2041(b)(1) defines a general power of appointment as a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. IRC § 2041(a)(2) provides that “the power of appointment shall be considered to exist on the date of the decedent’s death even though the exercise of the power is subject to a precedent giving of notice or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the date of the decedent’s death notice has been given or the power has been exercised.”

Whether the holder of a testamentary power of appointment chooses to exercise it, the property that was subject to the power will be deemed to have been acquired from the deceased testator and will, therefore, qualify for the step-up in basis. *See* Treas. Reg. §§ 1.1014-2(a)(4), (b)(2). Thus, it is important to consider under what circumstances and to what extent it is wise to confer a general power of appointment with respect to property held in trust to generate basis step-up and income tax savings.

A testamentary general power of appointment can be conferred by means of a formula in such a way that the power would be exercisable only to the extent holding such power would not,

by itself, cause imposition of any estate tax. Such a formula could effectively be further refined in such a way so as to have effect only with respect to certain assets in a trust, or to subject to such power, first, those trust assets having the lowest basis and then cascading to each next lowest basis asset until holding the power would no longer not cause any imposition of estate tax.

A trust instrument could also be drafted in such a way that an independent trustee or a trust protector may grant a general power of appointment (perhaps, a formula general power of appointment, as described above) to a beneficiary after having examined the income and transfer tax consequences of so doing. Conditioning the grant of a general power of appointment to the determination of an independent trustee or a trust protector may provide more flexibility than having the trust instrument itself confer the general power of appointment. Consider, however, whether a given independent trustee will have the willingness and sophistication to grant a general power of appointment to a beneficiary and whether such independent trustee will even be available when needed for such purpose.

3. Use Elderly Parents. Wealthy clients with elderly less wealthy parents (even incapacitated less wealthy parents) could consider giving low-basis property to an irrevocable trust for the lifetime benefit of a parent, or selling such property to an irrevocable grantor trust for the lifetime benefit of a parent, in either case naming the client or the client's descendants as remainder beneficiaries and conferring on such parent a narrowly circumscribed formula general power of appointment of the type described above. A client considering this strategy would need to have substantial confidence that the parent would not attempt to divert the property away from the client at the parent's death and that there would be no undue risk under applicable state law that the parent's creditors could gain access to the trust property. In fact, given that an individual is deemed to possess a general power of appointment conferred on him or her even if he or she is unaware of it, an adventurous client without less wealthy parents could use a variation of this strategy with an elderly person who is a perfect stranger as the lifetime beneficiary of such a trust!

G. Installment Sales to Irrevocable Grantor Trusts

A well-known leveraged estate planning strategy involves the creation of an irrevocable grantor trust in connection with an installment sale of assets having good or great appreciation potential to such trust. Virtually all respected estate planning commentators advise that such an installment sale be supported by a gratuitous transfer of additional assets to the trust so that there is a source from which a down-payment on the installment sale may be made (so the transaction bears characteristics similar to those that would exist in an installment sale between unrelated parties) and a source, independent from the assets sold to the trust from which annual interest payments may be made (to minimize the possibility of inclusion in the settlor's taxable estate of the value of trust property under IRC § 2041(a)(2)). Most such commentators suggest such a gratuitous transfer of additional assets be of assets having a value of at least 10% of the value of the assets being sold to the trust.

With an historically high basic exclusion amount, a client could, without incurring gift tax, engage in such a gratuitous transfer to support an installment sale to an irrevocable grantor trust using assets having a value much greater than before the TCJA was in place. Using a much

larger gratuitous transfer would enable implementing a geometrically larger installment sale, resulting in potentially much greater estate tax savings.

H. Long-Term Trusts

Trusts with a duration as long as applicable state law will permit (which duration in many states is “forever”) continue to have all the transfer tax and income tax potential benefits as such trust have had since long before the TCJA. With the TCJA, clearly the impact of such benefits may be greatly increased. A large gift to a long-term irrevocable grantor trust fully utilizing a client’s basic exclusion amount, to which the client’s GST exemption is allocated, puts potentially very substantial value in a vehicle that for the indefinite future escapes estate tax, gift tax and generation-skipping transfer tax and enables the fine-tuning of income tax consequences (basis step-up using formula general powers of appointment for beneficiaries and minimizing income taxes for the trust and its beneficiaries after grantor trust status has ended through the making of judicious distributions).

I. Defined Value Clauses

In conjunction with the making of large lifetime taxable gifts to take full advantage of today’s basic exclusion amount under the TCJA but seeking to avoid the risk of actually incurring gift tax (especially where difficult-to-value assets are involved), the use of defined value clauses in documents effectuating gifts or sales would seem imperative. The Internal Revenue Service appears to despise defined value clauses, having litigated many cases in an effort to have them declared as void due to public policy considerations, but it has been decades since the Service has prevailed in a defined value clause case, and there are several relatively recent cases that provide a virtual roadmap for how to design an effective defined value clause that will almost eliminate the risk of incurring gift tax. See *Estate of Christiansen v. Comm’r*, 586 F.3d 1061 (8th Cir. 2009); *Estate of Petter v. Comm’r*, 653 F.3d 1012 (9th Cir. 2011); *Hendrix v. Comm’r*, 101 T.C.M. (CCH) 1642 (2011); *Wandry v. Comm’r*, 103 T.C.M. (CCH) 1472 (2012).

J. Timing of Expenses Incurred in Estate or Trust Administration

The inclusion of IRC § 67(g) in the TCJA notwithstanding, Notice 2018-61, 2018-31 I.R.B. 278 (July 13, 2018), clearly indicates that, until January 1, 2016 or until applicable law is changed in the interim, estates and nongrantor trusts can take miscellaneous itemized deductions with respect to expenses incurred that are unique to estate or trust administration. What is less clear, however, is whether excess deductions passing through to a beneficiary under IRC § 642(h) in the year in which the estate or trust terminates, to the extent such excess deductions include expenses incurred that are unique to estate or trust administration, may be taken by the beneficiary on his or her personal income tax return. Section 4 of Notice 2018-61 solicits comments from the public regarding this IRC § 642(h) issue. At this time, it is impossible to predict the ultimate resolution of this issue. Accordingly, unless and until this issue is formally resolved in favor of allowing estate and trust beneficiaries to claim the excess deductions on termination, as described above, on their individual income tax returns, fiduciaries of estates and trusts should seek to pay as many expenses unique to estate or trust administration as possible in

years preceding the year of termination to the extent there is sufficient taxable income in the estate or trust in such years to be offset by such expenses.

K. Charitable Giving

The TCJA's doubling of the standard deduction, as summarized above, means that many taxpayers who previously found it advantageous to itemize their deductions no longer do. By one rough, unattributed estimate, 30% of taxpayers itemized on their 2017 income tax returns, and, for 2018, that figure was expected to decrease to 8 or 9%.

There are relatively few cases in which taxpayers have flexibility to make or not make, or to impact the timing of, payments that give rise to income tax deductions, but the deduction for charitable contributions is one such case. The freedom when or whether to contribute to charity is virtually unlimited.

1. "Bunching" of Charitable Contributions. To maximize the tax deduction impact of making contributions to charity, taxpayers should consider "bunching" their charitable contributions that they would otherwise have made over two or more years into a single year. Following this strategy could produce aggregate itemized deductions in that year in excess of the standard deduction, thereby generating income tax savings in that year that would otherwise have been unavailable in any year if charitable contributions were made evenly over the same number of years that were "bunched."

Some taxpayers may be unable to decide, in the year of "bunching," what charitable organizations they want to benefit from all the dollars they were otherwise anticipating giving to charity over two or more years. For these taxpayers, a donor advised fund may be a good solution. An individual or spouses could make his or her, or their, "bunched" charitable contribution (or a portion thereof) to a donor advised fund, obtain all the same tax benefits available when a contribution is made to a traditional public charity and then, after deciding later what organization they desire as ultimate recipients, communicate his, her or their wishes to the fund manager, who, as a practical matter, will almost always accede to a donor's requests as to ultimate distributees.

2. Charitable IRA Rollover. A charitable giving strategy that avoids altogether the impact of the new standard deduction in discouraging itemized deductions (and therefore, perhaps, the making of annual charitable contributions) is the so-called charitable IRA rollover. An individual age 70½ or older can direct charitable gifts to be made from his or her IRA up to a maximum of \$100,000 per year. Such charitable gifts come from funds that would, if distributed to the IRA owner, constitute taxable income to him or her. However, since such funds are passing directly to charity, they are not included in taxable income – generating in effect a charitable contribution income tax deduction for the IRA owner. Note, however, that a charitable IRA rollover cannot be made to a donor advised fund.

L. Converting S Corporations to C Corporations

New IRC § 199A, introduced into the law by the TCJA, provides a deduction of 20% for QBI from pass-through entities (with many limitations and qualifications, as described above). IRC § 199A was enacted to give a roughly offsetting income tax benefit to owners of equity of

closely held S corporations, partnerships and limited liability companies in recognition of the lowering of the income tax rate for C corporations from 35% to 21%.

It has been suggested that, new IRC § 199A notwithstanding, owners of S corporation stock should consider converting to C corporation status to take advantage of the 21% income tax rate C corporations now enjoy. That recommendation would appear, however, to have less practical utility than might initially appear. An S corporation shareholder who is in the 37% federal income tax bracket and can take full advantage of the 20% deduction would be subject to tax on his or her qualified business income at a 29.6% rate. From that perspective, a 21% rate obviously looks better. However, unlike a C corporation shareholder, that S corporation shareholder will experience no additional income tax by reason of distributions. A C corporation shareholder receiving distributions is subject to double taxation, first at the entity level and then at the shareholder level when distributions are made. So, the C corporation shareholder in the 37% income tax bracket, when both entity level and shareholder level taxes are considered, bears aggregate income taxes totaling 50.23%. When shareholder distributions are considered, the C corporation result (50.23% aggregate federal income taxes) looks much worse than the S corporation result (29.6% federal income tax). Thus, conversion of an S corporation to be a C corporation, in an effort to minimize income taxes in most cases will not make sense except in cases where the corporation plans to retain its earnings for a considerable period.

M. Remedial Measures

1. **Note Forgiveness.** Clients who have made loans to their children over the years in order to avoid making taxable gifts that would have resulted in incurring gift tax may now consider forgiving those loans. In many situations involving such loans that remain outstanding, loan forgiveness can be accomplished within the parameters of the enhanced basic exclusion amount under the TCJA.

2. **Allocation of GST Exemption.** The TCJA, in addition to nearly doubling the basic exclusion amount, also effectively nearly doubled the GST exemption. Clients may be transferors with respect to trusts established in the past that, for some reason, intentional or inadvertent, have an inclusion ratio for generation-skipping transfer tax purposes of greater than zero. Now could be an opportune time for those clients to allocate their larger GST exemption to the extent necessary to reduce inclusion ratios to zero.

3. **Trigger Estate Tax Inclusion After-the-Fact.**

a. **Estate of Powell v. Commissioner, 148 T.C. No. 18 (May 18, 2017).** On August 8, 2008, one of the decedent's sons, acting on the decedent's behalf pursuant to a power of attorney, transferred over \$10,000,000 in cash and securities from decedent's revocable trust to a family limited partnership (the "FLP") in exchange for a 99% limited partner interest. The FLP was formed by the decedent's two sons two days beforehand. The FLP could be dissolved by agreement of all the partners. The partnership agreement gave the decedent's son who was acting as the decedent's attorney-in-fact sole authority regarding distributions. The decedent died on August 15, 2008.

In the decedent's estate tax proceedings, the Internal Revenue Service issued a notice of deficiency asserting \$5,870,226 in tax due. The estate moved for summary judgment, claiming there was no deficiency. The IRS moved for summary judgment as well, asserting that the value of cash and securities transferred from the decedent's revocable trust to the FLP in exchange for a 99% limited partner interest was includable in the value of the decedent's gross estate under IRC § 2036(a)(1).

The Tax Court explained that IRC § 2036 includes the value of transferred property in the value of a decedent's gross estate if, after the transfer (except for a bona fide sale for an adequate and full consideration), the decedent retained the possession or enjoyment of, or the right to the income from, the property (IRC § 2036(a)(1)) or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom (IRC § 2036(a)(2)).

This case was reviewed by the entire Tax Court. The Tax Court ultimately sided with the IRS and held that the assets that had been transferred to the FLP were included in the decedent's gross estate under IRC § 2036(a)(2). The Tax Court found that the decedent's power, with her sons, to terminate the partnership, along with the attorney-in-fact's power to determine distributions from the partnership, each constituted a retained right to determine the possession or enjoyment of the transferred property or its income under IRC § 2036(a)(2). The Tax Court referred to its opinion in *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145, *aff'd*, 416 F.3d 468 (5th Cir. 2005), where it relied primarily on two factors to determine whether inclusion in the decedent's gross estate was appropriate. In *Strangi*, like this case, the decedent transferred property to a family limited partnership in exchange for a 99% limited partner interest. The decedent and the other partners could dissolve the family limited partnership and return the transferred property back in the decedent. In addition, like the present case, the decedent, through his attorney-in-fact, had control over partnership distributions. Thus, the Tax Court in *Strangi* concluded that, because the decedent could join together with others to dissolve the partnership and determine the amount and timing of partnership distributions, it was justified to include in his gross estate under IRC § 2036(a)(2) the value of the property he transferred in exchange for the partnership interest.

A decedent's estate in 2019 or a subsequent year through 2025 holding equity in a FLP created years ago (as in *Powell*) may now actually find inclusion in the gross estate to be advantageous. With the enhanced basic exclusion amount provided by the TCJA, estate tax inclusion may cause no estate tax to be imposed but, upon the making of an election under IRC § 754, could result in some basis step-up with respect to the FLP's underlying assets. Accordingly, the executor of such an estate may take the position that the Tax Court's holding in *Powell* *requires* the value of *all* FLP interests to be included in the gross estate under IRC § 2036, even if the decedent owned no portion of the general partner interest. Following the reasoning of *Powell*, the argument would be that the decedent, in conjunction with all the other partners, could compel termination of the FLP and direct the disposition of its assets.

b. Trust Decanting or Modification. Even when the provisions of an existing irrevocable trust instrument would not allow or are affirmatively designed to prevent inclusion of the value of trust property in the gross estate of a beneficiary, there are various

mechanisms that may be available under state law by which a general power of appointment could be added to a trust.

Decanting is the process by which a trustee of an irrevocable trust with discretionary distribution authority may, without court approval, transfer the trust property into a new, separate trust. The governing instrument of the new trust has administrative and/or dispositive terms different from those contained in the original trust instrument.

The decanting statutes in the various states whose laws authorize decanting vary widely. Under many such statutes, however, it would be possible (or would certainly appear to be possible) for a Trustee to decant to a new trust whose terms would confer a general power of appointment on a beneficiary, thereby generating basis step-up with respect to the assets of the trust at the beneficiary's death.

Notice 2011-101, 2011-52 I.R.B. 932, requests comments regarding the income, gift, estate and GST tax consequences arising from a decanting that changes a beneficiary's interest. Since the IRS has not yet issued decanting regulations, and has not listed decanting regulations in its latest priority guidance plan (*see* Department of the Treasury, *2018-2019 Priority Guidance Plan*, 2nd Quarter Update (April 5, 2019)), any decanting that changes beneficial interests should be undertaken with care.

A result similar to the decanting result described above may also be achieved by means of judicial or non-judicial modification or non-judicial settlement. *See, e.g.*, §§ 111, 411, 412 and 416 of the Uniform Trust Code. In addition, under common law, beneficiaries, trustees and any other interested parties effectively often have the power to agree among themselves privately to modify trust terms. Acker, *Modifying, Reforming and Terminating Irrevocable Trusts (the Uniform Trust Code Has Made This Harder!)*, 45TH ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING, Ch. 10 (2011). In some states and under some circumstances, whether such a modification or settlement could be used to insert a general power of appointment may turn on whether such a change would be considered to violate a material purpose of the trust and could be properly approved by the court.

Chapter 5

Presentation Slides: Blockchain and Cryptocurrency: New Technology, Old Tax Rules

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Blockchain & Cryptocurrency: New Technology, Old Tax Rules

**19th Annual Oregon Tax Institute
June 6, 2019**

**Lisa M. Zarlenga
Step toe & Johnson, LLP**

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Agenda

- What is Blockchain and Cryptocurrency?
- General Tax Treatment of Cryptocurrency
- Forks and Airdrops
- Token Offerings and SAFTs
- Compliance and Reporting Obligations

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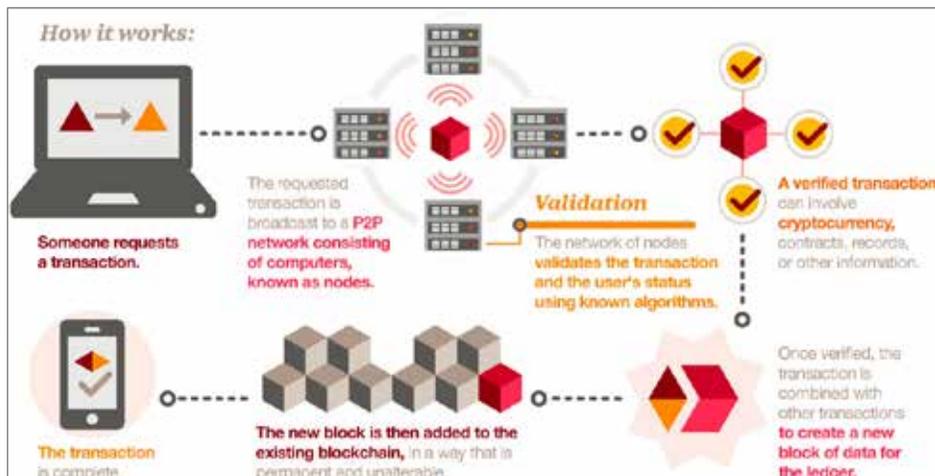
What is Blockchain?

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What is Blockchain?

A **blockchain** is a **decentralized ledger** of all transactions in a network. Using blockchain technology, participants in the network can confirm transactions **without the need for a trusted third-party** intermediary.



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Key Characteristics of Blockchain Technology

A peer-to-peer network of "nodes" for conducting transactions without an intermediary



A data store or append-only database for recording those transactions



A consensus mechanism for validating transactions and preventing fraudulent or false transactions.



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What is a Private or Permissioned Blockchain?

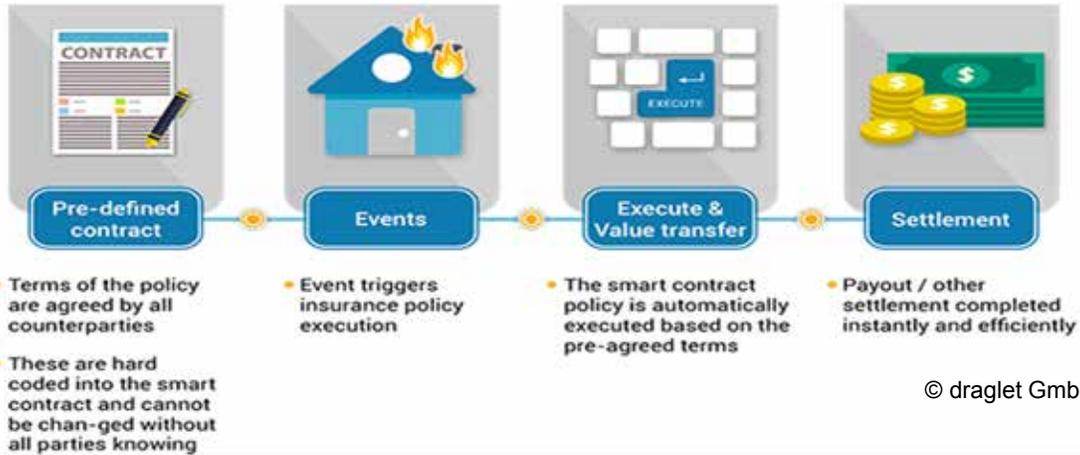
- Public (Permissionless) blockchains: access to read blockchain information, transact, and participate in the consensus process is open to anyone in the world
 - E.g., Bitcoin, Ethereum
- Private (Permissioned) blockchains: access to read blockchain information, transact, and participate in the consensus process is controlled or limited
 - Can set permissions for specific users, a whole company, or even a consortium
 - Useful for database management and auditing where public readability is not necessary
 - E.g., Hyperledger, Ripple

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What is a Smart Contract?

- Most efficient for simple “if-then” statements (e.g., automatic payments, life insurance, smart meters)



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Blockchain Applications



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Enterprise Applications

- Supply/Inventory Management
 - Reduce fraud and tampering
 - Identification of source
 - Enhances auditability
 - Customs compliance and information reporting
- Financial Services
 - Payment processing
 - Trade settlement and clearing
 - Smart contracts for leasing
- Energy
 - Trading excess capacity
- Insurance
 - Smart insurance policies

What is Cryptocurrency?

What is Cryptocurrency?

A type of digital or virtual currency that uses cryptography for security

Hundreds of Cryptocurrencies



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What is Bitcoin?

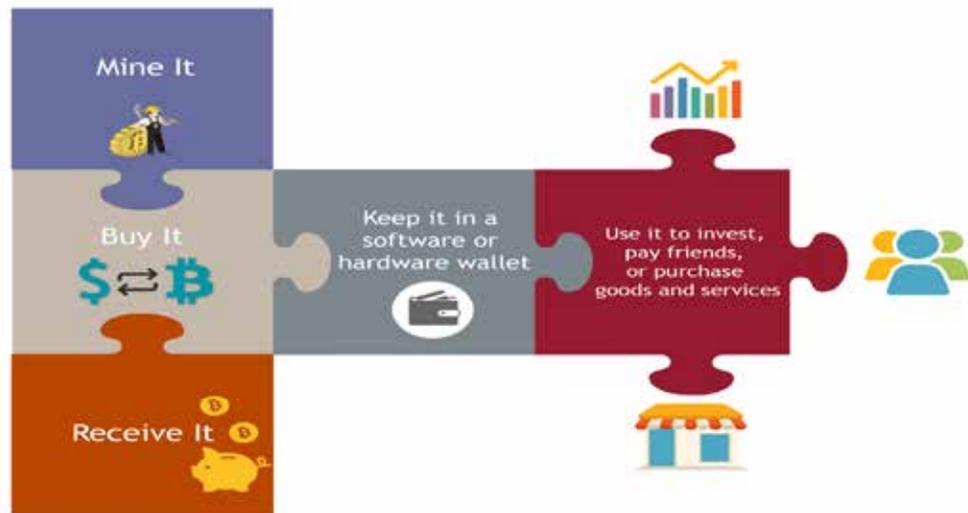
- Bitcoin is a **form of digital currency**, created and held electronically
- White Paper, “Bitcoin: A Peer-to-Peer Electronic Cash System,” by Satoshi Nakamoto laid out the **principles of bitcoin**, including its underlying technology, the blockchain
 - Meant to **solve problems associated with the digital transfer of value**, including the double-spend problem and the Byzantine Generals computing problem
 - As such, bitcoin is the **first blockchain application**
- It is **decentralized** - no one central authority (e.g., a bank) or governance body (e.g., a foundation or board of directors) controls it



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How Do You Get and Use Bitcoin?



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Proof-of-Work vs. Proof-of-Stake

- Prominent, early cryptocurrencies, such as Bitcoin, are based on proof of work
 - Transactions are verified by “miners” who compete to complete a resource-intensive computer calculation in order to verify cryptocurrency transactions
 - Miners are rewarded with new cryptocurrency to incentivize the verification of transactions
- Proof of stake is a different way to validate transactions
 - All cryptocurrency is “minted” prior to the launch of the currency
 - Instead of having separate miners, holders of proof-of-stake cryptocurrencies can voluntarily “stake” (i.e., deposit) their currency by joining a validation pool that verifies transactions
 - If a member of the validation pool is found to have violated the rules (e.g., incorrectly verifying a transaction), their stake is confiscated
 - Currency holders receive transaction fees (a percentage of each transaction) in exchange for staking their cryptocurrency

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Cryptocurrency Tax Issues

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IRS Notice 2014-21

- Virtual currency is treated as property for tax purposes
 - Not treated as foreign currency subject to foreign currency gain/loss rules
- Consequences of property characterization
 - Exchange of virtual currency results in gain or loss
 - Receipt of virtual currency for services is compensation
 - Can result in trade or business self-employment income – e.g., mining rewards
 - Subject to information reporting to the same extent as any other payment made in property (Forms W-2, 1099-MISC, and 1099-K)
- Issues not addressed by Notice 2014-21
 - Proof-of-stake cryptocurrencies
 - Treatment of forks or airdrops
 - Treatment of token offerings
 - Other information reporting – FATCA, FBAR, Broker reporting

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Tax Accounting Issues

- When a taxpayer disposes of virtual currency in a taxable exchange, the taxpayer must determine the adjusted basis and holding period of the disposed virtual currency
- If taxpayer acquired different lots of the same virtual currency at different times and/or for different prices, it must be determined which lot is considered to have been disposed
- Taxpayers generally should consistently apply a method of accounting that follows the method the taxpayer uses in keeping books
- Taxpayers holding virtual currency directly may use specific identification (relying on blockchain transaction ledger to document which lot is transferred)
 - It may be impractical or impossible for taxpayers holding virtual currency through a third-party to make a specific identification
 - It is not clear whether other methods of accounting are permitted: FIFO, LIFO, average cost method?
- Special rules may apply to a token that is properly treated as an equity interest for tax purposes or to coins/tokens held as inventory

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Basic Use Considerations

- Activities Related to Cryptocurrency
 - Investor vs. Trader vs. Dealer
- Tax Characterization of Cryptocurrency
 - Security vs. Commodity vs. Currency
- Effect of Classifications
 - Wash Sales
 - Loans of Cryptocurrency
 - Section 475(f) Election
 - Effectively Connected Income

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Forks and Airdrops

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What is a “Fork”?

- A “fork” is a technical event that occurs when a blockchain diverges into two potential paths forward – either with regard to a network’s transaction history or new rules in deciding which transactions are valid
- Differences between a “hard” fork (permanent divergence, new set of consensus rules) and “soft” fork (backward compatible method for upgrading the blockchain)
- Examples:
 - Bitcoin forks (e.g., Bitcoin Cash, Bitcoin Gold, SegWit2x Hard Fork)
 - Ethereum forks (e.g., Ethereum Classic, Constantinople)



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Tax Considerations Regarding Forks

- Is it a taxable event?
- Possible analogies to nontaxable events:
 - Stock splits or stock dividends (*Eisner v. Macomber*)
 - Purchasing the pregnant cow/pregnant racehorse (*Gamble v. Commissioner*) - addressing capital asset and tax basis issues related to the purchase and subsequent sale of a pregnant racehorse and its unborn foal; and Rev. Rul. 86-24)
 - Sale of extracted minerals (Reg. § 1.61-3(a)) or timber cut from land (*cf.* § 631(a))
 - Partition of tenancy in common (Rev. Rul. 56-437), division of trust (Rev. Rul. 57-495), or sale of portion of larger property (Reg. § 1.61-6(a))

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Tax Considerations Regarding Forks

- Possible analogies to taxable events:
 - Dividends of property (§§ 301, 316)
 - Found property (*Edward J. Dougherty v. Commissioner* and *Casarini v. United States*)
 - Free samples (*Haverly v. United States*)
 - General windfalls (*Commissioner of Internal Revenue v. Glenshaw Glass Co.* -- income is realized whenever there are instances of (1) undeniable accessions to wealth (2) clear realization and (3) taxpayer having complete dominion over the property)
 - IRS relief around home run baseballs (IR-98-56)
- If taxable, taxable when?
 - When is free and unrestricted control achieved (*Hornung v. Commissioner*; *Carter v. Commissioner*)?
 - Treasure trove – must be reduced to “undisputed possession” (Reg. § 1.61-14(a))

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What is an “Airdrop”?

- An “airdrop” involves the delivery of a cryptocurrency to a certain group of investors either for free (as a promotional activity) or in exchange for performing small tasks
 - Airdrops do not create two iterations of the same cryptocurrency



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Tax Considerations Regarding Airdrops

- Airdrops can raise similar issues to a hard fork
 - Analogy to free samples is stronger?
- Many airdrops require participants to take affirmative steps in order to receive tokens/coins
 - Timing of dominion and control easier to establish?
 - Compensation for marketing services?
- Valuation issues likely remain

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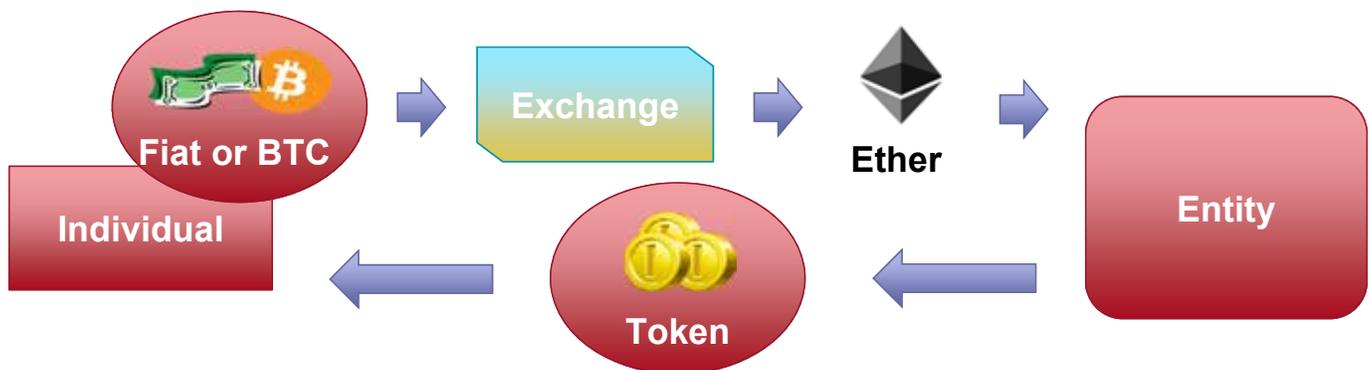
Token Offerings and SAFTs

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Token Offering/“Initial Coin Offering (ICO)”

When a new blockchain project sells part of its blockchain tokens to early adopters, enthusiasts, and/or platform users in exchange for money or bitcoin



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Token Offerings: Different Types

- Broadly speaking, there are three different types of token offerings that are typically being offered:
 - Utility (e.g., Filecoin)
 - Equity (e.g., The DAO)
 - Debt (e.g., Dharma Protocol)
- No one-size-fits-all treatment is appropriate for all token offerings.
 - Equity?
 - Debt?
 - Capital asset?
 - Prepaid goods or services?
- There is very limited guidance from the IRS as to the appropriate treatment
 - Some tokens may be similar to convertible virtual currency discussed in Notice 2014-21

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Simple Agreement for Future Tokens (SAFT)

- SAFT agreement is being used by many to raise funds in advance of a token offering
- The intended tax treatment typically is to defer recognition of income on amounts paid to SAFT issuer until the token offering
 - This treatment is uncertain and the strength of the arguments for deferral depends on the individual facts and circumstances
 - Other potential avenues for deferral exist (e.g., safe harbor for advance payments)

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Compliance and Reporting Obligations

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Tax Information Reporting Obligations

- Form 1099-B –
 - A broker or dealer that effects the sale of certain securities, commodities, and other contracts by a customer in the ordinary course of a trade or business must report customer’s name, address, and TIN, the property sold, the gross proceeds of the sale, and the sale date.
 - A “barter exchange” generally must report exchanges of personal property or services through the barter exchange, including exchanges made by means of “scrip,” or token, issued by the barter exchange that can be transferred from one member or client to another in payment for property or services.
- Foreign Account Tax Compliance Act (FATCA) - Taxpayers that have an interest in specified foreign financial assets that exceed specified value thresholds must report those assets on a Statement of Specified Foreign Financial Assets, Form 8938.
- Report of Foreign Bank and Financial Accounts (FBAR) – U.S. persons that have a financial interest in or signature authority over foreign financial accounts that exceed specified value thresholds must file Form 114.

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IRS Enforcement Update

- In November 2017, the U.S. District Court for the Northern District of California ordered Coinbase to produce certain documents for accounts with a transaction type — buy, sell, send, or receive — amounting to at least \$20,000 during one year between 2013 and 2015. *United States v. Coinbase Inc.*, No. 3:17-cv-01431 (N.D. Cal. 2017).
 - Affected about 13,000 customers.
 - IRS Criminal Investigation Division expecting fraud referrals as a result of the Coinbase summons response.
- On July 2, 2018, LB&I announced a new compliance campaign regarding the reporting of virtual currency transactions consistent with Notice 2014-21.
- On November 13, 2018, Commissioner Rettig, speaking at an AICPA conference stated that cryptocurrency is “information data currency that the IRS has and will have more information about than you could ever imagine.”
 - He also said the IRS is working on “informal” guidance.

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Questions?



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Lisa Zarlenga represents public and private companies on a wide range of corporate transactional and tax policy issues. She advises clients on structuring tax-free and taxable acquisitions and dispositions, tax-free spin-offs, and internal restructurings, including the special rules governing consolidated groups. Lisa also advises clients on tax policy issues before the Treasury Department and Internal Revenue Service involving regulations and other administrative guidance, and before Congress involving legislation. Lisa previously served as Tax Legislative Counsel at the US Treasury Department’s Office of Tax Policy.

Lisa has combined her policy and transactional backgrounds to advise clients on certain specialized tax issues, such as blockchain and digital currency and qualified opportunity zones. She advises clients on conducting digital currency transactions and conversions, token offerings, and different investment and entity structures. With respect to qualified opportunity zones, Lisa has advised investors and funds on the intricate tax rules that govern the investments and structured those investments.

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Chapter 6

Presentation Slides: Qualified Opportunity Zones, or A Journey to the Land of OZ

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Qualified Opportunity Zones or A Journey to the Land of OZ

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June 7, 2019

Topics to Cover

- 1) History and Policy of Opportunity Zones
- 2) Timeline of a Qualified Opportunity Fund
- 3) Tax Benefits to OZInvestors
- 4) Qualified Opportunity Fund Requirements
- 5) Qualified Opportunity Zone Property
- 6) Qualified Opportunity Zone Business
- 7) Regs Answer Many but Not All Open Questions
- 8) Comparison With 1031

Overview of Opportunity Zone Program



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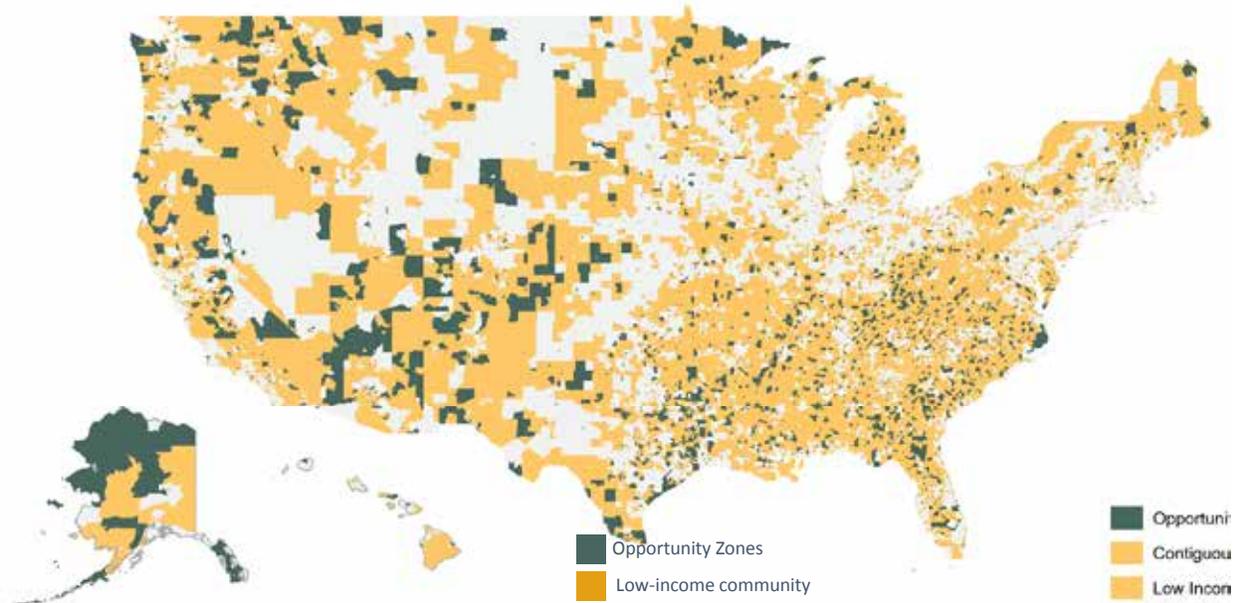
Background to Opportunity Zones

- Opportunity Zone program created by the Tax Cuts and Jobs Act of 2017
- New Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code
 - Proposed Regs (“Regs1”), Rev Ruling and draft Certification Form issued October 18, 2018
 - Additional Proposed Regs (“Regs2”) issued April 17, 2019
- Intent is to spur economic growth in low income areas by harvesting unrealized gains in the market
- Many comment letters submitted; second round of regs addressed many but not all issues

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Opportunity Zone Map



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Tax Benefits to OZ Investors

1. Gain Deferral
2. Partial forgiveness
3. Exclusion of additional gains

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Step 1 – OZInvestors Sell Appreciated Assets

- OZInvestors sell appreciated assets and reinvest the gain into a QOF.
 - Any type of existing asset qualifies (stocks, real estate, etc.). There is no “like kind” requirement.
 - Investment can be cash or property per Regs2
- The gain amount must be invested into a QOF within 180 days of the sale triggering those gains. This may be a variable timeline with entity sales.
- **TAX BENEFIT #1** – OZInvestors defer paying tax on gain reinvested into a QOF.
- OZInvestors can invest the amount of recovered invested principal (i.e. adjusted basis) as well as the amount of investment gains, but only the portion of a QOF investment attributable to the reinvested gain will be eligible for deferral or exclusion tax benefits.

Threshold Issues

- If a partnership sells an asset and allocates the gain to its partners, partners can reinvest the gain into a QOF and get the associated tax benefits?
 - Regs say yes
- Capital gains (including 1250 gain) and 1231 gains qualify, but probably not:
 - Dealer or other ordinary income
 - 1245 depreciation recapture
 - Mark to market income of dealers
- 1231 Gains subject to year end netting limit
 - This is controversial and will be subject of comment and possible revision

Threshold Issues

- Property Contributions
 - If carryover (e.g. 721) then credit for carryover basis and split interest for value exceeding basis
 - If taxable sale then FMV credit but no deferral on realized gain from sale
- May purchase from third party
- Pure profits (i.e. “carried”) interests do not get deferral but status of interests acquired with both profits and capital component still unclear.

Step 2 – QOF Invests in Qualifying Property

- QOF has to invest cash into business activities or utilize property within areas designated as Qualified Opportunity Zones (aka Qualified Opportunity Zone Business, or QOZB).
- There are numerous requirements that QOF must meet, including asset requirements and timing requirements.
 - Discussed in detail following

Step 3 – Payment of the Deferred Tax

- OZInvestor pays tax on the deferred gain at the earlier of (i) the sale or transfer of interest in the QOF deemed an “inclusion event”, or (ii) December 31, 2026, with caveats.
- **TAX BENEFIT #2**
 - If the OZInvestor holds QOF investment for at least 5 years, 10% of the deferred gain is permanently forgiven.
 - If the OZInvestor holds the QOF investment for at least 7 years, an additional 5% (for a total of 15%) of the deferred gain is permanently forgiven.
 - Note that to get the 7 year benefit, an investment in a QOF must be made no later than December 31, 2019.

Step 4 – Elimination of Tax at Exit

- The QOF Program incentives long-term investments.
- **TAX BENEFIT #3** – If the OZInvestor holds QOF investment for at least 10 years, there is no tax at all on the gain realized at exit.
 - Applies **only** to interest acquired equal to deferred gain amount due to “split investment” rule of IRC 1400Z-2(e)(1)
- The language in the Code implies that the exit must be an entity sale but Regs2 allow treatment for gain incurred on sale by QOF and allocated to OZInvestors.
 - Treatment does not seem to apply to gain recognized at a lower tier below the QOF – this is controversial and might be revised.
 - Taxpayers cannot rely on this until Regs go final.

Example

- Marie sells an existing investment on July 1, 2019 and realizes a capital gain of \$300
- Marie invests \$300 in a Qualified Opportunity Fund on November 30, 2019
- Since Marie invested an amount equal to her gains within the 180 day window, she defers tax on the \$300 gain in 2019

Example

- Marie sells QOF interest on December 1, 2022:
 - 2022 tax on full \$300 of gain because she sold prior to 12/31/2026. Still get 3 years deferral
- Marie sells QOF interest on December 1, 2024:
 - 2024 tax on \$270 since she gets the benefit of the 10% reduction by holding for 5 years
- Marie sells QOF interest on December 1, 2026:
 - 2026 tax on \$255 since she gets the benefit of the 15% reduction by holding for 7 years

Example

- If Marie holds QOF Interest past December 31, 2026 tax on \$255 of the deferred Gain will be triggered on 2026 return even though she still holds the QOF Interest.
- However, if we assume that QOF Interest appreciates to \$700 when she sells on December 1, 2029, Marie pays no tax at all on the \$400 appreciation since she held the QOF Interest for 10 years

Timeline of a QOF – Investment



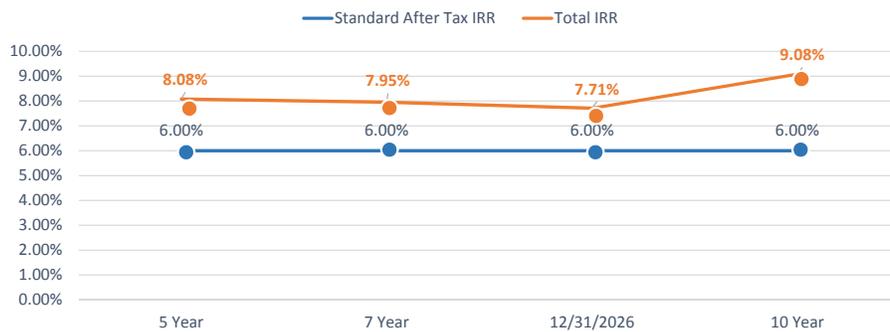
Timeline of a QOF – Exit



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Opportunity Zone Incremental Tax Benefit

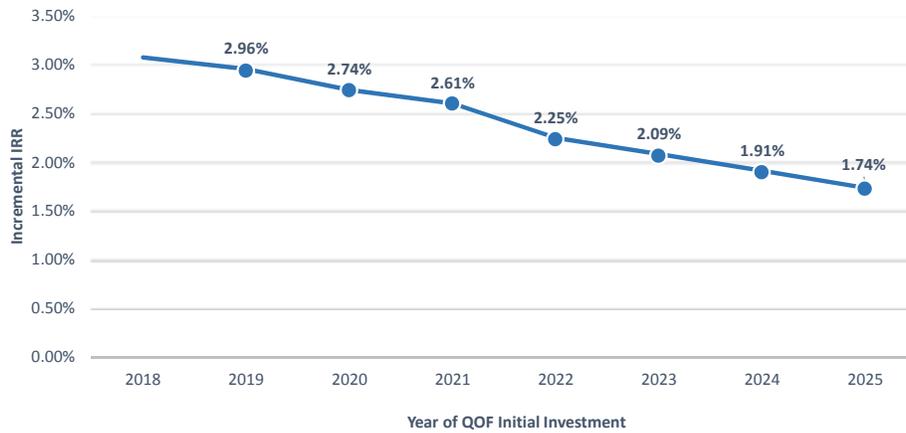


23.8% Tax Rate	5 Year	7 Year	12/31/2026	10 Year
Standard After Tax IRR	6.00%	6.00%	6.00%	6.00%
Incremental OZ Benefit	2.08%	1.95%	1.71%	3.08%
QOF Interest IRR	8.08%	7.95%	7.71%	9.08%
Percentage Increase	35%	32%	29%	51%

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Perishability of Incentives



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What is a QOF Anyway?

- A Qualified Opportunity Fund (QOF) is an investment vehicle organized as a domestic corporation or a partnership.
 - Regs say fed'l tax classification governs, so QOF can be an LLC
 - Can be in U.S. territories but only if the QOZB activity is there
- A QOF cannot invest in another QOF.
- 90% of the QOF's assets must be invested in Qualified Opportunity Zone Property (QOZP).
 - Referred to as the 90% test
- QOF must engage in Qualified Opportunity Zone Business

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90% Asset Test

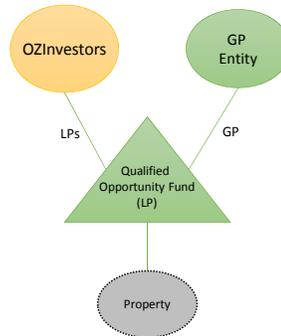
- The 90% test is measured by the average percentage of QOZP held by the QOF:
 - On the last day of the first 6-month period of the QOF taxable year, and
 - On the last day of the taxable year of the QOF.
- BUT, first testing date is at earlier of (i) end of full 6 mos after entity certifies as a QOF or (ii) end of first year if QOF election made less than 6 mos before end of year
 - If a QOF certifies on October 1, 2019 and uses the calendar year as its taxable year, the first testing date is December 31, 2019
- Regs now allow election to use financial statement or alternate cost basis valuation methodology for 90% test purposes rather than forcing use of financial statements where QOF has these.

QOFs Must Self-Certify

- There is no explicit approval or action required by the IRS.
- Form 8996 that a QOF must complete and attach to its tax return was released in draft on October 18, 2018. 2nd round of Regs indicates the form will be revised to require additional information

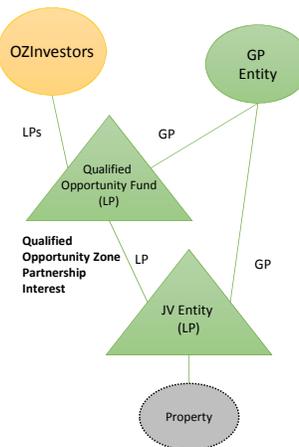
Single Tier Structure

- The QOF can meet its 90% asset test by owning Qualified Opportunity Zone Business Property (QOZBP) directly.
- QOZBP is tangible property used in a trade or business of the QOF if:
 - the property was acquired by QOF by purchase from an unrelated party after 12/31/17;
 - the **original use** of property in the Qualified Opportunity Zone commences with the QOF **or** the QOF **substantially improves** the property; and
 - during **substantially all (>90%)** of the QOF's holding period for property, **substantially all (>70%)** of the use of property was in a Qualified Opportunity Zone.



Two Tier Structure

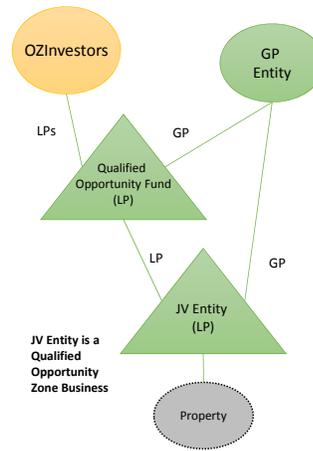
- The QOF can meet its 90% asset test by owning Qualified Opportunity Zone Stock (OZStock) or a Qualified Opportunity Zone Partnership Interest (OZInterest).
- Stock or a partnership interest will be OZStock or an OZInterest if:
 1. acquired by the QOF after 12/31/17 for cash;
 2. **at time of acquisition**, the issuer was a QOZB (or, if a new entity, was being organized for the purpose of being a QOZB); and
 3. during **substantially all (>90%)** of the QOF's holding period for interest, the issuer qualified as a **QOZB**.



Qualified Opportunity Zone Business

- A Qualified Opportunity Zone Business is a trade or business where:

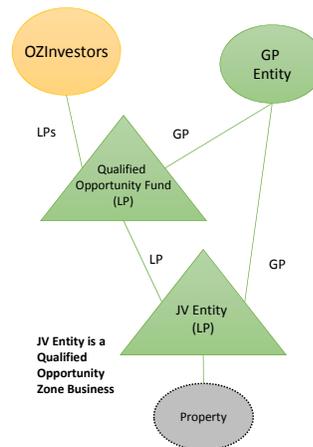
1. **substantially all (>70%)** tangible property owned or leased by the QOZB is QOZBP:
2. **at least 50%** of QOZB's gross income is derived from active conduct of the trade or business;
3. a **substantial portion (>40%)** of QOZB's intangible property is used in active conduct of the trade or business,
4. less than **5%** of QOZB's property is financial property such as stock, debt, options, etc. (but QOZB can hold reasonable amounts of working capital); and
5. which is not a specified "sin business".



Qualified Opportunity Zone Business Property

- QOZPB is tangible property used in a trade or business of the QOZB if:

1. the property was acquired by the QOZB by purchase from an unrelated party or by lease after 12/31/17;
2. the **original use** of property in the Qualified Opportunity Zone commences with the QOZB or the QOZB **substantially improves** the property; and
3. during **substantially all (>90%)** of the QOZB's holding period for such property, **substantially all (>70%)** of the use of property was in a Qualified Opportunity Zone.



Related Parties

- QOF/QOZB must acquire property by purchase from an unrelated party.
- “Acquired” – cannot be a carryover basis transaction.
- The relationship threshold is 20% for this purpose.
- Regs2 provide that this does not apply to leased property

Original Use

- The “original use” of the property held by the QOF or QOZB commences with the QOF/QOZB.
- How can you meet this test while your property is being constructed?
 - 30 month window
- What about a change in use?
 - Not relevant
- Original use refers to first party to place asset in service
 - Therefore OK to acquire newly constructed property not yet in service
- Regs adopt a 5 year lookback relating to vacant property being “in use”
- Acquisition of land cannot ever meet the original use test

Existing Assets: Substantial Improvement

- The QOF/QOZB “substantial improves” the property during any 30-month period.
- The test is met if “additions to basis with respect to the property” in the hands of QOF/QOZB exceed the adjusted basis of the property at the beginning of the 30-month period.
 - Land basis not used for testing
- Which 30-month period can you choose?
 - Does it start on project commencement or date of investment in QOF?
- What counts as an addition to basis?
 - Repairs versus Additions

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Qualified Opportunity Zone Business

- Substantially all tests
 - The partnership or corporation must be an QOZB during “substantially all” of QOF’s holding period in the partnership or corporation.
 - **90% test in Proposed Regs**
 - “Substantially all” of the tangible property owned or leased by the QOZB is QOZBP.
 - **70% Test in Proposed Regs**
- No more than 5% of the QOZB’s assets can be nonqualified financial property, but the QOZB can have a reasonable amount of working capital.
 - **Regs allow 31 months to deploy working capital**
 - **Note this applies to QOZBs but not QOFs**

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Sin Businesses Not Permitted

- Cross reference to IRC 144(c)(6)B):
 - private or commercial golf course
 - country club
 - massage parlor
 - hot tub facility
 - suntan facility
 - racetrack or other facility used for gambling
 - any store the principal business of which is the sale of alcoholic beverages for consumption off premises
- No mention of cannabis

Regs Provide Many Answers Inclusion/Exclusion Regimes

- Specific rules adopted to determine events or transactions that cause “inclusion” of deferred gain in income prior to 2026:
 - Sales (voluntary or deemed)
 - Gifts
 - S Corp and Partnership ownership changes and corp reorgs
 - Distributions by partnerships in excess of outside basis
- Testamentary Transfers and non-recognition entity transfers (i.e. 721) generally not inclusion events
- Exclusion benefit will survive for 20 years after 2027 expiration of the OZone regime

Regs Provide Many Answers

Partnership Issues

- Basis rules: inside/outside disparity in partnerships
- Allocation of debt under IRC 752
- Partnership level debt allocated to a partner does not create second class of interest but doesn't create deferral
- Consequences of interim distributions to a QOF investor: generally OK to the extent of outside basis determined under normal Sub K rules

Regs Provide Many Answers

QOF Investments and Operations

- Ground-up construction OK
- Triple net leases generally not regarded as active, but otherwise real estate leasing OK'd
- Leased Assets
 - Ground leases OK
 - Prior use by lessor does not preclude QOF lessee from satisfying original use requirement
 - Leases with related parties OK if on arms length terms
 - Cannot have non-FMV lessee purchase option
- Treatment of QOF gain on asset sales: exclusion applies
 - Unclear how this will apply to gain at QOZB level allocated to QOF
- Phase in for working capital held by QOFs expanded
- Combinations of assets straddling OZone and non-Ozone permitted

Regs Provide Many Answers QOF Investments and Operations

- Operating Businesses
 - OZ income sourcing: Regs create safe harbor methodologies to determine 50% test compliance
 - Hours of work performed in the OZ
 - Compensation for services performed in the OZ
 - Property located OZ and Management functions performed in OZ
 - Facts and circumstances
 - OZ asset sourcing to satisfy the “substantially all” test (70%)

But Leave Some Questions

- 1231 Netting
- Carried Interests combined with capital investment
- Calculation of penalty and reasonable cause exception

Comparing 1400Z-2 to 1031

- **Deferral of Old Gain**
 - 1400Z – temporary on at least 85%, possibly permanent on 15%
 - 1031 – temporary, unless basis step up at death
- **Deferral of New Gain**
 - 1400Z – exclusion after 10 years
 - 1031 – no exclusion, but deferral available
- **Timing**
 - 1400Z – no ID, 180 days to invest
 - 1031 – 45 day ID, 180 days to invest

Comparing 1400Z-2 to 1031

- **Investment Amount to Obtain Full Deferral**
 - 1400Z – Only amount of Old Gain required
 - 1031 – Amount realized on sale required
- **Source of Investment**
 - 1400Z – any source; no tracing of Old Gain sale proceeds. Can be entirely borrowed.
 - 1031 – sale proceeds must be reinvested; constructive receipt rules apply
- **Type of Investment**
 - 1400Z – must be interest in a qualified opportunity zone fund, not limited to real estate
 - 1031 – must be ownership of like-kind real estate

Comparing 1400Z-2 to 1031

- **Construction**
 - 1400Z – developments must reach minimum target amount within 30 months after investment
 - 1031 – like-kind rules require qualifying improvements exist at time of acquisition
- **State Law Conformity**
 - 1400Z – work in progress
 - 1031 – all states conform, with some deviations relating to out-of-state replacement property

Thank you!

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Chapter 7

Tax Practice Ethics—Contingent Fees and Conflicts of Interest

KAREN HAWKINS
Yachats, Oregon

Contents

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Contingency Fees in Tax Matters

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Annual Oregon Tax Institute June 2019

Ms. Hawkins is a past Chair of both the American Bar Association Taxation Section and the Taxation Section of the State Bar of California; a past chair of the ABA Taxation Subcommittee on Civil Penalties, and the IRS Liaison Meetings Committee. Ms. Hawkins served as a Director on the Council of the ABA Taxation Section and as the Section's Vice-Chair Professional Services. She is a Fellow of the American College of Tax Counsel and serves on the Board of Tax Analysts.

Ms. Hawkins is the founder of the San Francisco Pro Se/Pro Bono Tax Court project, and in the early 2000's she played a key role in the successful efforts to reform the "innocent spouse" statutes in both federal and California law. Her honors include the V. Judson Klein and Joanne Garvey Awards from the State Bar of California Section of Taxation in 2002 and 2012, respectively; the National Pro Bono Award from the American Bar Association Tax Section, and the Judith McKelvey Distinguished Alumna Award from Golden Gate University, both in 2004; the Jules Ritholz Memorial Merit Award from the ABA Taxation Section Civil & Criminal Tax Penalties Committee in 2008. In 2012, Golden Gate University School of Law named its Tax Law Library Collection in Ms. Hawkins' name and in 2015, awarded her an honorary Doctor of Laws (LLB).

Ms. Hawkins earned her J.D. and M.B.A. degrees from Golden Gate University, Schools of Law and Tax, respectively, in San Francisco, California. Ms. Hawkins also holds an M.Ed from the University of California, Davis. Her B.A. is from the University of Massachusetts, Amherst. Ms. Hawkins speaks and writes extensively on all aspects ethics in tax practice.



TOPICS

- Introductions
- Basic rules
- Recent case law affecting 10.27
- Specific issues

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Rule 1.5, Oregon Rules of Professional Conduct: Fees

- (a) A lawyer shall not make an agreement for, charge, or collect an illegal or clearly excessive fee or a clearly excessive amount for expenses.
- (b) A fee is clearly excessive when, after a review of the facts, a lawyer of ordinary prudence would be left with a definite and firm conviction that the fee is in excess of a reasonable fee. Factors to be considered as guides in determining reasonableness include:
 - (1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
 - (2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;
 - (3) the fee customarily charged in the locality for similar legal services;
 - (4) the amount involved and the results obtained;
 - (5) the time limitations imposed by the client or by the circumstances;
 - (6) the nature and length of the professional relationship with the client;
 - (7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and
 - (8) whether the fee is fixed or contingent.

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Oregon Rule 1.5 (cont'd)

(c) A lawyer shall not enter into an arrangement for, charge, or collect:

- (1) any fee in a domestic relations matter, the payment or amount of which is contingent upon the securing of a divorce or upon the amount of alimony or support, or property settlement in lieu thereof;
- (2) a contingent fee for representing a defendant in a criminal case.
- (3) A fee denominated as “earned on receipt”, “nonrefundable”, or in similar terms unless it is pursuant to a written agreement signed by the client.....(i)...(ii)

(d) A division of a fee between lawyers who are not in the same firm may be made only if:

- (1) The client gives informed consent to the fact that there will be a division of fees, and
- (2) The total fee of the lawyers...is not clearly excessive.

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Compare ABA Model Rule 1.5 (provisions excluded from ORRPC)

(b) The scope of the representation and the basis or rate of the fee and expenses for which the client will be responsible shall be communicated to the client, preferably in writing, before or within a reasonable time after commencing the representation, except when the lawyer will charge a regularly represented client on the same basis or rate. Any changes in the basis or rate of the fee or expenses shall also be communicated to the client.

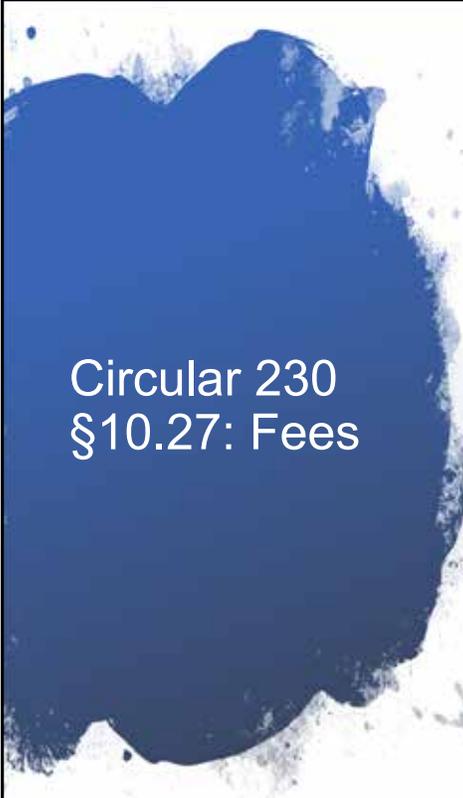
(c) A fee may be contingent on the outcome of the matter for which the service is rendered, except in a matter in which a contingent fee is prohibited by paragraph (d) or other law. A contingent fee agreement shall be in a writing signed by the client and shall state the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer in the event of settlement, trial or appeal; litigation and other expenses to be deducted from the recovery; and whether such expenses are to be deducted before or after the contingent fee is calculated. The agreement must clearly notify the client of any expenses for which the client will be liable whether or not the client is the prevailing party. Upon conclusion of a contingent fee matter, the lawyer shall provide the client with a written statement stating the outcome of the matter and, if there is a recovery, showing the remittance to the client and the method of its determination.

(e) A division of a fee between lawyers who are not in the same firm may be made only if:

- (1) the division is in proportion to the services performed by each lawyer or each lawyer assumes joint responsibility for the representation;
- (2) the client agrees to the arrangement, including the share each lawyer will receive, and the agreement is confirmed in writing; and
- (3) the total fee is reasonable.

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Circular 230
§10.27: Fees

(a) *In general.* A practitioner may not charge an unconscionable fee in connection with any matter before the Internal Revenue Service.

(b) *Contingent fees* —

(1) Except as provided in paragraphs (b)(2), (3), and (4) of this section, a practitioner may not charge a contingent fee for services rendered in connection with any matter before the Internal Revenue Service.

(2) A practitioner may charge a contingent fee for services rendered in connection with the Service's examination of, or challenge to —

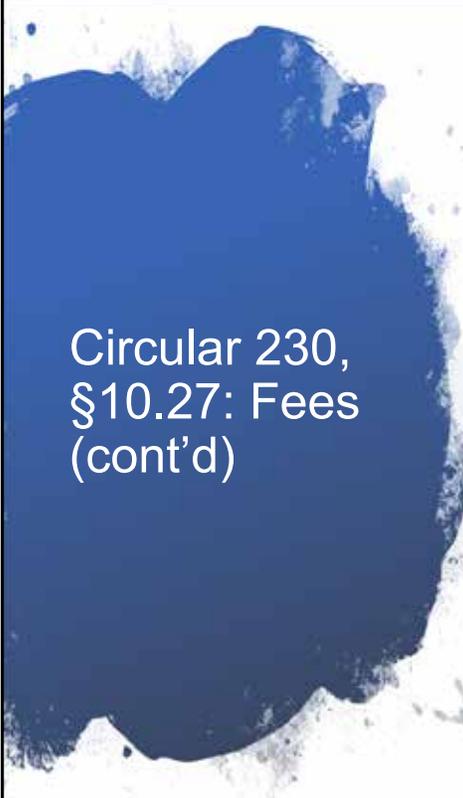
(i) An original tax return; or

(ii) An amended return or claim for refund or credit where the amended *return or claim for refund or credit was filed within 120 days of the taxpayer* receiving a written notice of the examination of, or a written challenge to the original tax return. [NB: This language was modified by Notice 2008-43-1.]

(3) A practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the Internal Revenue Service.

(4) A practitioner may charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

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Circular 230,
§10.27: Fees
(cont'd)

(c) *Definitions.* For purposes of this section —

(1) *Contingent fee* is any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the Internal Revenue Service or is sustained either by the Internal Revenue Service or in litigation. A contingent fee includes a fee that is based on a percentage of the refund reported on a return, that is based on a percentage of the taxes saved, or that otherwise depends on the specific result attained. A contingent fee also includes any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client's fee in the event that a position taken on a tax return or other filing is challenged by the Internal Revenue Service or is not sustained, whether pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect.

(2) *Matter before the Internal Revenue Service* includes tax planning and advice, preparing or filing or assisting in preparing or filing returns or claims for refund or credit, and all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, rendering written advice with respect to any entity, transaction, plan or arrangement, and representing a client at conferences, hearings, and meetings.

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Ridgely v. Lew, 55 F.Supp3d 89 (D.D.C. 2014)

- ▶ Preparation of “ordinary” refund claims (claims not on original returns, but before any IRS triggering event)
- Argument:
 - preparing such claims is not “practice before the IRS”
 - IRS can not regulate the kind of fees charged, i.e., Cir. 230 §10.27 restriction on “contingent” fees
- Held:
 - Loving reasoning controls- preparation of “ordinary” refund claims is not “practice before the IRS”
 - IRS cannot regulate contingent fee arrangements in the context of “ordinary” refund claims

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Observations
and... what
happens
now?

- The effect of Loving and Ridgely is that certain return and refund claim preparation is not within the group of activities constituting “practice before” the IRS
- But if “practice before” the IRS means only actual representation of taxpayers in controversies (audits, rulings, collection, appeals, etc.), even by persons (CPAs and attorneys) who are otherwise practitioners, then what happens to rules (and OPR’s authority) re:
 - Contingent fees on original returns?
 - Contingent fees in the course of representations before Exam or Appeals or Collection?

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Unreasonable/unconscionable fees

- Circular 230, section 10.27(a) is still good law
 - “(a) *In general.* A practitioner may not charge an unconscionable fee in connection with any matter before the Internal Revenue Service.”
- What’s “unconscionable”?
 - hourly rate?
 - Flat fee?
- Generally charged in conjunction with other Circular 230 violations
 - Failure to perform services
 - Incompetent advice
 - Fraud on client

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Contingent fees- Circular 230, §10.27

- **When are they permissible?**
- Mere preparation of original returns—arguably allowable under the combined reasoning of *Loving* and *Ridgley*
- Services in connection with examinations/challenges to original returns—allowed under §10.27(b)(2)(i)
- Mere preparation of ordinary claims for refund or credit—allowed under *Ridgley*
- Services in connection with examinations/challenges to amended original tax returns or amended claims for refund or credit—allowed under §10.27(b)(2)(ii) as clarified by Notice 2008-43. There is an open question if the amendment occurs more than 120 days after the IRS issues the notice of examination or other challenge.

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Contingent fees- Circular 230, §10.27 (cont'd)

- Services in connection with claims for credit/refund of statutory penalties or interest – allowed under §10.27(b)(3)
- Services in connection with whistleblower claims under I.R.C. §7623 – allowed under §10.27(4) as added by Notice 2008-43
- Services in connection with any judicial proceeding arising under the I.R.C. – allowed under §10.27(5) as renumbered by Notice 2008-43
- Services involved with giving written tax advice– arguably allowed under the combined reasoning of *Loving* and *Ridgley*
- Services in connection with collection matters – NOT allowed under the general rule or by *Ridgley/Loving*

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Creative approaches

- Can you use different rates for different situations?
 - Premium v. regular v. discount rates
 - “Difficult” clients or subject matter
 - Clients who can't pay

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Third-party payor Issues

- Typical situations
 - Insurers
 - Family members
 - Corporations for employees
- Issues: Conflicts
- Oregon RPC 1.8
 - (f) A lawyer shall not accept compensation for representing a client from one other than the client unless:
 - (1) the client gives informed consent;
 - (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
 - (3) information relating to representation of a client is protected as required by Rule 1.6.

Ethics

Section 10.27 of Circular 230: What Is Left?

By Karen L. Hawkins

On July 16, 2014, a federal district judge permanently enjoined the IRS Office of Professional Responsibility (OPR) from enforcing certain aspects of the “Fees” provision contained in Circular 230.¹ In doing so, the court concluded that the IRS lacked “statutory authority to promulgate or enforce the restrictions on contingent fee arrangements, as delineated in 31 C.F.R. §10.27, with respect to the preparation and filing of Ordinary Refund Claims, where ‘preparation and filing’ *precedes* the inception of any examination or adjudication of the refund claim by the IRS and any *formal* legal representation on the part of the practitioner.”² (Emphasis added.) Since the regulation has not been amended to reflect the court’s order, this column discusses what is left for OPR to enforce and what practitioners might be able to do, or not do, under current law.³

As most practitioners are aware, many of the ethical principles contained in Circular 230 are fashioned after the ABA Model Rules of Professional Conduct (hereafter “Model Rules”). The Fees provision is one example of this. Because fee arrangements of any sort have always been perceived as creating some level of conflict of interest between lawyer and client, the ABA historically has had some interest in regulating this aspect of the attorney-client relationship.⁴ While many of those who provide services in the tax context are not lawyers, the IRS clearly holds to the same general notion that the fee aspects of the practitioner-client relationship harbor the potential for creating conflicts of interest because it is primarily the tax practitioner who determines the fee and the manner of performance based on an analysis of the time and resources expected to be devoted to the services rendered and the desired “return on that investment.” This conflict is exacerbated in the contingent fee context, where the practitioner acquires an economic interest in his or her client’s tax matter(s). The arrangement clearly has the potential to cloud the practitioner’s professional judgment. And, because the usual concept of risk-sharing that obviates some of the conflict concerns in the general law does not exist with tax law, the “risk,” rather than being shared between practitioner and client, is borne almost entirely by the tax agency which must “catch” the collaborative efforts of a taxpayer and his or her advisor to reduce tax liability in a manner contrary to intended law.



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Unconscionable Fees

The contingent fee restriction contained in section 10.27 is just one aspect of that regulation. Prior to 1994, the Fees provision in Circular 230 was dominated by a general prohibition against “unconscionable fees” for “representation” in any matter before the IRS. An exception existed for amended returns and claims for refund/credit so long as “the practitioner reasonably anticipates at the time the fee arrangement is entered into that the amended tax return or refund claim will receive substantive review by the Internal Revenue Service.” The regulation has always been silent as to what constitutes an “unconscionable fee.” Presumably, the regulation drafters contemplated guidance coming from the Comments to the Model Rules.

This conflict is exacerbated in the contingent fee context, where the practitioner acquires an economic interest in his or her client’s tax matter(s). The arrangement clearly has the potential to cloud the practitioner’s professional judgment.

The prohibition on unconscionable fees remains in the current version of Circular 230, unaffected by recent case law such as *Ridgley*, with one significant wording change from 1994: “A practitioner may not charge an unconscionable fee in connection with⁵ any matter before the Internal Revenue Service.”⁶ A matter before the IRS is defined at 10.27(c)(2) to include “tax planning and advice, preparing or filing ... or assisting in preparing or filing returns, claims for refund or credit, and all matters connected with a presentation to the IRS ... relating to a taxpayer’s rights, privileges, or liabilities under laws or regulations administered by the IRS.”⁷

What constitutes an “unconscionable fee”? Model Rule 1.5(a) admonishes against entering into agreement that charges an unreasonable fee or charges an unreasonable amount for expenses. The rule delineates eight nonexclusive factors to consider when determining whether a fee is unreasonable:

- (1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
- (2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;

- (3) the fee customarily charged in the locality for similar legal services;
- (4) the amount involved and the results obtained;
- (5) the time limitations imposed by the client or by the circumstances;
- (6) the nature and length of the professional relationship with the client;
- (7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and
- (8) whether the fee is fixed or contingent.⁸

Presumably unreasonable fees or excess charges in ABA parlance equate to an “unconscionable fee” in “IRS-speak.” An “unconscionable fee” is often “in the eye of the beholder.” One practitioner’s outsized hourly rate is another’s standard operating procedure. In the world of discipline, however, there is at least one instance when a fee is always “unreasonable” or “unconscionable”: when money is taken and no services are performed. From that far end of the spectrum, all else is facts and circumstances driven by market conditions. Comment (2) to Model Rule 1.5 puts it this way:

When the lawyer has regularly represented a client, they ordinarily will have evolved an understanding concerning the basis or rate of the fee and the expenses for which the client will be responsible. In a *new* client-lawyer relationship, however, an *understanding* as to fees and expenses *must be promptly established*. Generally, it is desirable to furnish the client with at least a simple memorandum or copy of the lawyer’s customary fee arrangements that states the general nature of the legal services to be provided, the basis, rate or total amount of the fee and whether and to what extent the client will be responsible for any costs, expenses or disbursements in the course of the representation. *A written statement concerning the terms of the engagement reduces the possibility of misunderstanding.* (Emphasis added.)

Whatever the challenges to proving a particular fee is “unconscionable,” the reality for tax practitioners going forward is that the concept of unreasonable fees and excess charges remains a viable line of inquiry for OPR and for discipline under Circular 230. This should include an inquiry as to whether a particular fee arrangement, including a contingent fee arrangement, is reasonable (or unconscionable) in the context of the specific tax services being contracted for.

Contingent Fees

While the *Ridgley* court enjoined future enforcement against practitioners using contingent fee agreements in

the context of the mere preparation of “ordinary refund claims,”⁹ it did not specifically address such fee structures in the context of preparing or filing original returns, claims for credit, tax advising or planning or other tax practice activities. What aspects of the contingent fee provision in Circular 230 are still viable, and which have questionable validity, notwithstanding the IRS’s current failure to conform the language in the regulation to reflect current judicial interpretation?

Generally, the language still extant in section 10.27(b)(1) prohibits contingent fees in the context of “any matter” before the IRS, as defined at 10.27(c)(1). Section 10.27(c) defines a contingent fee as one which is based in some part on whether or not a position taken either in a tax return or other filing escapes an IRS challenge, or if challenged, is ultimately sustained administratively or judicially. It also includes the more traditional notion of a contingent fee—one based on a percentage of a refund, taxes saved or a specific economic result obtained. Further, a contingent fee agreement can include one which requires the practitioner to reimburse the client fee in some proportion if an IRS challenge occurs, or if a position is not administratively or judicially sustained when challenged. The Model Rule does not define a contingent fee specifically, but it does require a contingent fee arrangement to be in a writing which clearly identifies the terms and conditions for provision of the services to be rendered. Comment (3) to Model Rule 1.5 contains the observation that local law may impose additional restrictions¹⁰ and reminds lawyers that the fee is still subject to the general “reasonableness” standard and the eight factors listed in MR 1.5(a). It is reasonable to expect that federal judges before whom any future disciplinary actions for violations of section 10.27 are brought will look to the principles contained in Model Rule 1.5 for guidance.

Section 10.27(b)(2) lists exceptions to the general prohibition against contingent fees: 1) in connection with an IRS examination of, or challenge to, an original return or an amended return/claim for refund or credit; 2) claims for credits/refunds related to statutory interest or penalties; 3) whistleblower actions; and 3) judicial proceedings.¹¹ So, even under the existing language of section 10.27, contingent fees are permissible in pre-assessment administrative controversy practice, *i.e.*, situations where the IRS is examining, or otherwise challenging, an original tax return or an amended tax return or claim for refund/credit: situations the *Ridgley* court would likely define as both adversarial and requiring a power of attorney from the taxpayer to the practitioner to authorize the representation.

In often-overlooked Notice (2008-43),¹² the IRS clarified the 120-day rule associated with charging contingent fees

in the context of amended returns and claims for refund/credit by stating that contingent fees were permissible “for services rendered in connection with the [IRS] examination of, or challenge to”:

An amended return or claim for refund or credit filed before the taxpayer received a written notice of examination of, or a written challenge to, the original tax return; or filed no later than 120 days after the receipt of such written notice or written challenge. The 120 days is computed from the earlier of a written notice of the examination, if any, or a written challenge to the original return.¹³

Notice 2008-43 stated the Treasury’s intention to amend section 10.27(b) to reflect this clarification the next time the Circular was amended. Despite proposing and finalizing amendments to Circular 230 in 2011 and 2014, this clarifying language has never found its way into section 10.27(b). Such a focused clarifying amendment seems like a needless exercise at this point, unless the IRS intends to try to regulate contingent fees in contested cases where the amended return or claim for refund/credit is filed more than 120 days after taxpayer receives an IRS notice of examination or other written challenge to an original return.

There is one context in which the current state of the law regarding contingent fees appears to have remained intact: services performed in connection with IRS collection activity.

Ridgley clearly “deregulates” contingent fees in the context of preemptive claims for refund, *i.e.*, those which are initiated by the taxpayer (and, of course the advising representative) before any involvement by the IRS. The *Loving* case legacy makes it clear that those who provide mere tax return preparation are outside the scope of the OPR regulatory authority entirely. Is it not then a logical conclusion after *Ridgley* that those who, regardless of licensure status,¹⁴ charge a contingent fee for merely preparing an original tax return cannot be prohibited from doing so by Circular 230, unless they are otherwise “practicing” before the IRS?

The *Loving*¹⁵/*Ridgley* combination opens up a whole panoply of services for which tax professionals (whether

considered practitioners or not) may now propose contingent fee arrangements, judged only by the broad “unconscionable fee” prohibition at section 10.27(a). Any exceptions carved out by the regulations¹⁶ at section 10.27(b)(2)(i), (ii), (3) are largely irrelevant because the general rule has been “swallowed” by the current case law. The manner in which a contingent fee arrangement can be structured will be confined only by the creativity of the practitioner proposing such an arrangement (or by the client who prefers it) and, arguably, by the reasonableness of using a contingent fee agreement at all under a specific set of facts and circumstances.

What Is Left?

There is one context in which the current state of the law regarding contingent fees appears to have remained intact: services performed in connection with IRS collection activity. The existing regulation carved out exceptions for services performed during administrative proceedings in connection with examinations and challenges to returns and claims for refund or credit.¹⁷ The case law reinforces the concept that a “practitioner” who is representing before the IRS pursuant to a power of attorney IS subject to

It is equally clear that there is no dearth of tax practitioners prepared to pick over the skeletal remains of section 10.27 to limit even further its future applicability.

Circular 230. The general rule still is that a contingent fee may not be charged (except in the context of regulatory or judicially-created exceptions) “in connection with *any matter* before the Internal Revenue Service.” (Emphasis added.) Such matters include “all matters connected with a presentation to the IRS ... relating to a taxpayer’s rights, privileges, or liabilities under laws or regulations administered by the IRS.”¹⁸ The currently enjoined existing regulation contemplated exceptions only for services performed in connection with examinations of, or challenges to, original or amended returns and claims for refund/credit. Both of the judicially-created exceptions for mere tax return and ordinary refund claim preparation are premised on the lack of “representation” activity. While a preparer of returns/claims, whether original or subsequent iterations, has no legal authority to bind the taxpayer or act on the taxpayer’s behalf, and therefore is not “practicing”

before the IRS, a practitioner communicating with the IRS in an effort to reduce a tax liability or arrange for an alternative method of collection has clearly been authorized, at a minimum, to speak on the taxpayer’s behalf.

Collection activity involves a very different phase of IRS interaction. It does not constitute the examination of, or challenge to, returns or claims for refund/credit. If collection activity is occurring, the challenges/examinations are concluded, and a debt has been recorded. Representation in the context of IRS collection action involves preparing¹⁹ and/or presenting financial information and documentation with respect to a taxpayer’s liabilities (and perhaps rights and privileges under the laws administered by the IRS) and requires the submission of a power of attorney. The taxpayer hires the representative to speak on his or her behalf and to negotiate with the IRS about an assessed tax debt. The context is adversarial. The holder of the power of attorney becomes a “representative” “practicing” before the IRS and subject to Circular 230 in its entirety.²⁰ A practitioner providing services under a contingent fee agreement for such representation has no regulatory or judicial exceptions available and will be in violation of both the general rule against unconscionable fees, and the specific prohibition on contingent fees, contained in section 10.27.

There is a second context in which contingent fee prohibitions are questionable under the current state of the law: services involving written tax advice, the result of which finds its way onto a tax return or claim for refund. If the mere preparer of an original tax return or an ordinary refund/credit claim is no longer constrained under section 10.27(b), what is the basis for prohibiting tax professionals, who advise on the positions being taken in those documents, from entering into contingent fee agreements with the taxpayer, subject only to the unconscionable fee prohibition in section 10.27(a)?

Conclusion

Subject to a general prohibition on unconscionable fees, the current rules on contingent fee agreements for services in tax cases can be summarized as follows:

1. Mere preparation of original returns—arguably allowable under the combined reasoning of *Loving* and *Ridgley*
2. Services in connection with examinations/challenges to original returns—allowed under section 10.27(b)(2)(i)
3. Mere preparation of ordinary claims for refund or credit—allowed under *Ridgley*
4. Services in connection with examinations/challenges to amended original tax returns or amended claims for refund or credit—allowed under section 10.27(b)(2)(ii) as clarified by Notice 2008-43. There is an open

question if the amendment occurs more than 120 days after the IRS issues the notice of examination or other challenge

5. Services in connection with claims for credit/refund of statutory penalties or interest—allowed under section 10.27(b)(3)
6. Services in connection with whistleblower claims under Code Sec. 7623—allowed under section 10.27(4) as added by Notice 2008-43
7. Services in connection with any judicial proceeding

arising under the Code—allowed under section 10.27(5) as renumbered by Notice 2008-43

8. Services involved with giving written tax advice—arguably allowed under the combined reasoning of *Loving* and *Ridgley*

It is clear the law of fees in tax cases is not through evolving. It is equally clear that there is no dearth of tax practitioners prepared to pick over the skeletal remains of section 10.27 to limit even further its future applicability.

ENDNOTES

¹ Treasury Department Circular 230, 31 CFR Subtitle A, Part 10 (Rev 6-2014), section 10.27. Hereafter, all references are to "Circular 230" and the 2014 version except where noted otherwise.

² *Ridgley v. Lew* (Civ. No. 1:12-cv-00565 (CRC)). Order, D.D.C. July 16, 2014; 2014 WL 3506888. (Emphasis added.)

³ A thought-provoking article on *Ridgley's* effect on reportable transactions by Charles R. Markham appeared in the JTPP issue for October–November, 2015. Charles R. Markham, *Life After Ridgley: While Some Contingency Fee Restrictions Have Been Lifted, Practitioners Should Be Mindful That Reportable Transaction Rules Apply*, J. TAX PRACTICE AND PROCEDURE, Oct.–Nov. 2015, at 57. This author expresses no opinion on that piece.

⁴ See ABA Model Rule 1.8 clarified by Model Rule 1.5—attorneys are prohibited from acquiring a proprietary interest in their client's litigation; except where the fee agreement is reasonable and fair, not otherwise prohibited by the Rules or other law (domestic relations matters and criminal defense), and the agreement, stating the methodology for computing the fee, is in writing.

⁵ Prior language read "for representing a client in a matter before the [IRS]."

⁶ Section 10.27(a). (Emphasis added.)

⁷ The last phrase in this definition tracks precisely the language used to define "Practice" at section 10.2(a)(4).

⁸ Model Rule 1.5(a).

⁹ Defined by the court in *Ridgley* to mean claims for refund initiated after the filing of an original return and before any IRS-initiated activity challenging the return.

¹⁰ The Model Rule flatly prohibits contingent fees in domestic relations and criminal matters. It also specifically identifies as "local law" "government regulation regarding fees in certain tax cases."

¹¹ Cir. 230, section 10.27(b)(2) as clarified by Notice 2008-43.

¹² Notice 2008-43, IRB 2008-15, 748 (Apr. 14, 2008). The Notice can also be found on the OPR pages of IRS.GOV.

¹³ Section 10.27(b)(2)(ii) as clarified by Notice 2008-43.

¹⁴ Mr. Ridgley is a CPA. The court rejected the government's argument that this status

subjected Ridgley to Circular 230 for all tax practice activities.

¹⁵ *S. Loving*, CA-DC, 2014-1 USTC ¶150,175, 742 F3d 1013. This case has been addressed extensively in the past two years obviating the need for detailed discussion in this column.

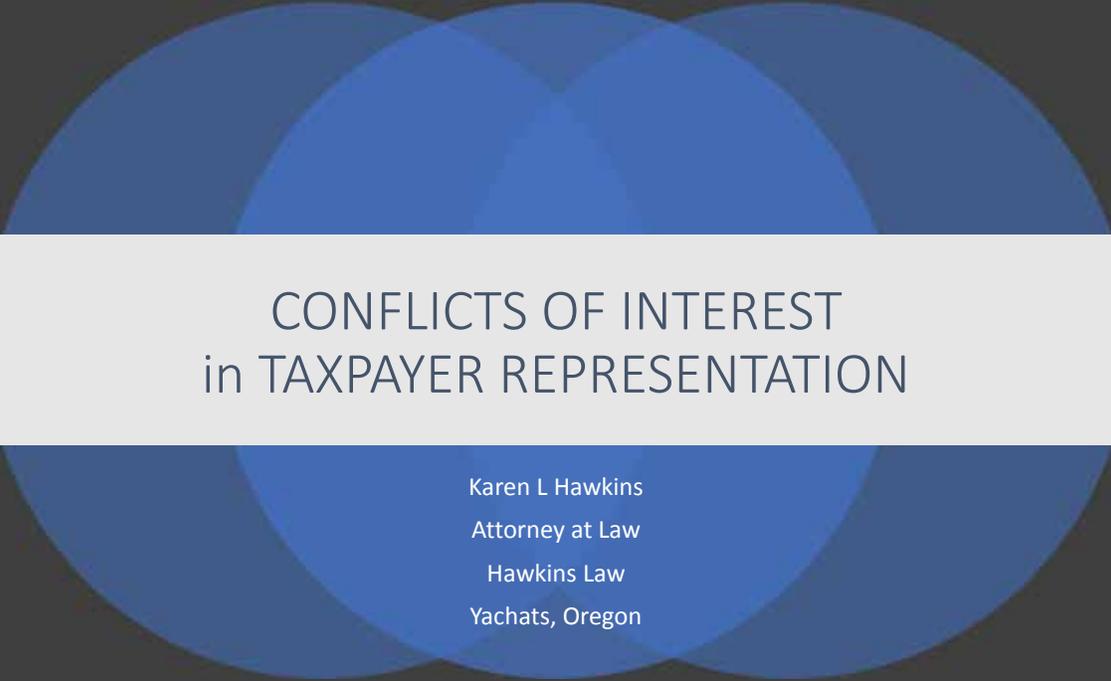
¹⁶ As clarified by Notice 2008-43.

¹⁷ The regulation acknowledges an exception for "judicial proceedings arising under the Internal Revenue Code" (see section 10.27(5)) but is silent with respect to administrative proceedings under the Code for collection of a tax liability. Section 10.27(c)(2).

¹⁸ Whether the "mere" preparation of a Form 433 will be shielded under a *Loving* analysis remains to be seen, but this writer believes proceeding with such an assumption is unwarranted.

²⁰ Individuals who are not otherwise subject to the regulations as practitioners become so through other provisions once the Form 2848 is submitted. See section 10.7(c) and Rev. Proc. 81-38, 1981-2 CB 592. The revenue procedure is almost impossible to find and has been posted for ease of access on the OPR pages of IRS.GOV.I

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CONFLICTS OF INTEREST in TAXPAYER REPRESENTATION

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Ms. Hawkins is a past Chair of both the American Bar Association Taxation Section and the Taxation Section of the State Bar of California; a past chair of the ABA Taxation Subcommittee on Civil Penalties, and the IRS Liaison Meetings Committee. Ms. Hawkins served as a Director on the Council of the ABA Taxation Section and as the Section's Vice-Chair Professional Services. She is a Fellow of the American College of Tax Counsel and serves on the Board of Tax Analysts.

Ms. Hawkins is the founder of the San Francisco Pro Se/Pro Bono Tax Court project, and in the early 2000's she played a key role in the successful efforts to reform the "innocent spouse" statutes in both federal and California law. Her honors include the V. Judson Klein and Joanne Garvey Awards from the State Bar of California Section of Taxation in 2002 and 2012, respectively; the National Pro Bono Award from the American Bar Association Tax Section, and the Judith McKelvey Distinguished Alumna Award from Golden Gate University, both in 2004; the Jules Ritholz Memorial Merit Award from the ABA Taxation Section Civil & Criminal Tax Penalties Committee in 2008. In 2012, Golden Gate University School of Law named its Tax Law Library Collection in Ms. Hawkins' name and in 2015, awarded her an honorary Doctor of Laws (LLB).

Ms. Hawkins earned her J.D. and M.B.A. degrees from Golden Gate University, Schools of Law and Tax, respectively, in San Francisco, California. Ms. Hawkins also holds an M.Ed from the University of California, Davis. Her B.A. is from the University of Massachusetts, Amherst. Ms. Hawkins speaks and writes extensively on all aspects ethics in tax practice.

Ethical Standards for Practitioners

- Virtually all difficult ethical problems arise from conflicts between a practitioner's responsibilities:
 1. to clients,
 2. to the tax system, and
 3. to the practitioner's own interest in remaining an ethical person while earning a satisfactory living.



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Authorities Relating to Tax Practice

Circular 230

OSB Rules of Professional Conduct

Tax Court Rules of Practice

ABA Model Rules of Professional Conduct



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CIRCULAR 230 – RELEVANT PROVISIONS

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Procedures to Ensure Compliance §10.36

Anyone who has, or shares **principal authority and responsibility** for overseeing a firm's Cir 230 practice must take **reasonable steps** to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of **complying with Subparts A, B and C of Circular 230**.

Anyone identified as having this principal authority **will be subject to discipline for failing to comply**.

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Compare Oregon RPC 5.1

- RULE 5.1 RESPONSIBILITIES OF PARTNERS, MANAGERS, AND SUPERVISORY LAWYERS
- A lawyer shall be responsible for another lawyer’s violation of these Rules of Professional Conduct if:
- (a) the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or
- (b) the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

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Competence §10.35

A practitioner must possess the necessary competence to engage in practice before the Internal Revenue Service

Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged

Be

Become

Hire/ consult

KNOW WHAT YOU DON'T KNOW!

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Compare Oregon RPC 1.1

- RULE 1.1 COMPETENCE
- A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

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Conflicting Interests § 10.29

- One client's interest is **directly adverse** to another's
- **Significant risk of material limitation** in Representing one client by responsibilities to:
 - another client,
 - former client,
 - third person,Or
 - by the **PERSONAL INTERESTS OF THE PRACTITIONER**



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Compare Oregon RPC 1.7

- Rule 1.7 Conflict of Interest: Current Clients
 - (a)(1) One client's interest is **directly adverse** to another's
 - (a)(2) **Significant risk of material limitation** in Representing one client by responsibilities to:
 - another client,
 - former client,
 - third person,Or
 - by the **PERSONAL INTERESTS OF THE PRACTITIONER**
 - (a)(3) The lawyer is related to another lawyer (parent, child, sibling, spouse etc) in a matter adverse to a person the lawyer knows is represented by the other lawyer in the same matter.

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Conflicting Interests

(Cir 230 § 10.29,
cont)

- May represent if:
 - **YOU** have reasonable belief in ability to provide competent, diligent representation to each affected client;
 - Not legally prohibited;And,
 - **EACH** affected client waives conflict, by giving **INFORMED** consent – in writing, at the time conflict is known
- Retain consents for at least 36 months after engagement concludes
- Provide written consents, on request, to any officer/employee of IRS

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Compare Oregon RPC 1.7 (cont)

- May represent if:
 - (b)(1) You have reasonable belief in ability to provide competent, diligent representation to each affected client;
 - (b)(2) Not legally prohibited;
 - (b)(3) the representation does not obligate the lawyer to contend for something on behalf of one client that the lawyer has a duty to oppose on behalf of another client;

And,

- (b)(4) **EACH** affected client waives conflict, by giving **INFORMED** consent confirmed in writing.

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Be
Aware.....

Conflicts of Interest are extremely fact dependent and can arise unexpectedly in the midst of an engagement

Duties to Former Clients, OR RPC 1.9 and ABA MR 1.9, has no comparable provision in Circular 230 but there are comparables in ORPC

There is no standard disclosure for a Conflict of Interest

Evaluating a conflict and adequately disclosing a conflict to the affected parties depends on the specific facts and relationships

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Oregon RPC 1.9 Duties to Former Clients

- Shall not, without informed written consent, represent
 - More than one person at different times in the same (or substantially related) matter if their interests are materially adverse, unless informed consent from both;
 - A new client if interests are adverse to former client and material information has been acquired which is protected by Rules 1.6 and 1.9(c);
 - Use information relating to the former representation to the disadvantage of the former client
 - Reveal information relating to the representation of a former client
- Matters are “substantially related” if (1) representation of the current client will injure or damage the former client in connection with the same transaction or legal dispute in which the lawyer previously represented the former client; or (2) there is a substantial risk that confidential factual information as would normally have been obtained in the prior representation of the former client would materially advance the current client’s position in the subsequent matter.

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Duties to Prospective Client

- Oregon RPC 1.18
- Identical to ABA MR 1.18; see slides # 33-34
- No Circular 230 equivalent

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Third Party Payor

Oregon RPC 1.8(f)

- No specific Circular 230 equivalent;
- Practitioner may be paid from source(s) other than the client;
- Client needs to be informed of that fact and needs to consent to the arrangement;
- Arrangement cannot compromise any of the practitioner's ethical duties to the client; including confidentiality.
- Remember who the client is.

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Businesses

- **WHO'S THE CLIENT?**
- Oregon RPC 1.13- Organization as Client
 - Identical to ABA MR 1.13 See slide #30-31
 - No Circular 230 equivalent
- Preparing returns for, or representation of, pass-through entity and one or more owners
- Entity-level tax advice/return preparation/representation impacting owners, some of whom are not your clients

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Tax Court Rules Regarding Conflicts of Interest

- Generally, in the absence of a specific TC Rule, ABA Model Rules are applied

 1. Rule 24(g) Obligations Regarding Conflict of Interest
 2. Rule 201(a) Obligation To Follow ABA Model Rules of Professional Conduct
 3. Rule 201(b) Court's Authority to Require Statement Regarding Terms of Employment

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ABA Model Rules of Professional Conduct

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ABA Model Rules

1. Rule 1.1 Competence
2. Rule 1.6 Confidentiality Of Information
3. Rules 1.7, 1.8 Conflict of Interest: Current Clients
4. Rule 1.9 Duties to Former Clients
5. Rule 1.10 Imputation of Conflicts of Interest
6. Rule 1.13 Organization As Client
7. Rule 1.16 Declining or Terminating Representation
8. Rule 1.18 Duties to Prospective Client

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Rule 1.1 Competence

- A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

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Rule 1.6 Confidentiality Of Information

- (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).
- (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
 - (1) to prevent reasonably certain death or substantial bodily harm;
 - (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;
 - (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

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Rule 1.7 Conflict Of Interest: Current Clients

- (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
 - (1) the representation of one client will be directly adverse to another client; or
 - (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.
- (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
 - (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
 - (2) the representation is not prohibited by law;
 - (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
 - (4) each affected client gives informed consent, confirmed in writing

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Rule 1.8 Conflict Of Interest: Current Clients

- (a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:
 - (1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;
 - (2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and
 - (3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

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Rule 1.8 Conflict Of Interest: Current Clients (cont)

- (b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent,...
- (c) A lawyer shall not solicit any substantial gift from a client, including a testamentary gift,...
-
- (f) A lawyer shall not accept compensation for representing a client from one other than the client unless:
 - (1) the client gives informed consent;
 - (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
 - (3) information relating to representation of a client is protected as required by Rule 1.6...

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Rule 1.8 Conflict Of Interest: Current Clients (cont)

- i) A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:
.....
- (2) contract with a client for a reasonable contingent fee in a civil case.

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Rule 1.9 Duties To Former Clients

- (a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.
- (b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client
 - (1) whose interests are materially adverse to that person; and
 - (2) about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(c) that is material to the matter;
 - unless the former client gives informed consent, confirmed in writing.
- (c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:
 - (1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or
 - (2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.

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Rule 1.10 Imputation Of Conflicts Of Interest



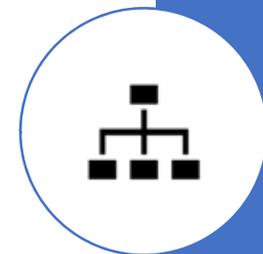
- (a) While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by Rules 1.7 or 1.9, unless
 - (1) the prohibition is based on a personal interest of the disqualified lawyer and does not present a significant risk of materially limiting the representation of the client by the remaining lawyers in the firm;
- or
- (2) the prohibition is based upon Rule 1.9(a) or (b) and arises out of the disqualified lawyer's association with a prior firm, and
 - (i) the disqualified lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom;
 - (ii) written notice is promptly given to any affected former client to enable the former client to ascertain compliance with the provisions of this Rule....

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Rule 1.13 Organization As Client

- (a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.
- (b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization... shall refer the matter to higher authority in the organization....

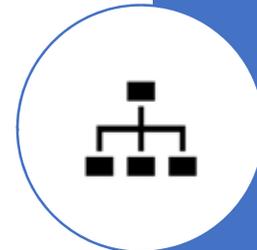


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Rule 1.13 Organization As Client (cont)

- (f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.
- (g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.



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Rule 1.16 Declining Or Terminating Representation

- (a) Except as stated in paragraph (c), a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if:
 - (1) the representation will result in violation of the rules of professional conduct or other law;
 - (2) the lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client; or
 - (3) the lawyer is discharged.
- (b) ...a lawyer may withdraw from representing a client if:
 - (1) withdrawal can be accomplished without material adverse effect on the interests of the client;
 - (2) the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent;
 - (3) the client has used the lawyer's services to perpetrate a crime or fraud;
 - (4) the client insists upon taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement;
 - (5) the client fails substantially to fulfill an obligation to the lawyer regarding the lawyer's services and has been given reasonable warning that the lawyer will withdraw unless the obligation is fulfilled....



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Rule 1.18 Duties To Prospective Clients

- (a) A person who consults with a lawyer about the possibility of forming a client-lawyer relationship with respect to a matter is a prospective client.
- (b) Even when no client-lawyer relationship ensues, a lawyer who has learned information from a prospective client shall not use or reveal that information, except [pursuant to Rule 1.9]....
- (c) A lawyer subject to paragraph (b) shall not represent a client with interests materially adverse to those of a prospective client in the same or a substantially related matter if the lawyer received information from the prospective client that could be significantly harmful to that person in the matter, except as provided in paragraph (d). If a lawyer is disqualified from representation under this paragraph, no lawyer in a firm with which that lawyer is associated may knowingly undertake or continue representation in such a matter, except as provided in paragraph (d).



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Rule 1.18 Duties To Prospective Clients (cont)

- (d) When the lawyer has received disqualifying information as defined in paragraph (c), representation is permissible if:
 - (1) both the affected client and the prospective client have given informed consent, confirmed in writing, or:
 - (2) the lawyer who received the information took reasonable measures to avoid exposure to more disqualifying information than was reasonably necessary to determine whether to represent the prospective client; and
 - (i) the disqualified lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom; and
 - (ii) written notice is promptly given to the prospective client.



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CASE STUDIES and HYPOTHETICALS

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IT'S COMPLICATED: JOINT REPRESENTATION OF SPOUSES

- Tax Lawyer (“TL”) has been advising Husband (H) and Wife (W) off and on for years, including on their current estate plan. One day, H calls TL in a panic and says: “I’ve been keeping a bank account in Israel for the past ten years and using it to bankroll my mistress who lives in Jerusalem. My wife does not know and cannot know. The bank has instructions to release the account to my mistress when I die so the money will never come back into the US. I’ve been procrastinating about signing up for the various voluntary disclosure programs the IRS has advertised for foreign bank account holders like me, but I understand the opportunities for disclosure are shrinking and more criminal cases are being initiated. I’m scared to death. I want to come clean with the IRS, but not with my wife. It will be the end of our marriage. I want to hire you to negotiate my disclosure to the IRS, but my wife must never know.”
- **May TL represent H during his bank account disclosure to the IRS?**
- Yes No

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IT'S REALLY COMPLICATED: REPRESENTING EX-SPOUSES

- Does the fact that a couple has divorced obviate your concern regarding conflicts of interest?
- Does it matter if they are seeking help for marital years' tax issues? Post-marital years?
- Is it problematic to represent both ex-spouses in an Offer in Compromise?
 - Does it matter if the spouses have different liabilities?

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IT'S NUANCED: POTENTIAL CONFLICT BETWEEN CURRENT AND FORMER CLIENT

- Tax Lawyer ("TL") is retained by Current Client ("CC") to assist with the implementation of the terms of a settlement between Client and a former business partner ("FBP"). TL did not represent either party during their dispute or the settlement negotiations. FBP had engaged TL at earlier times to perform tax services but has no current client relationship with TL. FBP is unrepresented in this transaction.
 - TL did not obtain a waiver of actual or potential conflicts from CC or FBP in connection with the representation of CC in this representation.
 - The settlement between CC and FBP requires a transfer of funds from CC to FBP which TL which facilitate through his client trust account. CC has made it clear to TL that the current tax deductibility of his settlement payment to FBP is the only reason he has settled the dispute. TL places CC's settlement funds in his attorney trust account.
 - TL makes contact with FBP to arrange for delivery of the settlement funds. FBP goes to TL's office. During their conversation, FBP states that it is his intention that the funds he is receiving are a non-taxable return of capital. Practitioner neither confirms nor denies this assumption by FBP when he hands FBP the check without another word.
- **Did TL engage in ethical misconduct?**
- Yes No

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IT’S A SLIPPERY SLOPE: JOINT REPRESENTATION OF BUSINESS AND OFFICERS

- Tax Lawyer (“TL”) is asked to represent USA, Inc. (“INC”) in connection with IRS collection efforts involving the company’s delinquent employment tax returns and tax payments. An engagement letter is drafted accordingly and signed by COO. TL’s primary contact at INC is its CFO, who is also an officer, director and shareholder. The COO and CIO are also officers, directors and shareholders of INC. INC has 25 employees.
 - CFO tells TL that INC got behind in its quarterly tax payments because the withheld funds were needed to keep a major project afloat. Once the tax payments couldn’t be made, CFO says she stopped filing returns, hoping to stay under the IRS’ radar. She advised COO of what she was doing but CIO is unaware of the problem. CFO expects the project to complete within 60 days at which time a large completion payment plus negotiated bonus will be due from the customer. The project has taken longer than anticipated and the customer has been difficult, including not making periodic payments to INC pursuant to the contract. CFO “hopes” customer is not having financial difficulties but does not know. CFO is hoping TL can “buy some time” from the IRS until the project completes and the funds are paid.
 - TL submits a power of attorney for INC, signed by COO, to the IRS revenue officer (“RO”) and discusses the situation over the phone. RO says INC is a recidivist with respect to employment tax filings and payments and is unwilling to discuss any collection activity relief unless all delinquent returns are filed within 10 days and all the officers and directors submit to an interview to determine who the responsible officers are for purposes of assessing the trust fund recovery penalty (“TFRP”). TL relays this demand to CFO who says she will have her in-house accountant prepare the returns right away. She says she wants TL to represent her during the RO interview and expects, once she relays the demand to the others, that COO and CIO will want TL to represent them as well.
- **Can TL continue to represent INC and represent CFO, COO and CIO during their interviews with the RO?**
- Yes
 - No

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Potential Conflicts Among Current Clients and Potential Client

- Practitioner prepares returns for several employees of an international delivery company. The employees own stock in the company through the employee stock ownership plan. Practitioner’s law practice includes filing client whistleblower claims with the IRS. A new whistleblower client contacts Practitioner to discuss a potential claim based on a multi-billion-dollar tax scheme involving the international delivery company. If the potential client’s information is accurate and can be substantiated, the company’s gross income could increase by more than ten billion dollars for the last three years.
- *Can the Practitioner represent the whistleblower?*
 - *Does the Practitioner need to obtain waivers from the employees of the company?*
 - *Can the Practitioner use information acquired in preparing the employees’ returns in the course of her representation of the whistleblower?*

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TAX COURT REPRESENTATION

- You obtain waivers of the conflicts of interest at the outset of an engagement to represent husband and wife during the examination of their joint income tax return for 2016. With husband's concurrence, you assist wife in submitting a claim for relief from joint and several liability pursuant to IRC § § 6015(b), (c) and (f). IRS denies the claim and eventually issues a Notice of Deficiency. You file a joint Petition in the U.S. Tax Court, denying the adjustments and, in the alternative, pleading 6015 relief for wife. Shortly before trial, husband catches wife with her lover and files for divorce. Both wife and husband want you to continue joint representation before the U.S. Tax Court to avoid delay of the proceeding and unnecessary legal fees incurred with new counsel.
- What rules govern your conduct at this point?
- What are your obligations to IRS counsel? The court?
- Can you continue as the lawyer for both husband and wife?
- Should you ever have represented both husband and wife?

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OSB ETHICS OPINIONS

- **MATTER- SPECIFIC CONFLICT: FORMER CLIENTS**
 - Formal Opinion No 2005-11 (2005)
- **ISSUE –SPECIFIC CONFLICTS: CURRENT CLIENTS**
 - Formal Opinion No 2007-177 (2007)

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Chapter 8

Presentation Slides: Local Taxes—City of Portland and Multnomah County Update

SCOTT KARTER

Audit & Accounting Division Manager

City of Portland Office of Management and Finance Revenue Division
Portland, Oregon

TYLER WALLACE

Tax Division Manager

City of Portland Office of Management and Finance Revenue Division
Portland, Oregon



- Local Taxes -
City of Portland and Multnomah
County Update

Tyler Wallace, EA
Scott Karter, CPA
City of Portland Revenue Division

1



City of Portland
Business License Tax (BLT)
and
Multnomah County Business
Income Tax (MCBIT)

2

Clean Energy Surcharge

- Measure 26-201 passed by Portland voters
- Large Retailers – more than \$1 billion in everywhere gross retail revenue with \$500,000 in Portland retail revenue
- Filing Requirement for all business meeting the \$1B/\$500K
- Administrative Rules posted on website
- Generally does not apply to groceries, medicine or healthcare services
- Starts for tax years beginning on or after 1/1/2019
- Payments must be allocated separately from BLT

3

Clean Energy Surcharge Schedule



CLEAN ENERGY SURCHARGE (CES) SCHEDULE City of Portland Business Income Tax

ATTACH TO COMBINED TAX RETURN

BUSINESS NAME	ACCOUNT #
FEN #	TAXABLE YEAR From: _____ To: _____

The Clean Energy Surcharge (Portland City Code 7.02.500 F) is applicable to Large Retailers defined in Portland City Code 7.02.100. This surcharge is 1% of Retail Gross Revenue earned within Portland. For all tax years starting on or after January 1, 2019, all taxfilers with total gross income of \$1 billion or more and Portland gross income of \$500,000 or more (as reported on lines 18a and 18b on your Combined Tax Return) must file this schedule with their Combined Tax Return.

To meet the definition of a Large Retailer subject to this surcharge, only the Retail Sales reported on lines 18a and 18b must exceed the revenue thresholds. If you reduce the sales reported on lines 18a and 18b by your non-Retail Sales (refer to BTAR 500.19-4 for more information) and you no longer exceed either threshold, you are not subject to the Clean Energy Surcharge. However, you are required to file this form even if you are not subject to payment of the surcharge.

Any taxfiler that meets the definition of a Large Retailer must determine their Retail Gross Revenue subject to this surcharge. To calculate your Retail Gross Revenue, reduce your Portland Retail Sales by all Retail Sales of Qualified Groceries, Qualified Medicine or Drugs, or Qualified Health Care Services (refer to BTAR 500.19-2 and BTAR 500.19-3 for more information). You are also allowed a deduction for the portion of the Business License Tax paid on your Retail Gross Revenue.

The amount of surcharge due reported on Line 9 of this form should be entered on Line 22d of your Combined Tax Return. You do not need to send a separate check for this surcharge.

	Portland	Everywhere
Filing Requirement		
1. Gross Income (as reported on Lines 18a/18b of your Combined Tax Return).....	\$ _____	\$ _____
Large Retailer Determination		
2. Less: Non-Retail Sales	\$ _____	\$ _____
3. Total Retail Sales (Line 1 minus Line 2)	\$ _____	\$ _____
Retail Gross Revenue Calculation		
4. Less: Retail Sales of Qualified Groceries	\$ _____	\$ _____
5. Less: Retail Sales of Qualified Medicine or Drugs	\$ _____	\$ _____
6. Less: Retail Sales of Qualified Health Care Services	\$ _____	\$ _____
7. Less: Portland Business License Tax Paid*	\$ _____	\$ _____
<small>Use Portland Business License Tax Paid Worksheet on page 2</small>		
8. Retail Gross Revenue Subject to Surcharge (sum of Lines 3 through 7)	\$ _____	\$ _____
9. Clean Energy Surcharge Due (.01 x Line 8)	\$ _____	\$ _____
Report this amount on Line 22d of your Combined Tax Return.		

Page 1

City of Portland Revenue Division, 111 SW Columbia St., Suite #600, Portland, OR 97201-5840
OFFICE: (503) 823-5157 FAX (503) 823-5192 WEB: www.portlandoregon.gov/biztax
CES SCHEDULE Rev. 03/15/2019

4

Residential Rental Registration

- Passed by Portland City Council July 2018
- No fee associated with program for tax year 2018. May be fee in future tax years.
- Any residential property rented or offered for rent for a period of more than 30 consecutive days (does not apply to hotels or short-term rentals)
- Annual registration requirement
- Digital reporting format accepted and preferred for 10 or more units

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Residential Rental Registration



RESIDENTIAL RENTAL REGISTRATION (SCHEDULE R)
City of Portland Business Income Tax

ATTACH TO COMBINED TAX RETURN OR ANNUAL EXEMPTION REQUEST

BUSINESS (OR TAX-EXEMPT ENTITY) NAME		ACCOUNT #
FEN #	SSN #	TAXABLE YEAR From _____ To _____

Residential Rental Registration Program
According to Portland City Code 7.02.890, all owners of residential rental property in the City are required to annually provide a schedule that includes the address of all owned residential rental units within the City. For purposes of this form, "residential rental unit" means any residential property rented or offered for rent for a period of more than 30 consecutive days. (Short-term rentals, such as hotels, are not required to complete this form.) If a property contains more than one residential living quarter, the term residential rental unit refers to each separate living quarter.

You will need to complete this form if your business (including subsidiaries) or tax-exempt entity owns any residential rental property within the city boundaries of Portland. (Please note that "Portland" is often assigned by the USPS to addresses that are in unincorporated areas outside the city boundaries of Portland.) To determine whether a property is within Portland, go to www.portlandmaps.com and enter the address in the search field. If "Portland" is listed as a "Jurisdiction", the property should be included below.

Attach the completed Schedule R form to your Combined Tax Return.

Line #	Address (PO Box not allowed)	Apt./Unit #	City	ZIP Code	Check if Disposed
1				97	<input type="checkbox"/>
2				97	<input type="checkbox"/>
3				97	<input type="checkbox"/>
4				97	<input type="checkbox"/>
5				97	<input type="checkbox"/>
6				97	<input type="checkbox"/>
7				97	<input type="checkbox"/>
8				97	<input type="checkbox"/>
9				97	<input type="checkbox"/>

Total number of units owned as of the last day of the tax year: _____

Note: Consecutive unit numbers/letters for the same property can be separated with a hyphen and non-consecutive unit numbers/letters for the same property can be separated with a comma. If a property is no longer owned (sold or otherwise disposed of) as of the last day of the tax year, please check the "Check if Disposed" box.

If more space is needed to report your properties, please provide a full schedule that includes the requested information for all properties. Please include the business or entity name on all pages of this schedule. If you have more than nine rental units to report and would prefer to provide the information requested above digitally/electronically, please email the information to pdotd@portlandoregon.gov.

For the 2018 tax year, there is no fee associated with the Residential Rental Registration Program.

City of Portland Revenue Division, 111 SW Columbia St., Suite #600, Portland, OR 97201-5840

OFFICE: (503) 823-5157 FAX (503) 823-5192 WEB: www.portlandoregon.gov/biztax

SCHEDULE R Form 1227(2018)

6

Heavy Vehicle Use Tax (HVT)

- Effective for four tax years starting with 2016
- Additional BLT imposed on companies with heavy vehicles (over 26,000 lbs.) that are subject to the Oregon Weight-Mile Tax
- Tax applies only if those vehicles use City streets
- Calculated on the HVT Schedule and then reported on line 22a of the Combined Tax Return
- Heavy Vehicle Use Tax is 2.8% of the Oregon Weight-Mile Tax
- Must use BL/MCBIT form, even if exempt
- The minimum tax is \$100
- Petition available if Portland miles are minimal
 - 50% Reduction or
 - Minimum Tax

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HVT SCHEDULE

HEAVY VEHICLE USE TAX (HVT) SCHEDULE
City of Portland Business Income Tax

ATTACH TO COMBINED TAX RETURN

BUSINESS NAME	BUSINESS TAX ACCOUNT #	FEN# OR SEN#
OWMT ACCOUNT #	TAXABLE YEAR From: _____ To: _____	

According to Portland City Code 7.02.500 D, a Heavy Vehicle Use Tax (HVT) is applicable to **tax years 2016 through 2019**. The proceeds of this tax are dedicated to supplementing the funding of City of Portland street maintenance and safety. The HVT is imposed on taxpayers who operate one or more heavy vehicles on streets owned or maintained by the City of Portland. For purposes of this tax, a heavy vehicle is any vehicle that is subject to the Oregon Weight-Mile Tax (OWMT). The HVT is 2.8% of the total (statewide) OWMT calculated for all periods within the tax year. If imposed, the minimum HVT due for a tax year is \$100.

You need to complete this form if your business (including subsidiaries) is subject to the OWMT during the tax year. Attach the completed form to your Combined Tax Return.

1. Enter the total (statewide) OWMT due for the tax year: \$ _____

2. Did any of the vehicles subject to the OWMT drive on or otherwise use Portland streets?
Check one: NO - Enter \$0 on Line 22a of your Combined Tax Return.
 YES - Continue to Line 3, below.

3. Enter 2.8% (.028) of the OWMT reported on Line 1. This is your tentative HVT. \$ _____

4. Enter the greater of the amount on Line 3 or \$100. \$ _____
This is your HVT. Report this amount on Line 22a of your Combined Tax Return.

City of Portland Revenue Division, 111 SW Columbia St., Suite #600, Portland, OR 97201-5340

OFFICE: (503) 823-5157 FAX: (503) 823-5192 WEB: www.portlandoregon.gov/bltax

HVT Rev. 03/2016

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Tax Year 2018

Pay Ratio Surtax

- Passed by Portland City Council December 2016
- Effective for tax years starting with 2017
- The pay ratio is tied to SEC filings of publicly traded companies, which compare the highest paid individual to the median employee
- BLT increases 10% if the ratio is 100:1 or greater but less than 250:1
- BLT increases 25% if the ratio is 250:1 or greater

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PRS SCHEDULE



PAY RATIO SURTAX (PRS) SCHEDULE
City of Portland Business Income Tax

ATTACH TO COMBINED TAX RETURN	
BUSINESS NAME	ACCOUNT #
FEN #	TAXABLE YEAR From _____ To _____

The Pay Ratio Surtax (Portland City Code 7.02.500 E.) is applicable to publicly traded companies subject to U.S. Securities and Exchange Commission pay ratio reporting requirements. The surtax is imposed in addition to the 7.5 percent tax calculated on Line 22 of the Combined Tax Return. A surtax of 10 percent of base tax liability is imposed if a company subject to this section reports a pay ratio of at least 100:1 but less than 250:1 on U.S. Securities and Exchange Commission disclosures. A surtax of 25 percent of base tax liability is imposed if a company subject to this section reports a pay ratio of 250:1 or greater on U.S. Securities and Exchange Commission disclosures.

All publicly traded companies subject to the City of Portland Business License Tax are required to complete this form and attach it to their Combined Tax Return for all tax years beginning on or after January 1, 2017.

1. Enter the annual total compensation of the CEO	\$ _____
2. Enter the median of the annual total compensation of all employees, except the CEO	\$ _____
3. Enter the ratio of these two amounts (Line 1 divided by Line 2)	: 1
4. Enter the amount from Line 22 of your Combined Tax Return	\$ _____
5. Check one of the following boxes:	
A <input type="checkbox"/> The ratio on Line 3 above is less than 100 : 1. If box A is checked, enter zero on Line 22b of your Combined Tax Return.	
B <input type="checkbox"/> The ratio on Line 3 above is equal to or above 100 : 1, but less than 250 : 1. If box B is checked, multiply Line 4 above by 10% (.10) and enter the amount here: _____ \$ and on Line 22b of your Combined Tax Return.	
C <input type="checkbox"/> The ratio on Line 3 above is equal to or above 250 : 1. If box C is checked, multiply Line 4 above by 25% (.25) and enter the amount here: _____ \$ and on Line 22b of your Combined Tax Return.	

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PRS Rev. 12/27/2016

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C-2018

COMBINED TAX RETURN FOR CORPORATIONS FORM C-2018

Multnomah County Business Income Tax City of Portland Business License Tax (Calendar Year Filers: 4/15/2019)

DUE DATE: 15th day of 4th month after taxable year end

From: TAXABLE YEAR To: FEIN #

ACCOUNT # FEDERAL BUSINESS CODE

NAME OFFICIAL USE ONLY

MAILING ADDRESS (Notify the Revenue Division if business location address changes) CITY STATE/PROV ZIP CODE

AMENDED RETURN? MAILING ADDRESS CHANGE? CEASED PORTLAND/MULTNOMAH BUSINESS? (attach explanation)

ATTACH OREGON FORM 20, FEDERAL FORM 1120, & 1125-E, IF FILED

INCOME	1. Net Income or Loss	1M		1P	
	2. Business Income Tax & Business License Tax Add Back	2M		2P	
	3. Compensation (# of controlling shareholders)	3M		3P	
	4. Other additions or subtractions	4M		4P	
	5. Adjusted Net Income (total lines 1, 2, 3 and 4)	5M		5P	
	6. Compensation Allowance Deduction (see instructions) Enter as negative sum	6M	()	6P	()
	7. Subject Net Income (line 5 minus line 6)	7M		7P	
Multnomah County Avg. Sum of Multnomah Employees in 2018:					
8a. County Gross Income		8c = (8a + 8b)		8c	
8b. Total Gross Income					
City of Portland Avg. Sum of Portland Employees in 2018:					
18a. Portland Gross Income		18c = (18a + 18b)		18c	
18b. Total Gross Income					
ATTACH CHECK HERE					
9. County Apportioned Net Income (line 7M x line 8c)	9				
10. Net Operating Loss Deduction (max 75% of line 9) Enter as negative sum	10	()			
11. Income Subject to Tax (line 9 minus line 10)	11				
12. Tax (line 11 x tax rate of 1.45%) MINIMUM \$100	12				
13. Prepayments Enter as negative sum	13	()			
14. Penalty	14				
15. Interest	15				
16. Balance Due or (Overpayment)	16				
17. REFUND (CREDIT) TRANSFER TO PORTLAND	17				
OWNERS OF RESIDENTIAL RENTAL PROPERTY IN PORTLAND MUST ATTACH SCHEDULE R					
City of Portland Avg. Sum of Portland Employees in 2018:					
19a. Portland Gross Income		19c = (19a + 19b)		19c	
19b. Total Gross Income					
ATTACH CHECK HERE					
19. Portland Apportioned Net Income (line 7P x line 19c)	19				
20. Net Operating Loss Deduction (max 75% of line 19)	20				
21. Income Subject to Tax (line 19 minus line 20)	21				
22. Tax (line 21 x tax rate of 2.6%) MINIMUM \$100	22				
22a. Heavy Vehicle Use Tax (HVT) (amount from line 4 of HVT Schedule)	22a				
22b. Pay Ratio Surtax - only applicable to publicly traded corporations (see PRS Schedule)	22b				
23. Prepayments Enter as negative sum	23	()			
24. Penalty	24				
25. Interest	25				
26. Balance Due or (Overpayment)	26				
27. REFUND (CREDIT) TRANSFER TO MULT CO DONATE TO WORK FOR ART	27				
28. COMBINED AMOUNT DUE WITH REPORT (total lines 16 and 26) Check #	28				

Make check payable to City of Portland, 111 SW Columbia St., Suite #600, Portland, OR 97201-5840.
The undersigned declares that the information given on this report is true. The undersigned is authorized to act as a representative of the filer. Filers of incomplete returns (including returns that have not reported the Average Sum of Employees) may be subject to civil penalties of up to \$500.

Signature of Filer _____ Date _____ Filer's Daytime Phone () _____

Signature of Preparer _____ Date _____ Preparer's Phone () _____

Preparer's Name/Address _____ FAX (503) 823-6192 TDD (503) 823-6868

REVENUE DIVISION (503) 823-5157

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Market-Based Apportionment

- Oregon change is effective 1/1/18
- The City and County would need a code/rule change to conform to the state's new methodology
- Initially, the City/County will not make the change in order to connect with Oregon
- The revenue impacts are difficult to estimate and potentially large
- The City/County may choose to connect at a later date

Short-term Rentals

- Taxpayers renting out rooms through websites such as Airbnb, HomeAway, FlipKey, etc.
- If the website is not collecting/remitting hotel tax, the owner/host should be collecting and remitting to the City (and State)
- Short Term Rentals are also Required to have a current ASTR permit
- Pass-Through Registration
- For more information on these requirements:
 - www.portlandoregon.gov/revenue/29976
 - www.portlandoregon.gov/bds/65603

13

Tax System Replacement

- The Revenue Division has used the same platform since 1998
- With the timing of the FTI exchange, e-filing, etc., planning for a system change makes sense
- Project expected to launch in 2019

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Revenue Division Contacts

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Chapter 9

Recent Federal Income Tax Developments

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RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

“Recent developments are just like ancient history, except they happened less long ago.”

By

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Oregon Tax Institute
June 7, 2019

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This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted — unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide an opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to us, at least) — income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.

I. ACCOUNTING

A. Accounting Methods

1. *Many more taxpayers now can use the cash method of accounting.* The **2017 Tax Cuts and Jobs Act**, § 13102, made several amendments to expand the universe of C corporations, partnerships, and businesses with inventory that can use the cash method of accounting. These amendments apply to taxable years beginning after 2017.

General Rules for C Corporations. Code § 448(a) provides as a general rule that a C corporation, or a partnership with a C corporation as a partner, cannot use the cash method of accounting. Prior to amendment by the 2017 Tax Cuts and Jobs Act, an exception in § 448(b)(3) provided that this prohibition did not apply to an entity that met a gross receipts test for *all* prior tax years, and § 448(c)(1) provided that an entity met the gross receipts test for a year if its average annual gross receipts (measured over the three preceding tax years) did not exceed \$5 million. The legislation made two significant changes. *First*, the legislation removed the requirement that an entity must meet the gross receipts test for all prior tax years in order to use the cash method. Instead, under amended § 448(b)(3), the inquiry is simply whether the entity's average annual gross receipts, measured over the three preceding tax years, were below a specified limit. *Second*, the legislation increased the \$5 million limit to \$25 million. Accordingly, a C corporation, or a partnership with a C corporation as a partner, can use the cash method of accounting for a year if its average annual gross receipts, measured over the three prior years, do not exceed \$25 million.

Farming C Corporations. Under Code § 447(a), taxable income from farming of a C corporation (or a partnership with a C corporation as a partner) engaged in the trade or business of farming must be determined using the accrual method of accounting. Prior to amendment by the 2017 Tax Cuts and Jobs Act, § 447(c)(2) provided that this requirement did not apply if the C corporation met the gross receipts test specified in § 447(d). This gross receipts test required that, for all prior tax years, the C corporation's gross receipts must not have exceeded \$1 million (\$25 million in the case of family corporations). The legislation amended § 447(c)(2) to apply the same gross receipts test (in § 448(c)) that applies to C corporations generally. Pursuant to this amendment, a C corporation (or a partnership with a C corporation as a partner) engaged in the trade or business of farming can use the cash method of accounting for a year if its average annual gross receipts, measured over the three prior years, do not exceed \$25 million.

Businesses with Inventory. Under § 471(c)(1)(A) as amended by the 2017 Tax Cuts and Jobs Act, a business that meets the gross receipts test of § 448(c) (average annual gross receipts, measured over the three prior years, do not exceed \$25 million) can use the cash method of accounting *even if inventories are a material income-producing factor*. Thus, even if a C corporation has inventory, as long as it meets the gross receipts test, it can use the cash method of accounting.

Inflation Adjustment. According to § 448(c)(4), as amended by the 2017 Tax Cuts and Jobs Act, the \$25 million figure used for purposes of the average gross receipts test will be adjusted for inflation (rounded to the nearest million) for taxable years beginning after 2018.

Change in Method of Accounting. A business that changes from the accrual method to the cash method to take advantage of the new rules will have a change in method of accounting. According to §§ 447(d) and 448(d)(7), these changes in method of accounting are treated as made with the consent of the Service. Presumably, the Service will issue automatic change procedures to facilitate such changes.

- *Guidance on changing from accrual to cash method.* In [Rev. Proc. 2018-40](#), 2018-34 I.R.B. 320 (08/06/18), the Service provided the procedures by which eligible taxpayers (referred to as “small business taxpayers”) may obtain automatic consent to change their method of accounting from the accrual to the cash method pursuant to the changes enacted in the 2017 Tax Cuts and Jobs Act.

2. *Congress has expanded the small construction contract exception to the percentage-of-completion method of accounting.* Generally, § 460(a) requires taxpayers to account for long-term contracts using the percentage-of-completion method of accounting. An exception exists, commonly known as the “small construction contract” exception, pursuant to which a taxpayer need not use the percentage-of-completion method for construction contracts if (1) at the time the contract is entered into, the taxpayer expects the contract to be completed within the two-year period beginning on the contract commencement date, and (2) the taxpayer’s average annual gross receipts (measured over the three taxable years preceding the taxable year in which such contract is entered into) do not exceed a specified limit. Prior to amendment by the [2017 Tax Cuts and Jobs Act](#), § 460(e)(1)(B)(ii) provided that this limit was \$10 million. Section 13102 of the legislation amended Code § 460(e)(1)(B)(ii) to provide that the test used for purposes of the second part of the small construction contract exception is the gross receipts test of § 448(c) (average annual gross receipts, measured over the three prior years, do not exceed \$25 million). This change applies to contracts entered into after December 31, 2017, in taxable years ending after that date. Any change in method of accounting that a taxpayer makes pursuant to this new rule is treated, according to § 460(e)(2)(B), as made with the consent of the Service and must be effected on a cut-off basis for all similarly classified contracts entered into on or after the year of change.

- *Guidance on changing methods of accounting for long-term construction contracts and home construction contracts.* In [Rev. Proc. 2018-40](#), 2018-34 I.R.B. 320 (08/06/18), the Service provided the procedures by which eligible taxpayers (referred to as “small business taxpayers”) may obtain automatic consent to (1) change their method of accounting for exempt long-term construction contracts described in § 460(e)(1)(B) from the percentage-of-completion method of accounting described in Reg. § 1.460-4(b) to an exempt contract method of accounting described in Reg. § 1.460-4(c), or (2) stop capitalizing costs under § 263A for home construction contracts defined in § 460(e)(1)(A).

3. *A genuine issue of material fact existed as to whether a C corporation (that eventually changed to an S corporation) adopted the deposit, in lieu of the deferral, method of accounting.* [Thrasys, Inc. v. Commissioner](#), 116 T.C.M. (CCH) 531, 2018 T.C.M. (RIA) ¶ 2018-199 (12/4/18). This case concerned whether the taxpayer, Thrasys, Inc., could, in its 2008 tax year, properly account for a \$15 million payment received from its customer, Siemens, under the deferral method allowed by Rev. Proc. 2004-34. The Tax Court (Judge Lauber) dismissed the Service’s motion for summary judgment and concluded that genuine issues of material fact existed as to whether the taxpayer had adopted the “deposit” method of accounting in 2008. The Service argued in its motion for summary judgment that the taxpayer could not switch from the “deposit” method of accounting—which the Service argued the taxpayer had adopted for this type of payment through its accounting treatment—to the deferral method because it never received the Service’s consent to make that switch. Section 446(a) provides that “[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.” Under Reg. § 1.446-1(e)(1), “[a] taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return.” Section 446(e) provides that “a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.” Moreover, according to the court, under § 446(a) and (e), “an accounting treatment constitutes a ‘method of accounting’ if the taxpayer ‘regularly computes his income’ using it.” The court denied the Service’s motion for summary judgment, **first**, because the taxpayer treated only one customer payment (the 2008 \$15 million payment from Siemens) as a deposit for book or

federal income tax purposes (and then shifted the \$15 million to the deferred revenue category on its Form 1120S in 2009). Therefore, “[a] question of material fact exists as to whether [taxpayer’s] ‘deposit’ treatment displayed the consistency required to constitute a method of accounting on the basis of which Thrasys ‘regularly compute[d]’ its income.” And, **second**, the Tax Court noted that a change in the taxpayer’s “method of accounting does not include ‘a change in treatment resulting from a change in underlying facts’” under Reg. § 1.446-1(e)(2)(ii)(b). Thrasys (and its auditor) “may reasonably have believed that treating the \$15 million payment as a deposit was a required ‘change in treatment resulting from a change in underlying facts’” because “Thrasys treated the \$15 million payment differently from [other] customer payments received during 2005 to 2007,” which were treated as advance payments and unearned, deferred revenue on its financial statements. The \$15 million treatment as a deposit was based on the adjustments an independent auditor had made to taxpayer’s 2008 financial statements (i.e., potentially a change in treatment due to a change in underlying facts). Therefore, the Tax Court found that genuine issues of material fact existed regarding whether Thrasys in 2008 actually “adopted the ‘deposit’ method as a method of accounting for customer payments,” and accordingly the Tax Court denied the Service’s motion for summary judgment.

B. Inventories

1. *Simplified inventory accounting for small businesses.* Under § 471(a) and Reg. § 1.471-1, taxpayers for whom the production, purchase, or sale of merchandise is an income-producing factor must account for inventories. Generally, under Reg. § 1.446-1(c)(2), when the use of inventories is necessary to clearly reflect income, a taxpayer must use the accrual method for purchases and sales. The **2017 Tax Cuts and Jobs Act**, § 13102, redesignated § 471(c) as § 471(d) and added new § 471(c). New § 471(c) provides that taxpayers meeting the gross receipts test of § 448(c) (average annual gross receipts, measured over the three prior years, do not exceed \$25 million) are not required to account for inventories under § 471. Instead, such taxpayers can use a method of accounting for inventories that either (1) treats inventories as non-incidental materials and supplies, or (2) conforms to the taxpayer’s financial accounting treatment of inventories (either in an “applicable financial statement” as defined in § 451(b)(3) or in the taxpayer’s books and records). This rule applies to taxable years beginning after 2017. Any change in method of accounting that a taxpayer makes pursuant to this new rule is treated, according to § 471(c)(4), as made with the consent of the Service. Presumably, the Service will issue automatic change procedures to facilitate such changes.

- *Guidance on accounting method changes for inventory.* In **Rev. Proc. 2018-40**, 2018-34 I.R.B. 320 (08/06/18), the Service provided the procedures by which eligible taxpayers (referred to as “small business taxpayers”) may obtain automatic consent to change their method of accounting to treat inventory as non-incidental materials and supplies under Reg. § 1.162-3 pursuant to the changes enacted in the 2017 Tax Cuts and Jobs Act.

2. *Final regulations amend the UNICAP rules.* **T.D. 9843**, 83 F.R. 58476-01 (11/20/18). Treasury and the Service have issued final regulations under § 263A (i.e., Reg. § 1.263A-1, -2, and -3) with respect to allocating costs to certain property produced or acquired for resale by a taxpayer (i.e., inventory). We leave the details to the sadists, but the final rules generally cover the following topics concerning inventory accounting: (i) the treatment of “negative adjustments” related to certain costs required to be capitalized to property produced or acquired for resale; (ii) a new simplified method of accounting for determining the additional costs allocable to property produced or acquired for resale; and (iii) redefining how certain types of costs are categorized for purposes of the simplified methods. Temporary and proposed regulations were issued in 2012. See REG-126770-06, 77 F.R. 54482 (9/5/12). The final regulations adopt the temporary and proposed regulations with only minor revisions. The final regulations are effective immediately.

- *Guidance on accounting method changes relating to final regulations.* In **Rev. Proc. 2018-56**, 2018-50 I.R.B. 985 (11/19/18), the Service provides procedures whereby taxpayers may obtain automatic consent to change to the methods of accounting provided under final Reg. § 1.263A-1, -2, and -3.

C. *Installment Method*D. *Year of Inclusion or Deduction*1. *An expanded exception to the uniform capitalization rules for small businesses.*

The [2017 Tax Cuts and Jobs Act](#), § 13102, redesignated Code § 263A(i) as § 263A(j) and added new § 263A(i). New § 263A(i) excludes from the uniform capitalization rules of § 263A any taxpayers meeting the gross receipts test of § 448(c) (average annual gross receipts, measured over the three prior years, do not exceed \$25 million). In the case of a taxpayer other than a corporation or a partnership, the gross receipts test is applied as if each trade or business of the taxpayer were a corporation or partnership. This exclusion is broader than one that existed before this change. Prior to this amendment, taxpayers that produced property and those that acquired property for resale generally were subject to § 263A, but an exception existed for taxpayers acquiring property for resale with average annual gross receipts that did not exceed \$10 million. Under new § 263A(i), all taxpayers (other than tax shelters), including those that produce property, with average annual gross receipts that do not exceed \$25 million, are not subject to the uniform capitalization rules. This provision applies to taxable years beginning after 2017. Any change in method of accounting that a taxpayer makes pursuant to this new rule is treated, according to § 263A(i)(3), as made with the consent of the Service. Presumably, the Service will issue automatic change procedures to facilitate such changes.

- *Guidance on accounting method changes for the exception from the requirement to capitalize costs under § 263A.* In [Rev. Proc. 2018-40](#), 2018-34 I.R.B. 320 (08/06/18), the Service provided the procedures by which eligible taxpayers (referred to as “small business taxpayers”) may obtain automatic consent to change their method of accounting from capitalizing costs under § 263A to a method of accounting that no longer capitalizes costs under § 263A (including costs for self-constructed assets), pursuant to § 263A(i) as enacted by the 2017 Tax Cuts and Jobs Act.

- *Replanting citrus trees?* [Rev. Proc. 2018-35](#), 2018-28 I.R.B. 204 (6/19/18)

The [2017 Tax Cuts and Jobs Act](#), § 13102, added § 263A(d)(2)(C) to provide that § 263A does not apply to certain costs that are paid or incurred by designated taxpayers for replanting after the loss or damage of citrus plants. [Rev. Proc. 2018-35](#) provides procedures by which these taxpayers may obtain automatic consent to change their method of accounting to discontinue applying § 263A to such replanting costs.

2. *Accrual-method taxpayers may have to recognize income sooner as a result of legislative changes.* The [2017 Tax Cuts and Jobs Act](#), § 13221, amended Code § 451 to make two changes that affect the recognition of income and the treatment of advance payments by accrual method taxpayers. Both changes apply to taxable years beginning after 2017. Any change in method of accounting required by these amendments for taxable years beginning after 2017 is treated as initiated by the taxpayer and made with the consent of the Service.

All events test linked to revenue recognition on certain financial statements. The legislation amended Code § 451 by redesignating § 451(b) through (i) as § 451(d) through (k) and adding a new § 451(b). New § 451(b) provides that, for accrual-method taxpayers, “the all events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in” either (1) an applicable financial statement, or (2) another financial statement specified by the Service. Thus, taxpayers subject to this rule must include an item in income for tax purposes upon the earlier of satisfaction of the all events test or recognition of the revenue in an applicable financial statement (or other specified financial statement). According to the Conference Report that accompanied the legislation, this means, for example, that any unbilled receivables for partially performed services must be recognized to the extent the amounts are taken into income for financial statement purposes. Income from mortgage servicing contracts is not subject to the new rule. The new rule also does not apply to a taxpayer that does not have either an applicable financial statement or another specified financial statement. An “*applicable financial statement*” is defined as (1) a financial statement that is certified as being prepared in accordance with generally accepted accounting principles that is (a) a 10-K or annual statement to shareholders required to be filed with the Securities and Exchange Commission, (b) an audited financial statement used for credit purposes, reporting to shareholders, partners, other proprietors, or beneficiaries, or for any other substantial nontax purpose, or (c) filed with any other federal agency for purposes other than federal tax purposes; (2) certain financial statements made on the basis of

international financial reporting standards and filed with certain agencies of a foreign government; or (3) a financial statement filed with any other regulatory or governmental body specified by Service.

Advance payments for goods or services. The legislation amended Code § 451 by redesignating § 451(b) through (i) as § 451(d) through (k) and adding a new § 451(c). This provision essentially codifies the deferral method of accounting for advance payments reflected in Rev. Proc. 2004-34, 2004-22 I.R.B. 991. New § 451(c) provides that an accrual-method taxpayer who receives an advance payment can either (1) include the payment in gross income in the year of receipt, or (2) elect to defer the category of advance payments to which such advance payment belongs. If a taxpayer makes the deferral election, then the taxpayer must include in gross income any portion of the advance payment required to be included by the applicable financial statement rule described above, and include the balance of the payment in gross income in the taxable year following the year of receipt. An advance payment is any payment: (1) the full inclusion of which in gross income for the taxable year of receipt is a permissible method of accounting (determined without regard to this new rule), (2) any portion of which is included in revenue by the taxpayer for a subsequent taxable year in an applicable financial statement (as previously defined) or other financial statement specified by the Service, and (3) which is for goods, services, or such other items as the Service may identify. The term “advance payment” does *not* include several categories of items, including rent, insurance premiums, and payments with respect to financial instruments.

- *Guidance on accounting method changes relating to new § 451(b).* [Rev. Proc. 2018-60](#), 2018-51 I.R.B. 1045 (11/29/18). Rev. Proc. 2018-60 procedure modifies Rev. Proc. 2018-31, 2018-22 I.R.B. 637, to provide procedures under § 446 and Reg. § 1.446-1(e) for obtaining automatic consent with respect to accounting method changes that comply with § 451(b), as amended by [2017 Tax Cuts and Jobs Act](#), § 13221. In addition, Rev. Proc. 2018-60 provides that for the first taxable year beginning after December 31, 2017, certain taxpayers are permitted to make a method change to comply with § 451(b) without filing a Form 3115, *Application for Change in Accounting Method*.

3. *Let's hope this tax services firm has more success on behalf of its clients. Amounts received from customers had to be included in income despite a promise to return the funds if the taxpayer did not obtain a successful result, and costs incurred on behalf of clients were not deductible.* [RJ Channels, Inc. v. Commissioner](#), 115 T.C.M. (CCH) 1105, 2018 T.C.M. (RIA) ¶ 2018-27 (3/14/18). The taxpayer, a subchapter C corporation that used the accrual method of accounting, provided return preparation and other tax services. The taxpayer received payments from two different clients. It received approximately \$215,000 in its taxable year ending May 31, 2012, and \$153,000 in its taxable year ending May 31, 2013. The taxpayer represented to each client that, if it were unable to obtain a favorable result for the client through its provision of tax services, it would return the payment to the client. The taxpayer deposited the payments in its bank account and was able to use the funds without restriction. The taxpayer did not return either payment to the client and did not include either payment in gross income for the years in which it had received them. During its taxable year ending May 31, 2012, the taxpayer deducted certain costs it had paid on behalf of clients. The taxpayer characterized these amounts as “Legal and Professional Fees” and as “Taxes.” The clients later reimbursed the taxpayer for these costs. The Service issued a notice of deficiency with respect to the taxpayer’s 2012 and 2013 tax years. The Service included in the notice of deficiency the taxpayer’s gross income from the payments the taxpayer had received from clients and disallowed the taxpayer’s deduction of the costs paid on behalf of clients. The Tax Court (Judge Chiechi) ruled in favor of the Service on both issues. With respect to the issue whether the payments received from clients were includible in income, the court characterized the question not as *whether* the payments should be included in income, but *when* the payments should be included in income. The court cited *Schlude v. Commissioner*, 372 U.S. 128 (1963), and *Charles Schwab Corp. v. Commissioner*, 107 T.C. 282 (1996), for the proposition that

[t]he right of a taxpayer on the accrual method of accounting to receive income is fixed upon the earliest of (1) the taxpayer’s receipt of payment, (2) the contractual due date of the payment, or (3) the taxpayer’s performance.

The court also referred to the claim of right doctrine, under which a taxpayer that receives funds under a claim of right must include them in gross income in the year of receipt, even though the taxpayer

might not be entitled to retain the funds and might be liable to return them. See *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932). The court characterized the taxpayer's obligation to return the payments to its clients as a condition subsequent (rather than a condition precedent). Under this view, the taxpayer did not have a current obligation to return the funds, and under *Schlude* and *Charles Schwab*, was required to include them in gross income in the year of receipt. With respect to the issue whether the taxpayer could deduct amounts it had paid on behalf of clients, the court cited *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943), as well as other authorities, for the proposition that amounts a taxpayer pays for the obligations of another taxpayer are not ordinary and necessary expenses within the meaning of § 162(a).

- With respect to the issue whether the taxpayer had to include the payments from clients in its gross income, the court rejected the taxpayer's reliance on *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990), as "inapposite." In *Indianapolis Power*, the Court held that amounts a utility company had received from customers were deposits, rather than advance payments, and therefore were not included in the taxpayer's income. The Court in *Indianapolis Power* emphasized that the utility had an obligation to return the amounts it had received and that the timing and amount of any refund were within the customer's control. The Tax Court characterized *Indianapolis Power* as inapposite because it addressed the question *whether* the amounts received by the taxpayer constituted income, rather than *when* the amounts received constituted income.

4. *Guidance on FASB changes and tax accounting.* [Rev. Proc. 2018-29](#), 2018-22 I.R.B. 634 (5/10/18). The Service has issued guidance that explains automatic consent procedures for taxpayers to change their method of accounting in response to new financial accounting standards issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). According to [Rev. Proc. 2018-30](#), these new standards require an entity to recognize revenue for promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services based on the following five sequential steps: (i) identify the contracts with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations; and (v) recognize revenue as the entity satisfies a performance obligation. The new standards impact taxpayers in the technology and construction industries as well as service providers with warranty and repair service contracts. Publicly-traded entities, certain not-for-profit entities, and certain employee benefit plans are required to adopt the new standards for annual reporting periods beginning after December 15, 2017. All other entities are required to adopt the new standards for annual reporting periods beginning after December 15, 2018. In addition, [Rev. Proc. 2018-49](#), 2018-41 I.R.B. 548 (9/24/18), modifies [Rev. Proc. 2018-30](#) to provide automatic change procedures for early adopters of the new standards who otherwise might not be covered by the procedures announced in [Rev. Proc. 2018-30](#).

5. *Updated list of accounting method changes to which automatic change procedures apply, but not with respect to automatic accounting method changes permitted by TCJA.* [Rev. Proc. 2018-31](#), 2018-22 I.R.B. 637 (5/9/18). In this revenue procedure, the Service has updated the "List of Automatic Changes" to which the automatic change procedures in [Rev. Proc. 2015-13](#), 2015-5 I.R.B. 419, as clarified and modified by [Rev. Proc. 2015-33](#), 2015-24 I.R.B. 1067, and as modified by [Rev. Proc. 2017-59](#), 2017-48 I.R.B. 543, and by section 17.02 of [Rev. Proc. 2016-1](#), 2016-1 I.R.B. 1, apply. Regardless, this updated list does not address accounting method changes permitted by the 2017 Tax Cut and Jobs Act revisions to §§ 263A, 448, and 471 (which are addressed separately above).

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

1. *The long reach of the uniform capitalization rules.* [Wasco Real Properties I, LLC v. Commissioner](#), T.C. Memo. 2016-224 (12/13/16). The Tax Court (Judge Buch) held that real estate taxes on land on which commercial almond trees were planted were subject to capitalization as indirect costs under § 263A:

Although WRP I deducted its property taxes, those taxes directly benefit the growing of the almond trees and are allocable to the produced property (the almond trees) that will produce income in the future. Allowing a current deduction of the property taxes would distort WRP I's actual income for the subject years and would otherwise allow WRP I to offset its unrelated income. This is precisely the mismatch of expenses and revenues that section 263A was enacted to prevent.

In addition, interest on a loan to acquire the land on which the commercial almond trees were planted was subject to capitalization under § 263A(f). “The land does not have to be the property that is being produced to bring interest on a financing of the land within the reach of section 263A. Rather, pursuant to the command of section 263A(f)(2)(A)(i), the interest that the entities paid on their financing of their land must be capitalized as a cost of their almond trees if the cost of the land is a production expenditure with respect to the almond trees.” Capitalized interest is added to the basis of the almond trees, not the land.

a. *This decision is nuts! The Ninth Circuit has affirmed the Tax Court's decision that interest and property taxes with respect to land used to grow almonds are subject to the uniform capitalization rules.* Today, these partnerships might be able to elect not to be subject to § 263A. [Wasco Real Properties I, LLC v. Commissioner](#), 744 Fed. Appx. 534 (9th Cir. 12/5/18). In a brief, memorandum opinion, the U.S. Court of Appeals for the Ninth Circuit has affirmed the Tax Court's decision and held that real property taxes on land used by the taxpayers to grow almond trees and interest on a loan used to acquire the land had to be capitalized under the uniform capitalization rules of § 263A. The court held that the real property taxes corresponding to the portion of the property used to grow almond trees were indirect costs allocable to the production of the almond trees and were required to be capitalized under I.R.C. § 263A(2)(B). With respect to the interest on the financing used to acquire the land, the court held that the interest was allocable to the almond trees within the meaning of § 263A(f)(1)(B) because the cost of the land was a production expenditure of the trees and therefore the interest was directly attributable to the production expenditures of the almond trees. “The cost of the land is an indirect cost because it ‘directly benefit[s]’ or is ‘incurred by reason of the performance of production’ of the almond trees. 26 C.F.R. § 1.263A-1(e)(3)(i)(A).”

- The [2017 Tax Cuts and Jobs Act](#), § 13102, redesignated Code § 263A(i) as § 263A(j) and added new § 263A(i). New § 263A(i) excludes from the uniform capitalization rules of § 263A any taxpayers meeting the gross receipts test of § 448(c) (average annual gross receipts, measured over the three prior years, do not exceed \$25 million). Unlike the prior, more limited exclusion from the uniform capitalization rules, this exclusion applies both to those who acquire property for resale and those who produce property. Thus, beginning in 2018, the taxpayers in this case could elect not to apply the uniform capitalization rules of § 263A and instead deduct the property taxes and interest.

2. *Up in Smoke: the deductions of this medical marijuana business were disallowed by § 280E and could not be capitalized under the uniform capitalization rules of § 263A.* [Patients Mutual Assistance Collective Corp. v. Commissioner](#), 151 T.C. No. 11 (11/29/18). The taxpayer, a subchapter C corporation engaged in the medical marijuana business in California, argued that its deductions for business expenses were not subject to disallowance under § 280E. Section 280E disallows any deduction or credit otherwise allowable if such amount is paid or incurred in connection with a trade or business “if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances” In a lengthy opinion by Judge Holmes, the Tax Court rejected the taxpayer's argument that the words “consists of” in § 280E mean that the statute applies only to businesses that exclusively or solely engage in trafficking controlled substances and does not apply to businesses, like the taxpayer's, that also engage in other activities such as offering acupuncture services and group sessions for yoga and tai chi. Judge Holmes noted that the court had “cursorily rejected” a nearly identical argument in *Olive v. Commissioner*, 139 T.C. 19 (2012), *aff'd*, 792 F.3d 1146 (9th Cir. 2015), but given the importance of the issue to the industry, explained the court's reasoning at greater length. The court further held that the taxpayer had only one trade or business. Accordingly, § 280E applied to disallow the taxpayer's deductions. The court also considered whether the taxpayer was required to determine cost of goods sold under the rules of § 471 or instead the rules of § 263A. Section 263A provides that both resellers as well as producers of property must include indirect costs in cost of goods sold and broadens the indirect costs that must be included. The

court concluded that the rules of § 263A did not apply to the taxpayer because of the flush language of § 263A(a)(2), which provides:

Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.

The court analyzed the regulations that interpret this provision and concluded that the statute's meaning is that "if something wasn't deductible before Congress enacted section 263A, taxpayers cannot use that section to capitalize it." The court rejected several arguments of the taxpayer to the contrary. Because the rules of § 263A did not apply, only the rules of § 471 did. (Unlike § 263A, § 471 was in place when Congress enacted § 280E.) The rules of § 471 distinguish between resellers and producers of property. Under Reg. § 1.471-3(b), resellers must use as their cost of goods sold the price they pay for inventory plus any "transportation or other necessary charges incurred in acquiring possession of the goods." The court concluded that the taxpayer was a reseller and therefore, pursuant to the regulations under § 471, could not include indirect costs in determining cost of goods sold. Finally, the court rejected the taxpayer's argument that the government was barred by *res judicata* from pursuing the case because of the government's prior decision to abandon a civil forfeiture action against the taxpayer.

C. Reasonable Compensation

1. *Could we see compensation levels of top corporate officers actually decline?* Code § 162(m) limits to \$1 million the deduction of publicly traded corporations for compensation to covered employees (generally, certain top corporate officers). Certain types of compensation are not subject to this limit and are not taken into account in determining whether compensation exceeds \$1 million, including remuneration payable (1) on a commission basis, or (2) solely on account of attainment of one or more performance-based goals if certain approval requirements are met ("performance-based compensation"). The [2017 Tax Cuts and Jobs Act](#), § 13601, amended Code § 162(m) to eliminate the exceptions for commissions and performance-based compensation. Accordingly, such compensation must be taken into account in determining the amount of compensation with respect to a covered employee for a taxable year that exceeds \$1 million and therefore is not deductible. The legislation also amended the definition of "covered employee" in four ways: (1) the statutory definition now includes the principal executive officer and principal financial officer (whereas formerly the statutory definition referred only to the chief executive officer), (2) the definition includes persons who served as principal executive officer or principal financial officer *at any time during the taxable year* (rather than at the end of the year), (3) the definition includes officers whose compensation must be reported to shareholders under the Securities Exchange Act of 1934 by reason of their being among the *three* highest compensated officers (rather than four highest compensated officers), and (4) the definition now includes a person who was a covered employee for any preceding taxable year beginning after 2016 (which means the limit applies to compensation paid after termination of employment or after the employee's death). Finally, the legislation expands the category of corporations subject to the § 162(m) limit by defining "publicly traded corporation" to include foreign corporations publicly traded through American depository receipts (ADRs) and certain large private corporations and S corporations. These changes apply to taxable years beginning after 2017. A transition rule provides that the changes do not apply to remuneration provided pursuant to a written binding contract that was in effect on November 2, 2017 as long as the contract is not materially modified after that date. Compensation provided pursuant to a renewal of a grandfathered contract is subject to the new rules.

a. *Initial guidance on amended § 162(m).* [Notice 2018-68](#), 2018-36 I.R.B. 418 (8/21/18). The Service has provided guidance on certain aspects of the amendments made to § 162(m) by the [2017 Tax Cuts and Jobs Act](#). Very generally, the notice addresses the amended rules for identifying covered employees and the operation of the grandfather rule for remuneration provided pursuant to a written binding contract that was in effect on November 2, 2017, including when such a contract will be considered materially modified so that it is no longer grandfathered. Treasury and the Service expect to issue proposed regulations under § 162(m) that will incorporate the guidance provided in this notice.

D. *Miscellaneous Deductions*

1. *Standard mileage rates for 2018.* Notice 2018-3, 2018-2 I.R.B. 285 (12/14/17). The standard mileage rate for business miles in 2018 goes up to 54.5 cents per mile (from 53.5 cents in 2017) and the medical/moving rate goes up to 18 cents per mile (from 17 cents in 2017). The charitable mileage rate remains fixed by § 170(i) at 14 cents. The portion of the business standard mileage rate treated as depreciation is 25 cents per mile for 2018 (unchanged from 2017).

a. *Minor changes to reflect the 2017 Tax Cuts and Jobs Act.* Notice 2018-42, 2018-24 I.R.B. 750 (5/25/18). This notice modifies Notice 2018-3, 2018-2 I.R.B. 285 (12/14/17) to reflect changes made by Congress in the 2017 Tax Cuts and Jobs Act. Specifically, the notice clarifies that (1) the business standard mileage rate listed in Notice 2018-3 cannot be used to claim an itemized deduction for unreimbursed employee travel expenses because Congress disallowed miscellaneous itemized deductions for 2018, and (2) the standard mileage rate for moving is not applicable for the use of an automobile as part of a move because Congress disallowed the deduction of moving expenses for 2018 (except for members of the military on active duty who move pursuant to military orders incident to a permanent change of station, who can still use the standard mileage rate for moving). The notice also modifies Notice 2018-3 to reflect the 2017 Tax Cuts and Jobs Act's increase to the depreciation limitations for passenger automobiles placed in service after December 31, 2017. Notice 2018-3 had identified a maximum standard automobile cost of \$27,300 for passenger automobiles and \$31,000 for trucks and vans for purposes of computing the allowance under a fixed and variable rate (FAVR) plan. This notice provides that the maximum standard automobile cost may not exceed \$50,000 for passenger automobiles (including trucks and vans) placed in service after December 31, 2017.

2. *Standard mileage rates for 2019.* Notice 2019-2, 2019-2 I.R.B. 281 (12/14/18). The standard mileage rate for business miles in 2019 goes up to 58 cents per mile (from 54.5 cents in 2018) and the medical/moving rate goes up to 20 cents per mile (from 18 cents in 2018). The charitable mileage rate remains fixed by § 170(i) at 14 cents. The portion of the business standard mileage rate treated as depreciation goes up to 26 cents per mile for 2019 (from 25 cents in 2018). The maximum standard automobile cost may not exceed \$50,400 (up from \$50,000 in 2018) for passenger automobiles (including trucks and vans) for trucks and vans for purposes of computing the allowance under a fixed and variable rate (FAVR) plan.

- The notice reminds taxpayers that (1) the business standard mileage rate cannot be used to claim an itemized deduction for unreimbursed employee travel expenses because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed miscellaneous itemized deductions for 2019, and (2) the standard mileage rate for moving has limited applicability for the use of an automobile as part of a move during 2019 because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed the deduction of moving expenses for 2019 (except for members of the military on active duty who move pursuant to military orders incident to a permanent change of station, who can still use the standard mileage rate for moving).

3. *Oh, come on! No more deductions for taking a client to a professional sports game?* The 2017 Tax Cuts and Jobs Act, § 13304, amended Code § 274(a) to disallow deductions for costs “[w]ith respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation.” Similarly, no deduction is allowed for membership dues with respect to any club organized for business, pleasure, recreation or other social purposes. This rule applies to taxable years beginning after 2017.

- *What is “entertainment”?* Regulations issued before the Tax Cuts and Jobs Act (Reg. § 1.274-2(b)(1)) provide that whether an activity constitutes entertainment is determined using an objective test and set forth the following definition of the term “entertainment”:

[T]he term “entertainment” means any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family. The term “entertainment” may include an activity, the cost of which is claimed as a business expense by the taxpayer, which

satisfies the personal, living, or family needs of any individual, such as providing food and beverages, a hotel suite, or an automobile to a business customer or his family. The term “entertainment” does not include activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as (a) supper money provided by an employer to his employee working overtime, (b) a hotel room maintained by an employer for lodging of his employees while in business travel status, or (c) an automobile used in the active conduct of trade or business even though used for routine personal purposes such as commuting to and from work.

Reg. § 1.274-2(b)(1).

- The complete disallowance of deductions for costs of activities of a type generally considered to constitute entertainment will give rise to some difficult issues. Activities can be thought of as falling on a spectrum. At one end of the spectrum are activities that clearly are not entertainment. At the other end are activities that clearly are entertainment. The difficult issues will arise for the many activities that fall somewhere in the middle, as illustrated by the following examples.

Example 1: A self-employed CPA travels out of town to perform an audit. The CPA flies to the client’s location and stays at a hotel for several days. While there, the CPA buys breakfast, lunch, and dinner each day. The meals are not “entertainment” and therefore are not subject to disallowance under amended § 274(a). They are, however, subject to the 50 percent limitation of § 274(n)(1).

Example 2: A self-employed attorney invites a client to attend a professional sports game and pays the entire cost associated with attending. The cost of attending will be regarded as entertainment and therefore not deductible.

Example 3: The client of a self-employed attorney spends the day in the attorney’s office to review strategy for an upcoming Service Appeals conference. They take a break for lunch at a restaurant down the street. During lunch, they continue their discussion. The attorney pays for the meal. Is the meal nondeductible “entertainment”? Or is it (at least in part) a deductible business expense subject to the 50 percent limitation of § 274(n)(1)?

a. *Business meals are not “entertainment” and are still deductible subject to the normal 50 percent limitation, says the Service.* Notice 2018-76, 2018-42 I.R.B. 599 (10/3/18). In this notice, the Service announced that Treasury and the Service will issue proposed regulations under § 274 that will include guidance on the deductibility of expenses for certain business meals. According to the notice, the 2017 TCJA did not change the definition of “entertainment” under § 274(a)(1), and therefore the regulations under § 274(a)(1) that define entertainment continue to apply. Further, the notice states that, although the 2017 TCJA did not address the circumstances in which the provision of food and beverages might constitute entertainment, its legislative history “clarifies that taxpayers generally may continue to deduct 50 percent of the food and beverage expenses associated with operating their trade or business.” The notice provides that, until proposed regulations are issued, taxpayers can rely on this notice and can deduct 50 percent of an otherwise allowable business meal expense if five requirements are met: (1) the expense is an ordinary and necessary expense under § 162(a) paid or incurred during the taxable year in carrying on any trade or business; (2) the expense is not lavish or extravagant under the circumstances; (3) the taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages; (4) the food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact; and (5) in the case of food and beverages provided during or at an entertainment activity, the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The notice also provides that the entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages. The notice provides the following examples:

Example 1.

1. Taxpayer A invites B, a business contact, to a baseball game. A purchases tickets for A and B to attend the game. While at the game, A buys hot dogs and drinks for A and B.
2. The baseball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets is an entertainment expense and is not deductible by A. The cost of the hot dogs and drinks, which are purchased separately from the game tickets, is not an entertainment expense and is not subject to the § 274(a)(1) disallowance. Therefore, A may deduct 50 percent of the expenses associated with the hot dogs and drinks purchased at the game.

Example 2.

1. Taxpayer C invites D, a business contact, to a basketball game. C purchases tickets for C and D to attend the game in a suite, where they have access to food and beverages. The cost of the basketball game tickets, as stated on the invoice, includes the food and beverages.
2. The basketball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets is an entertainment expense and is not deductible by C. The cost of the food and beverages, which are not purchased separately from the game tickets, is not stated separately on the invoice. Thus, the cost of the food and beverages also is an entertainment expense that is subject to the § 274(a)(1) disallowance. Therefore, C may not deduct any of the expenses associated with the basketball game.

Example 3.

1. Assume the same facts as in Example 2, except that the invoice for the basketball game tickets separately states the cost of the food and beverages.
2. As in Example 2, the basketball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expense and is not deductible by C. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets, is not an entertainment expense and is not subject to the § 274(a)(1) disallowance. Therefore, C may deduct 50 percent of the expenses associated with the food and beverages provided at the game.

4. *And no more deductions for employers for most qualified transportation fringe benefits such as employer-paid parking.* The [2017 Tax Cuts and Jobs Act](#), § 13304(c), amended Code § 274(a) by adding § 274(a)(4), which provides that, for amounts paid or incurred after 2017, no deduction is allowed for any “qualified transportation fringe” (as defined in § 132(f)) provided to an employee of the taxpayer. A qualified transportation fringe is any of the following provided by an employer to an employee: (1) transportation in a commuter highway vehicle in connection with travel between the employee’s residence and place of employment, (2) any transit pass, (3) qualified parking, and (4) any qualified bicycle commuting reimbursement. Further, the legislation added new § 274(l), which provides:

1. *General Rule.* No deduction shall be allowed under this chapter for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee.
2. *Exception.* In the case of any qualified bicycle commuting reimbursement (as described in section 132(f)(5)(F)), this subsection shall not apply for any amounts paid or incurred after December 31, 2017, and before January 1, 2026.

Effect on Employers. Under § 274 as amended, an employer *cannot* deduct the cost of transportation in a commuter highway vehicle, a transit pass, or qualified parking paid or incurred after 2017. However, the employer *can* deduct the cost of a qualified bicycle commuting reimbursement paid or incurred after 2017 and before 2026.

Effect on Employees. With one exception, the legislation did not change the tax treatment of employees with respect to qualified transportation fringes. Employees can still (as under prior law)

exclude from gross income (subject to applicable limitations) any of the following provided by an employer: (1) transportation in a commuter highway vehicle in connection with travel between the employee's residence and place of employment, (2) any transit pass, or (3) qualified parking. The exception is a qualified bicycle commuting reimbursement, which, under new § 132(f)(8), must be included in an employee's gross income for taxable years beginning after 2017 and before 2026.

a. *Guidance on determining the nondeductible portion of the cost of employer-provided parking.* Notice 2018-99, 2018-52 I.R.B. 1067 (12/10/18). In this notice, the Service announced that Treasury and the Service will issue proposed regulations under § 274 that will include guidance on determining nondeductible parking expenses and other expenses for qualified transportation fringes (and also the calculation of increased unrelated business taxable income (UBTI) of tax-exempt organizations that provide qualified transportation fringes). Until further guidance is issued, employers that own or lease parking facilities where their employees park can rely on interim guidance provided in the notice to determine the nondeductible portion of parking expenses under § 274(a)(4) and the corresponding increase in the amount of UBTI under § 512(a)(7) attributable to nondeductible parking expenses.

Employer Pays a Third Party for Employee Parking Spots. According to the notice, in situations in which an employer pays a third party an amount so that employees may park at the third party's parking lot or garage, the amount disallowed by § 274(a)(4) generally is the taxpayer's total annual cost of employee parking paid to the third party. Nevertheless, if the amount paid by the employer exceeds the § 132(f)(2) monthly limitation on exclusion (\$260 for 2018 and \$265 for 2019), the employer must treat the excess amount as compensation and wages to the employee. Accordingly, the excess amount is not disallowed as a deduction pursuant to § 274(e)(2), which provides that § 274(a) does not disallow as a deduction expenses for goods, services, and facilities to the extent the taxpayer treats the expenses as wages to its employees. The result is that the employer can deduct the monthly cost of parking provided to an employee to the extent the cost exceeds the § 132(f)(2) monthly limitation. These rules are illustrated by examples 1 and 2 in the notice.

Taxpayer Owns or Leases All or a Portion of a Parking Facility. The notice provides that, until further guidance is issued, if a taxpayer owns or leases all or a portion of one or more parking facilities where employees park, the nondeductible portion of the cost of providing parking can be calculated using any reasonable method. The notice provides a four-step methodology that is deemed to be a reasonable method. The notice cautions that, because § 274(a)(4) disallows a deduction for the *expense* of providing a qualified transportation fringe, using the *value* of employee parking to determine expenses allocable to employee parking is not a reasonable method. For purposes of the notice, the term "total parking expenses," a portion of which is disallowed, does *not* include a deduction for depreciation on a parking structure used for parking by the taxpayer's employees, but *does* include, without limitation, "repairs, maintenance, utility costs, insurance, property taxes, interest, snow and ice removal, leaf removal, trash removal, cleaning, landscape costs, parking lot attendant expenses, security, and rent or lease payments or a portion of a rent or lease payment." Under the four-step methodology provided in the notice, employers can determine the nondeductible portion of parking costs by: (1) determining the percentage of parking spots that are reserved employee spots and treating that percentage of total parking expenses as disallowed; (2) determining whether the primary use of the remaining spots (greater than 50 percent actual or estimated usage) is providing parking to the general public, in which case the remaining portion of total parking expenses is not disallowed by § 274(a)(4); (3) if the primary use of the remaining parking spots (from step 2) is *not* to provide parking to the general public, identifying the number of remaining spots exclusively reserved for nonemployees, including visitors, customers, partners, sole proprietors, and 2-percent shareholders of S Corporations and treating this percentage of total parking expenses as not disallowed by § 274(a)(4); and (4) if there are any remaining parking expenses not specifically categorized as deductible or nondeductible after completing steps 1-3, reasonably determining "the employee use of the remaining parking spots during normal business hours on a typical business day ... and the related expenses allocable to employee parking spots." This four-step methodology is illustrated by examples 3 through 8 in the notice.

5. *Rats! We knew that we should have been architects or engineers instead of tax advisors.* The 2017 Tax Cuts and Jobs Act, § 11011, added § 199A, thereby creating an unprecedented, new deduction for trade or business (and certain other) income earned by sole proprietors, partners of partnerships (including members of LLCs taxed as partnerships or as sole proprietorships), and shareholders of S corporations. The Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, Division T, § 101 (“CAA 2018”), signed by the President on March 23, 2018, amended § 199A principally to address issues related to agricultural or horticultural cooperatives. New § 199A is intended to put owners of flow-through entities (but also including sole proprietorships) on par with C corporations that will benefit from the new reduced 21% corporate tax rate; however, in our view, the new provision actually makes many flow-through businesses even more tax-favored than they were under pre-TCJA law.

Big Picture. Oversimplifying a bit to preserve our readers’ (and the authors’) sanity, new § 199A essentially grants a special 20 percent deduction for “qualified business income” (principally, trade or business income, but not wages) of certain taxpayers (but not most personal service providers except those falling below an income threshold). In effect, then, new § 199A reduces the top marginal rate of certain taxpayers with respect to their trade or business income (but not wages) by 20 percent (i.e., the maximum 37 percent rate becomes 29.6 percent on qualifying business income assuming the taxpayer is not excluded from the benefits of the new statute). Most high-earning (over \$415,000 taxable income if married filing jointly) professional service providers (including lawyers, accountants, investment advisors, physicians, etc., but *not* architects or engineers) are excluded from the benefits of new § 199A. Of course, the actual operation of new § 199A is considerably more complicated, but the highlights (lowlights?) are as summarized above.

Effective dates. Section 199A applies to taxable years beginning after 2017 and before 2026.

Initial Observations. Our initial, high-level observations of new § 199A are set forth below:

1. *How § 199A applies.* New § 199A is applied at the individual level of any qualifying taxpayer by first requiring a calculation of taxable income excluding the deduction allowed by § 199A and then allowing a special deduction of 20 percent of qualified business income against taxable income to determine a taxpayer’s ultimate federal income tax liability. Thus, the deduction is *not* an above-the-line deduction allowed in determining adjusted gross income; it is a deduction that reduces taxable income. The deduction is available both to those who itemize deductions and those who take the standard deduction. The deduction cannot exceed the amount of the taxpayer’s taxable income reduced by net capital gain. The § 199A deduction applies for income tax purposes; it does *not* reduce self-employment taxes. Query what states that piggyback off federal taxable income will do with respect to new § 199A. Presumably, the deduction will be disallowed for state income tax purposes.
2. *Eligible taxpayers.* Section 199A(a) provides that the deduction is available to “a taxpayer other than a corporation.” The deduction of § 199A is available to individuals, estates, and trusts. For S corporation shareholders and partners, the deduction applies at the shareholder or partner level. Section 199A(f)(4) directs Treasury to issue regulations that address the application of § 199A to tiered entities.
3. *Qualified trades or businesses (or, what’s so special about architect and engineers?)—§ 199A(d).* One component of the § 199A deduction is 20 percent of the taxpayer’s qualified business income. To have qualified business income, the taxpayer must be engaged in a qualified trade or business, which is defined as any trade or business *other than* (1) the trade or business of performing services as an employee, or (2) a specified service trade or business. A specified service trade or business is defined (by reference to Code § 1202(e)(3)(A)) as “any trade or business involving the performance of services in the fields of health, ... law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.” Architects and engineers must be special, because they are excluded from the definition of a specified service trade or business. There is no reasoned explanation for this exclusion in the 2017 TCJA Conference Report. *Note:* taxpayers whose taxable income, determined without regard to the § 199A deduction, is below

a specified threshold are not subject to the exclusion for specified service trades or businesses, i.e., these taxpayers can take the § 199A deduction even if they are doctors, lawyers, accountants etc. The thresholds are \$315,000 for married taxpayers filing jointly and \$157,500 for all other taxpayers. (These figures will be adjusted for inflation in years beginning after 2018.) Taxpayers whose taxable income exceeds these thresholds are subject to a phased reduction of the benefit of the § 199A deduction until taxable income reaches \$415,000 for joint filers and \$207,500 for all other taxpayers, at which point the service business cannot be treated as a qualified trade or business.

4. *Qualified business income—§ 199A(c)*. One component of the § 199A deduction is 20 percent of the taxpayer's qualified business income, which is generally defined as the net amount from a qualified trade or business of items of income, gain, deduction, and loss included or allowed in determining taxable income. Excluded from the definition are: (1) income not effectively connected with the conduct of a trade or business in the United States, (2) specified investment-related items of income, gain, deduction, or loss, (3) amounts paid to an S corporation shareholder that are reasonable compensation, (4) guaranteed payments to a partner for services, (5) to the extent provided in regulations, payments to a partner for services rendered other than in the partner's capacity as a partner, and (6) qualified REIT dividends or qualified publicly traded partnership income (because these two categories are separate components of the § 199A deduction).
5. *Determination of the amount of the § 199A deduction—§ 199A(a)-(b)*. Given the much-touted simplification thrust of the 2017 Tax Cuts and Jobs Act, determining the amount of a taxpayer's § 199A deduction is surprisingly complex. One way to approach the calculation is to think of the § 199A deduction as the sum of two buckets, subject to one limitation. *Bucket 1* is the sum of the following from all of the taxpayer's qualified trades or businesses, determined separately for each qualified trade or business: the lesser of (1) 20 percent of the qualified trade or business income with respect to the trade or business, or (2) the greater of (a) 50 percent of the W-2 wages with respect to the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property. (*Note: this W-2 wages and capital limitation does not apply to taxpayers whose taxable income is below the \$157,500/\$315,000 thresholds mentioned earlier in connection with the definition of a qualified trade or business. For taxpayers below the thresholds, Bucket 1 is simply 20 percent of the qualified trade or business income. For taxpayers above the thresholds, the wage and capital limitation phases in and fully applies once taxable income reaches \$207,500/\$415,000.*) *Bucket 2* is 20 percent of the sum of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income. The *limitation* is that the sum of Buckets 1 and 2 cannot exceed the amount of the taxpayer's taxable income reduced by the taxpayer's net capital gain. Thus, a taxpayer's § 199A deduction is determined by adding together Buckets 1 and 2 and applying the limitation.
6. *Revised rules for cooperatives and their patrons*. The [Consolidated Appropriations Act, 2018, Pub. L. No. 115-141](#), Division T, § 101, signed by the President on March 23, 2018, amended § 199A to fix what was commonly referred to as the "grain glitch." Under 199A as originally enacted, farmers selling goods to agricultural cooperatives were permitted to claim a deduction effectively equal to 20 percent of gross sales, while farmers selling goods to independent buyers effectively could claim a deduction equal to 20 percent of net income. Some independent buyers argued that this difference created an unintended market preference for producers to sell to agricultural cooperatives. Under the amended version of § 199A, agricultural cooperatives would determine their deduction under rules set forth in § 199A(g) that are similar to those in old (and now repealed) section § 199. The § 199A deduction of an agricultural cooperative is equal to 9 percent of the lesser of (1) the cooperative's qualified production activities income, or (2) taxable income calculated without regard to specified items. The cooperative's § 199A deduction cannot exceed 50 percent of the W-2 wages paid of the cooperative. A cooperative can pass its § 199A deduction through to their farmer patrons. In addition, the legislation modified the original version of § 199A to eliminate the 20-percent

deduction for qualified cooperative dividends received by a taxpayer other than a corporation. Instead, under the amended statute, taxpayers are entitled to a deduction equal to the lesser of 20 percent of net income recognized from agricultural and horticultural commodity sales or their overall taxable income, subject to a wage and capital limitation.

7. *An incentive for business profits rather than wages.* Given a choice, most taxpayers who qualify for the § 199A deduction would prefer to be compensated as an independent contractor (i.e., 1099 contractor) rather than as an employee (i.e., W-2 wages), unless employer-provided benefits dictate otherwise because, to the extent such compensation is “qualified business income,” a taxpayer may benefit from the 20 percent deduction authorized by § 199A.
8. *The “Edwards/Gingrich loophole” for S corporations becomes more attractive.* New § 199A exacerbates the games currently played by S corporation shareholders regarding minimizing compensation income (salaries and bonuses) and maximizing residual income from the operations of the S corporation. For qualifying S corporation shareholders, minimizing compensation income not only will save on the Medicare portion of payroll taxes, but also will maximize any deduction available under new § 199A.

a. *Let the games begin! Treasury and the Service have issued final regulations under § 199A.* T.D. 9847, [Qualified Business Income Deduction](#), 84 F.R. 2952 (2/8/19). The Treasury Department and the Service have finalized proposed regulations under § 199A (see [REG-107892-18, Qualified Business Income](#), 83 F.R. 40884 (8/16/18)). The regulations address the following six general areas. In addition, Reg. § 1.643(f)-1 provides anti-avoidance rules for multiple trusts.

Operational rules. Reg. § 1.199A-1 provides guidance on the determination of the § 199A deduction. The operational rules define certain key terms, including qualified business income, qualified REIT dividends, qualified publicly traded partnership income, specified service trade or business, and W-2 wages. According to Reg. § 1.199A-1(b)(14), a “trade or business” is “a trade or business that is a trade or business under section 162 (a section 162 trade or business) other than performing services as an employee.” In addition, if tangible or intangible property is rented or licensed to a trade or business conducted by the individual or a “relevant passthrough entity” (a partnership or S corporation owned directly or indirectly by at least one individual, estate, or trust) that is commonly controlled (within the meaning of Reg. § 1.199A-1(b)(1)(i)), then the rental or licensing activity is treated as a trade or business for purposes of § 199A even if the rental or licensing activity would not, on its own, rise to the level of a trade or business. The operational rules also provide guidance on computation of the § 199A deduction for those with taxable income below and above the \$157,500/\$315,000 thresholds mentioned earlier as well as rules for determining the carryover of negative amounts of qualified business income and negative amounts of combined qualified REIT dividends and qualified publicly traded partnership income. The regulations clarify that, if a taxpayer has an overall loss from combined qualified REIT dividends and qualified publicly traded partnership income, the overall loss does not affect the amount of the taxpayer’s qualified business income and instead is carried forward separately to offset qualified REIT dividends and qualified publicly traded partnership income in the succeeding year. Reg. § 1.199A-1(c)(2)(i). The operational rules also provide rules that apply in certain special situations, such as Reg. § 1.199A-1(e)(1), which clarifies that the § 199A deduction has no effect on the adjusted basis of a partner’s partnership interest or the adjusted basis of an S corporation shareholder’s stock basis.

Determination of W-2 Wages and the Unadjusted Basis of Property. Reg. § 1.199A-2 provides rules for determining the amount of W-2 wages and the unadjusted basis immediately after acquisition (UBIA) of qualified property. The amount of W-2 wages and the UBIA of qualified property are relevant to taxpayers whose taxable incomes exceed the \$157,500/\$315,000 thresholds mentioned earlier. For taxpayers with taxable income in excess of these limits, one component of their § 199A deduction (*Bucket 1* described earlier) is the lesser of (1) 20 percent of the qualified trade or business income with respect to the trade or business, or (2) the greater of (a) 50 percent of the W-2 wages with respect to the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the UBIA of all qualified property. The rules of Reg. § 1.199A-2 regarding W-2 wages generally follow the rules under former § 199 (the now-repealed domestic production activities deduction) but, unlike the rules under former § 199, the W-2

wage limitation in § 199A applies separately for each trade or business. The amount of W-2 wages allocable to each trade or business generally is determined according to the amount of deductions for those wages allocated to each trade or business. Wages must be “properly allocable” to qualified business income to be taken into account for purposes of § 199A, which means that the associated wage expense must be taken into account in determining qualified business income. In the case of partnerships and S corporations, a partner or S corporation shareholder’s allocable share of wages must be determined in the same manner as that person’s share of wage expenses. The regulations provide special rules for application of the W-2 wage limitation to situations in which a taxpayer acquires or disposes of a trade or business. Simultaneously with the issuance of these regulations, the Service issued [Rev. Proc. 2019-11](#), 2019-9 I.R.B. 742 (1/18/19), which provides guidance on methods for calculating W-2 wages for purposes of § 199A. The regulations also provide guidance on determining the UBIA of qualified property. Reg. § 1.199A-2(c)(1) restates the statutory definition of qualified property, which is depreciable tangible property that is (1) held by, and available for use in, a trade or business at the close of the taxable year, (2) used in the production of qualified business income, and (3) for which the depreciable period has not ended before the close of the taxable year. The regulations clarify that UBIA is determined without regard to both depreciation and amounts that a taxpayer elects to treat as an expense (e.g., pursuant to § 179, 179B, or 179C) and that UBIA is determined as of the date the property is placed in service. Special rules address property transferred with a principal purpose of increasing the § 199A deduction, like-kind exchanges under § 1031, involuntary conversions under § 1033, subsequent improvements to qualified property, and allocation of UBIA among partners and S corporation shareholders.

Qualified Business Income, Qualified REIT Dividends, and Qualified Publicly Traded Partnership Income. Reg. § 1.199A-3 provides guidance on the determination of the components of the § 199A deduction: qualified business income (QBI), qualified REIT dividends, and qualified publicly traded partnership (PTP) income. The proposed regulations generally restate the statutory definitions of these terms. Among other significant rules, the regulations clarify that (1) gain or loss treated as ordinary income under § 751 is considered attributable to the trade or business conducted by the partnership and therefore can be QBI if the other requirements of § 199A are satisfied, (2) § 1231 gain or loss is *not* QBI if the § 1231 “hotchpot” analysis results in these items becoming long-term capital gains and losses, and that § 1231 gain or loss *is* QBI if the § 1231 analysis results in these items becoming ordinary (assuming all other requirements of § 199A are met), (3) losses previously suspended under §§ 465, 469, 704(d), or 1366(d) that are allowed in the current year are treated as items attributable to the trade or business in the current year, except that such losses carried over from taxable years ending before January 1, 2018, are not taken into account in a later year for purposes of computing QBI, and (4) net operating losses carried over from prior years are *not* taken into account in determining QBI for the current year, except that losses disallowed in a prior year by § 461(l) (the provision enacted by the 2017 TCJA that denies excess business losses for noncorporate taxpayers) *are* taken into account in determining QBI for the current year.

Aggregation Rules. Reg. § 1.199A-4 permits, but does not require, taxpayers to aggregate trades or businesses for purposes of determining the § 199A deduction if the requirements in Reg. § 1.199A-4(b)(1) are satisfied. Treasury and the Service declined to adopt the existing aggregation rules in Reg. § 1.469-4 that apply for purposes of the passive activity loss rules on the basis that those rules, which apply to “activities” rather than trades or businesses and which serve purposes somewhat different from those of § 199A, are inappropriate. Instead, the regulations permit aggregation if the following five requirements are met: (1) the same person, or group of persons, directly or indirectly owns 50 percent or more of each of the businesses to be aggregated, (2) the required level of ownership exists for the majority of the taxable year in which the items attributable to the trade or business are included in income, (3) all of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year (not taking into account short taxable years), (4) none of the aggregated businesses is a specified service trade or business, and (5) the trades or businesses to be aggregated meet at least two of three factors designed to demonstrate that the businesses really are part of a larger, integrated trade or business. The regulations also impose a consistency rule under which an individual who aggregates trades or businesses must consistently report the aggregated trades or businesses in subsequent taxable years. In addition, the regulations require that taxpayers attach to the relevant return a disclosure statement that identifies the trades or businesses that are aggregated.

Specified Service Trade or Business. Reg. § 1.199A-5 provides extensive guidance on the meaning of the term “specified service trade or business.” For purposes of § 199A, a qualified trade or business is any trade or business *other than* (1) the trade or business of performing services as an employee, or (2) a specified service trade or business. Code § 199A(d)(2) defines a specified service trade or business (by reference to Code § 1202(e)(3)(A)) as “any trade or business involving the performance of services in the fields of health, ... law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.” Architects and engineers are excluded. For taxpayers whose taxable incomes are below the \$157,500/\$315,000 thresholds mentioned earlier, a business is a qualified trade or business even if it is a specified service trade or business. The regulations provide guidance on what it means to be considered providing services in each of these categories. Regarding the last category, the regulations state that a trade or business in which the principal asset is the reputation or skill of one or more employees means any trade or business that consists of one or more of the following: (1) a trade or business in which a person receives fees, compensation, or other income for endorsing products or services, (2) a trade or business in which a person licenses or receives fees (or other income) for use of an individual’s image, likeness, name, signature, voice, trademark, or symbols associated with that person’s identity, or (3) receiving fees or other income for appearing at an event or on radio, television, or another media format. The regulations set forth several examples. The regulations also create a de minimis rule under which a trade or business (determined before application of the aggregation rules) is not a specified service trade or business if it has gross receipts of \$25 million or less and less than 10 percent of its gross receipts is attributable the performance of services in a specified service trade or business, or if it has more than \$25 million in gross receipts and less than 5 percent of its gross receipts is attributable the performance of services in a specified service trade or business.

Special Rules for Passthrough Entities, Publicly Traded Partnerships, Trusts, and Estates. Reg. § 1.199-6 provides guidance necessary for passthrough entities, publicly traded partnerships trusts, and estates to determine the § 199A deduction of the entity or its owners. The regulations provide computational steps for passthrough entities and publicly traded partnerships, and special rules for applying § 199A to trusts and decedents’ estates.

Effective Dates. The regulations generally apply to taxable years ending after February 8, 2019, the date on which the final regulations were published in the Federal Register. Nevertheless, taxpayers can rely on the final regulations in their entirety, or on the proposed regulations published in the Federal Register on August 16, 2018 (see [REG-107892-18, Qualified Business Income](#), 83 F.R. 40884 (8/16/18)) in their entirety, for taxable years ending in 2018. However, to prevent abuse, certain provisions of the regulations apply to taxable years ending after December 22, 2017, the date of enactment of the 2017 TCJA. In addition, Reg. § 1.643(f)-1, which provides anti-avoidance rules for multiple trusts, applies to taxable years ending after August 16, 2018.

b. *The Service has issued a revenue procedure that provides guidance on methods for calculating W-2 wages for purposes of § 199A.* [Rev. Proc. 2019-11](#), 2019-9 I.R.B. 742 (1/18/19). This revenue procedure provides three methods for calculating “W-2 wages” as that term is defined in § 199A(b)(4) and Reg. § 1.199A-2. The first method (the unmodified Box method) allows for a simplified calculation while the second and third methods (the modified Box 1 method and the tracking wages method) provide greater accuracy. The methods are substantially similar to the methods provided in [Rev. Proc. 2006-47](#), 2006-2 C.B. 869, which applied for purposes of former Code § 199. The revenue applies to taxable years ending after December 31, 2017.

c. *The Service has provided a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of § 199A.* [Notice 2019-7](#), 2019-9 I.R.B. 740 (1/18/19). Whether a rental real estate activity constitutes a trade or business for federal tax purposes has long been an area of uncertainty, and the significance of this uncertainty has been heightened by Congress’s enactment of § 199A. To help mitigate this uncertainty, the Service has issued a proposed revenue procedure that provides a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of § 199A and the regulations issued under that provision. If a rental real estate enterprise does not fall within the safe harbor, it can still be treated as a trade or business if it otherwise meets the definition of trade or business in Reg. § 1.199A-

1(b)(14). The proposed revenue procedure defines a “rental real estate enterprise” as “an interest in real property held for the production of rents [that] may consist of an interest in multiple properties.” Those relying on the revenue procedure must hold the interest directly or through a disregarded entity and must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents (with certain exceptions) as a single enterprise. Commercial and residential real estate cannot be part of the same enterprise and taxpayers cannot vary this treatment from year-to-year unless there has been a significant change in facts and circumstances. For a rental real estate enterprise to fall within the safe harbor, the following three requirements must be met:

1. Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;
2. For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental enterprise. For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year (or in each year for an enterprise held for less than five years), 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise; and
3. The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. Such records are to be made available for inspection at the request of the IRS. The contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2019.

The proposed revenue procedure provides a definition of “rental services.” To claim the benefit of the safe harbor, a taxpayer (or passthrough entity) must include a statement, signed under penalties of perjury by an authorized representative, attached to the return on which it claims the § 199A deduction or (passes through § 199A information) that the three requirements listed above have been satisfied. The proposed revenue procedure is proposed to apply to taxable years ending after December 31, 2017. Taxpayers can rely on the safe harbor in the proposed revenue procedure prior to the revenue procedure being published in final form.

6. *Unless you fit in one of the exceptions, Congress just increased the interest rate on all your business loans.* The [2017 Tax Cuts and Jobs Act](#), § 13301, amended § 163(j) to limit the deduction for business interest expense. Consequently, if your business is impacted by amended § 163(j), you will pay more for the use of borrowed funds, which is a de facto interest increase. Basically, the deduction for business interest expense under amended § 163(j) will be limited to the sum of: (1) business interest income, (2) 30 percent of “adjusted taxable income,” and (3) floor plan financing interest. The term “adjusted taxable income” is defined essentially as earnings before interest, tax, depreciation and amortization (EBITDA) for 2018 through 2022, and then earnings before interest and taxes (EBIT) for subsequent years. Businesses with average annual gross receipts (computed over 3 years) of \$25 million or less and businesses in certain industries (notably real estate if a proper election is made, but also floor plan financing of auto dealers and regulated utilities) are exempted from the limitations of amended §163(j). Real estate businesses must accept slightly longer recovery periods by using the alternative depreciation system for certain depreciable property if they elect out of the § 163(j) limitation. Because real estate businesses making the election out must use the alternative depreciation system for so-called qualified improvement property (among other categories), electing out of the § 163(j) limitation would seem to have the effect of making qualified improvement property ineligible for bonus depreciation under § 168(k).

a. *Treasury and the Service have provided interim guidance by giving insight on forthcoming proposed regulations regarding the § 163(j) limitation on deduction of business interest.* [Notice 2018-28](#), 2018-16 I.R.B. 492 (4/2/18). In this notice, the Treasury Department and the Service have announced that they intend to issue proposed regulations providing guidance on several issues related to the limitation of § 163(j) on the deduction of business interest. The notice describes some of

the rules that will be included in the proposed regulations in order to provide taxpayers with interim guidance. These rules fall into the following five broad categories.

Treatment of Interest Disallowed by Former § 163(j) in Tax Years Beginning Before 2018. The version of § 163(j) in effect before the amendments made by the Tax Cuts and Jobs Act applied only to corporations. Under the pre-TCJA version of § 163(j), interest disallowed as a deduction was treated as interest paid or accrued in the succeeding taxable year and could be carried forward indefinitely. In addition, under the prior version of § 163(j), a corporation could carry forward for three years any “excess limitation” (the amount by which 50 percent of the corporation’s adjusted taxable income exceeded its net interest expense), which made it less likely that the corporation would be subject to § 163(j) in those subsequent years. The notice provides that the proposed regulations will (1) clarify that taxpayers with interest disallowed under the prior version of § 163(j) for the last taxable year beginning before January 1, 2018, may carry such interest forward as business interest to the taxpayer’s first taxable year beginning after December 31, 2017, and that the rules of new § 163(j) then will apply to the interest carried forward, and (2) provide that, because new § 163(j) does not have a mechanism for carrying forward any excess limitation, no amount previously treated as an excess limitation carryforward may be carried to taxable years beginning after December 31, 2017. The proposed regulations also will address the interaction of § 163(j) (including the rules for amounts carried forward from taxable years beginning before 2018) with new § 59A, commonly referred to as the base erosion and anti-abuse tax (BEAT) provision, which imposes a minimum tax on certain large corporations that make deductible payments to related foreign parties.

Business Interest Expense and Income of C Corporations. The notice provides that the proposed regulations will take the position that (1) all interest paid or accrued by a C corporation on indebtedness of the C corporation will be business interest within the meaning of § 163(j)(5), and (2) with respect to indebtedness held by a C corporation, all interest that is includible in the C corporation’s gross income will be business interest income within the meaning of § 163(j)(6). In other words, a C corporation is not treated as having investment interest or investment income; instead, all interest paid or accrued by a C corporation and all interest included in income of a C corporation is treated as business interest and business interest income. The notice provides that this rule will not apply to subchapter S corporations. According to the notice, the proposed regulations also will address whether and to what extent interest is properly characterized as business interest or business interest income when it is paid or accrued by, or includible in the gross income of, a non-corporate entity such as a partnership in which a C corporation holds an interest.

Application of § 163(j) to Consolidated Groups. With respect to a corporate consolidated group, the notice provides that the proposed regulations will apply the § 163(j) limitation at the consolidated group level. Accordingly, the limitation of 30 percent of adjusted taxable income will be determined with reference to consolidated taxable income, which necessarily means that intercompany obligations will be disregarded for purposes of the § 163(j) limitation. The proposed regulations also will address other issues, such as the allocation of the § 163(j) limitation among consolidated group members. The notice indicates, however, that Treasury and the Service anticipate that the proposed regulations will *not* treat as a single taxpayer for purposes of § 163(j) an affiliated group of corporations that does not file a consolidated return.

Impact of § 163(j) on Earnings and Profits. According to the notice, the proposed regulations will clarify that the limitation of § 163(j) does not affect whether or when business interest expense of a C corporation reduces the corporation’s earnings and profits.

Application of § 163(j) to Partnerships and S Corporations. With respect to partnerships, § 163(j)(4) provides that the limitation on business interest applies at the partnership level. Partners, however, also are subject to § 163(j) in determining their taxable income. The notice indicates that the proposed regulations will provide that, in determining a partner’s annual limitation under § 163(j), a partner can include the partner’s share of the partnership’s business interest income for the taxable year only to the extent of the partner’s share of the excess of (1) the partnership’s business interest income over (2) the partnership’s business interest expense (not including floor plan financing). In addition, the proposed regulations will provide that a partner cannot include the partner’s share of the

partnership's floor plan financing interest in determining the partner's annual limitation under § 163(j). Similar rules will apply to an S corporation and its shareholders.

b. *Proposed regulations provide guidance on the 163(j) limitation on the deduction of business interest.* [REG-106089-18, Limitation on Deduction for Business Interest Expense](#), 83 F.R. 67490 (12/28/18). Treasury and the Service have issued lengthy proposed regulations regarding the limitation of § 163(j) on the deduction of business interest. The proposed regulations provide general rules and definitions and rules for calculating the limitation in consolidated group, partnership, and international contexts.

7. *Violations of law just became a little more expensive.* The [2017 Tax Cuts and Jobs Act](#), § 13306, amended Code § 162(f) to disallow deductions:

for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law.

Prior to amendment, § 162(f) stated simply that “[n]o deduction shall be allowed ... for any fine or similar penalty paid to a government for the violation of any law.” The intent of this provision appears to be to broaden the category of nondeductible items beyond those that might technically constitute a fine or penalty. The amended statute contains exceptions for (1) certain amounts for restitution or remediation (including remediation of property) or to come into compliance with law that are identified as such in a court order or settlement agreement, (2) amounts paid or incurred pursuant to a court order in a suit in which no government or governmental entity is a party, and (3) any amount paid or incurred as taxes due. Payments of restitution for failure to pay taxes that are assessed as restitution in the same manner as a tax qualify for the first exception just listed only if the amounts “would have been allowed as a deduction under this chapter if it had been timely paid.” This rule appears to mean that a payment of restitution in a tax case qualifies for the exception only if the taxes would have been deductible if timely paid. The legislation also adds to the Code § 6050X, which requires government agencies to report to the Service and the taxpayer the amount of each settlement agreement or order entered into where the aggregate amount required to be paid or incurred to or at the direction of the government is at least \$600 (or such other amount as may be specified by Treasury). These reports will separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance. The disallowance of deductions and the new reporting requirement apply to amounts paid or incurred on or after December 22, 2017, the date of enactment, but do not apply to amounts paid or incurred under any binding order or agreement entered into before that date.

a. *Guidance on amended § 162(f).* [Notice 2018-23](#), 2018-15 I.R.B. 474 (3/27/18). Section 162(f), as amended by the Tax Cuts and Jobs Act, is effective for amounts paid or incurred on or after December 22, 2017, the date of enactment. Nevertheless, Notice 2018-23 delays the information reporting requirement otherwise imposed upon officials of government and governmental entities under § 6050X until a date specified in to-be-proposed regulations (but not earlier than January 1, 2019). Notice 2018-23 also requests comments addressing the development of regulations under amended § 162(f) and new § 6050X. In addition, Notice 2018-23 provides transitional guidance regarding one of the exceptions to the disallowance rule of § 162(f)(1). One exception, set forth in § 162(f)(2), provides that an amount otherwise deductible under the Code is not disallowed if the taxpayer satisfies the requirements of § 162(f)(2)(A)(i), (ii), and (iii). Section 162(f)(2)(A)(i) requires a taxpayer to establish that the amount paid or incurred (1) constitutes restitution (including remediation of property) for damage or harm that was or may be caused by violation of any law or the potential violation of any law; or (2) is paid to come into compliance with any law that was violated or otherwise involved in the investigation or inquiry into the potential violation of any law (the “establishment requirement”). Section 162(f)(2)(A)(ii) further requires that the amount paid or incurred be identified as restitution or as an amount paid to come into compliance with such law in the court order or settlement agreement (the “identification requirement”). Finally, § 162(f)(2)(A)(iii) provides that in the case of any amount of restitution for failure to pay any tax imposed under the Code, the amount is treated as if it were a payment of tax if it would have been allowed as a deduction had it been timely paid. Section 162(f)(2)(A) further provides that meeting the identification requirement of

§ 162(f)(2)(A)(ii) alone is not sufficient to meet the establishment requirement under § 162(f)(2)(A)(i). Until proposed regulations are issued, the identification requirement in § 162(f)(2)(A)(ii) is treated as satisfied for an amount if the settlement agreement or court order specifically states on its face that the amount is restitution, remediation, or for coming into compliance with the law. Notice 2018-23 reiterates that even if the identification requirement is treated as satisfied under the Notice, taxpayers must meet the establishment requirement as well in order to qualify for the § 162(f)(2) exception.

8. *Tax Court blows out the flame on California medical marijuana dispensary's deductions. A related subchapter S corporation's deductions also were disallowed.* [Alternative Health Care Advocates v. Commissioner](#), 151 T.C. No. 13 (12/20/18). A California medical marijuana dispensary claimed deductions under § 162 for business expenses. The dispensary was organized as a C corporation (Alternative) that operated the dispensary and a subchapter S corporation (Wellness) that handled daily operations for Alternative, including paying employee wages and salaries. The Tax Court (Judge Pugh) agreed with the IRS that the deductions claimed by both Alternative and Wellness were disallowed by § 280E. Section 280E disallows any deduction or credit otherwise allowable if such amount is paid or incurred in connection with a trade or business “if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances” Judge Pugh concluded that Alternative had only one trade or business because its nonmarijuana activities “were only ancillary” to its primary activity of operating a marijuana dispensary. Therefore, Alternative could not allocate its expenses between a trafficking business and a non-trafficking business and § 280E operated to disallow all of Alternative’s claimed deductions. With respect to the subchapter S corporation, Wellness, the court concluded that “Wellness employees were directly involved in the provision of medical marijuana to the patient members of Alternative’s dispensary.” Further, according to the court, Wellness employees were engaged in the purchase and sale of marijuana on behalf of Alternative and this activity was the primary business of Wellness. Accordingly, although Wellness never took title to marijuana, the court held that Wellness was engaged in trafficking in controlled substances. Therefore, § 280E disallowed deductions claimed by Wellness, which resulted in additional income flowing to the shareholders of Wellness. The court also held that Alternative could not add direct and indirect costs of inventory to its cost of goods sold under § 263A because, by virtue of § 263A(a)(2), “[s]ection 263A puts into COGS only expenses otherwise deductible.” (The court previously had reached this conclusion and applied it to a medical marijuana business in [Patients Mutual Assistance Collective Corp. v. Commissioner](#), 151 T.C. No. 11 (11/29/18).) The court held that Alternative was not a producer, but rather a reseller of marijuana products, and therefore could not increase its cost of goods sold § 471 beyond what the IRS had allowed for the taxable years at issue. Finally, the Tax Court held that Alternative was liable for the § 6662(a) accuracy-related penalty for the taxable years at issue due to substantial understatements of income tax for those years.

E. Depreciation & Amortization

1. *Certain depreciation and amortization provisions of the 2017 Tax Cuts and Jobs Act:*

a. *Increased limits and expansion of eligible property under § 179.*

Increased § 179 Limits. The [2017 Tax Cuts and Jobs Act](#), § 13101, increased the maximum amount a taxpayer can deduct under § 179 to \$1 million (increased from \$520,000). This limit is reduced dollar-for-dollar to the extent the taxpayer puts an amount of § 179 property in service that exceeds a specified threshold. The legislation increased this threshold to \$2.5 million (increased from \$2,070,000). These changes apply to property placed in service in taxable years beginning after 2017. The legislation did not change the limit on a taxpayer’s § 179 deduction for a sport utility vehicle, which remains at \$25,000. The basic limit of \$1 million, the phase-out threshold of \$2.5 million, and the sport utility vehicle limitation of \$25,000 all will be adjusted for inflation for taxable years beginning after 2018.

Revised and expanded definition of qualified real property. The [2017 Tax Cuts and Jobs Act](#), § 13101, also simplified and expanded the definition of “qualified real property,” the cost of which can be deducted under § 179 (subject to the applicable limits just discussed). Prior to amendment by the 2017 Tax Cuts and Jobs Act, § 179(f) defined qualified real property as including “qualified leasehold improvement property,” “qualified restaurant property,” and “qualified retail improvement property.”

The legislation revised the definition of qualified real property by replacing these three specific categories with a single category, “qualified improvement property” as defined in § 168(e)(6). Section 168(e)(6) defines qualified improvement property (subject to certain exceptions) as “any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service.” In addition, the legislation expands the category of qualified real property by defining it to include the following improvements to nonresidential real property placed in service after the date the property was first placed in service: (1) roofs, (2) heating, ventilation, and air-conditioning property, (3) fire protection and alarm systems, and (4) security systems. These changes apply to property placed in service in taxable years beginning after 2017.

Section 179 property expanded to include certain personal property used to furnish lodging. The [2017 Tax Cuts and Jobs Act](#), § 13101, also amended Code § 179(d)(1). The effect of this amendment is to include within the definition of § 179 property certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging (such as beds or other furniture, refrigerators, ranges, and other equipment).

- *Guidance on the procedure for electing to treat qualified real property as § 179 property.* In [Rev. Proc. 2019-8](#), 2019-3 I.R.B. 347 (12/21/18), the Service provided the procedure by which taxpayers can elect to deduct the cost of qualified real property under § 179(a). According to the notice, for qualified real property placed in service in taxable years beginning after 2017, taxpayers make the election “by filing an original or amended Federal tax return for that taxable year in accordance with procedures similar to those in § 1.179-5(c)(2) and section 3.02 of [Rev. Proc. 2017-33](#).” Taxpayers that have filed an original return can elect to increase the portion of the cost of qualified real property deducted under § 179(a) by filing an amended return and will not be treated as having revoked a prior election under § 179 for that year.

b. *Goodbye, basis; hello 100 percent § 168(k) bonus first-year depreciation!*

100 percent bonus depreciation for certain property. The [2017 Tax Cuts and Jobs Act](#), § 13201, amended Code § 168(k)(1) and 168(k)(6) to permit taxpayers to deduct 100 percent of the cost of qualified property for the year in which the property is placed in service. This change applies to property *acquired and placed in service* after September 27, 2017, and before 2023. The percentage of the property’s adjusted basis that can be deducted is reduced from 100 percent to 80 percent in 2023, 60 percent in 2024, 40 percent in 2025, and 20 percent in 2026. (These periods are extended by one year for certain aircraft and certain property with longer production periods). Property *acquired on or before September 27, 2017* and placed in service after that date is eligible for bonus depreciation of 50 percent if placed in service before 2018, 40 percent if placed in service in 2018, 30 percent if placed in service in 2019, and is ineligible for bonus depreciation if placed in service after 2019.

Used property eligible for bonus depreciation. The legislation also amended Code § 168(k)(2)(A) and (E) to make used property eligible for bonus depreciation under § 168(k). Prior to this change, property was eligible for bonus depreciation only if the original use of the property commenced with the taxpayer. This rule applies to property *acquired and placed in service* after September 27, 2017. Note, however, that used property is eligible for bonus depreciation only if it is acquired “by purchase” as defined in § 179(d)(2). This means that used property is *not* eligible for bonus depreciation if the property (1) is acquired from certain related parties (within the meaning of §§ 267 or 707(b)), (2) is acquired by one component member of a controlled group from another component member of the same controlled group, (3) is property the basis of which is determined by reference to the basis of the same property in the hands of the person from whom it was acquired (such as a gift), or (4) is determined under § 1014 (relating to property acquired from a decedent). In addition, property acquired in a like-kind exchange is not eligible for bonus depreciation.

Qualified property. The definition of “qualified property” eligible for bonus depreciation continues to include certain trees, vines, and plants that bear fruits or nuts (deductible at a 100 percent level for items planted or grafted after September 27, 2017, and before 2023, and at reduced percentages for items planted or grafted after 2022 and before 2027). The definition also includes a qualified film or television production. Excluded from the definition is any property used in a trade or business that has

had floor plan financing indebtedness (unless the business is exempted from the § 163(j) interest limitation because its average annual gross receipts over a three-year period do not exceed \$25 million).

Section 280F \$8,000 increase in first-year depreciation. For passenger automobiles that qualify, § 168(k)(2)(F) increases by \$8,000 in the first year the § 280F limitation on the amount of depreciation deductions allowed. The legislation continues this \$8,000 increase for passenger automobiles *acquired and placed in service* after 2017 and before 2023. For passenger automobiles *acquired on or before* September 27, 2017, and placed in service after that date, the previously scheduled phase-down of the \$8,000 increase applies as follows: \$6,400 if placed in service in 2018, \$4,800 if placed in service in 2019, and \$0 after 2019.

- *The Service has issued proposed regulations that provide guidance on § 168(k) first-year depreciation.* REG-104397-18, [Additional First-Year Depreciation Deduction](#), 83 F.R. 39292 (8/8/18). These proposed regulations provide guidance regarding the additional first-year depreciation deduction under § 168(k) as amended by the 2017 Tax Cuts and Jobs Act. They affect taxpayers who deduct depreciation for qualified property acquired and placed in service after September 27, 2017. Generally, the proposed regulations describe and clarify the statutory requirements that must be met for depreciable property to qualify for the additional first-year depreciation deduction provided by § 168(k). These regulations are proposed to apply to qualified property placed in service (or planted or grafted) during or after the taxpayer's taxable year that includes the date of publication of final regulations in the Federal Register. Until final regulations are issued, taxpayers can choose to apply the proposed regulations to qualified property acquired and placed in service (or planted or grafted) after September 27, 2017, during taxable years ending on or after September 28, 2017.

c. *Changes to the 280F depreciation limits on passenger automobiles and removal of computer and peripheral equipment from the definition of listed property.* The [2017 Tax Cuts and Jobs Act](#), § 13202, amended Code § 280F(a)(1)(A) to increase the maximum amount of allowable depreciation for passenger automobiles and for which bonus depreciation under § 168(k) is not claimed. The maximum amount of allowable depreciation is \$10,000 for the year in which the vehicle is placed in service, \$16,000 for the second year, \$9,600 for the third year, and \$5,760 for the fourth and later years in the recovery period. The legislation also amended § 280F(d)(4) to remove computer or peripheral equipment from the definition of listed property. Both changes apply to property placed in service after 2017 in taxable years ending after 2017.

d. *Changes to the depreciation of certain property used in a farming business.*

Modifications to the depreciation of farm machinery and equipment. The [2017 Tax Cuts and Jobs Act](#), § 13203, made two changes with respect to the depreciation of any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) that is used in a farming business. (For this purpose, the term "farming business" is defined in Code § 263A(e)(4).) The legislation amended Code § 168(b)(2) and (e)(3)(B) to repeal the required use of the 150 percent declining balance method and to reduce the recovery period from 7 years to 5 years. Accordingly, such machinery and equipment should be depreciable over 5 years using the double declining balance method and the half-year convention. This change applies to property placed in service after 2017 in taxable years ending after 2017.

Mandatory use of ADS for farming businesses that elect out of the new interest limitation. The [2017 Tax Cuts and Jobs Act](#), § 13205, amended Code § 168 to add new § 168(g)(1)(G), which requires a farming business that elects out of the newly-enacted interest limitation of § 163(j) to use the alternative depreciation system for any property with a recovery period of 10 years or more. This change applies to taxable years beginning after 2017. Note: aside from longer recovery periods, the requirement to use the alternative depreciation system for property with a recovery period of 10 years or more would seem to have the effect of making such property ineligible for bonus depreciation under § 168(k) even if it normally would be eligible for bonus depreciation.

- For guidance on the application of the alternative depreciation system in this situation, see [Rev. Proc. 2019-8](#), 2019-3 I.R.B. 347 (12/21/18).

e. *Revised definitions and minor adjustments to recovery periods for real property.* With respect to real property, the [2017 Tax Cuts and Jobs Act](#), § 13204, amended Code § 168

to simplify certain definitions and make minor adjustments for purposes of the alternative depreciation system.

Three categories consolidated into one. The legislation replaced the categories of “qualified leasehold improvement property,” “qualified restaurant property,” and “qualified retail improvement property” with a single category, “qualified improvement property.” Code § 168(e)(6) defines qualified improvement property (subject to certain exceptions) as “any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service.” Qualified improvement property is depreciable over 15 years using the straight-line method and is subject to the half-year convention. This change applies to property placed in service after 2017. **Note:** the Conference Agreement indicates that the normal recovery period for qualified improvement property is 15 years, but § 168 as amended does not reflect this change. This should be addressed in technical corrections.

Residential rental property has a 30-year ADS recovery period. The legislation reduced the recovery period for residential rental property for purposes of the alternative depreciation system from 40 years to 30 years. The general recovery period for such property remains at 27.5 years. This change applies to property placed in service after 2017. An optional depreciation table for residential rental property with a 30-year ADS recovery period appears in [Rev. Proc. 2019-8](#), 2019-3 I.R.B. 347 (12/21/18).

Mandatory use of ADS for real property trades or businesses electing out of the new interest limitation. The legislation amended Code § 168 to add new § 168(g)(1)(F) and (g)(8), which require a real property trade or business that elects out of the newly-enacted interest limitation of § 163(j) to use the alternative depreciation system for nonresidential real property, residential rental property, and qualified improvement property. This change applies to taxable years beginning after 2017. Note: aside from longer recovery periods, the requirement to use the alternative depreciation system for qualified improvement property would seem to have the effect of making qualified improvement property ineligible for bonus depreciation under § 168(k).

- For guidance on the application of the alternative depreciation system in this situation, see [Rev. Proc. 2019-8](#), 2019-3 I.R.B. 347 (12/21/18).

2. *The IRS comes to the rescue to allow depreciation of passenger automobiles that qualify for 100 percent bonus depreciation under § 168(k).* [Rev. Proc. 2019-13](#), 2019-9 I.R.B. (2/13/19). Under § 280F(a)(1)(B)(i), the “unrecovered basis” of a passenger automobile that is subject to the § 280F limits on depreciation is treated as an expense for the first taxable year after the automobile’s recovery period. For passenger automobiles eligible for 100 percent first year depreciation under § 168(k), the amount by which the cost of the vehicle (before any § 179 deduction) exceeds the first year § 280F limitation is the “unrecovered basis” for purposes of § 280F(a)(1)(B)(i). In other words, if a taxpayer does not elect out of 100 percent first-year bonus depreciation, then the taxpayer can deduct in the year the vehicle is placed in service the maximum amount allowed under § 280F(a)(1)(A) and then cannot deduct any additional portion of the vehicle’s cost until after the recovery period has passed, at which point the taxpayer can deduct the unrecovered cost as an expense, subject to the annual \$5,670 limitation specified in § 280F(a)(1)(B)(ii). The revenue procedure gives the following example:

For example, if a calendar-year taxpayer places in service in December 2018 a passenger automobile that costs \$50,000 and is qualified property for which the 100-percent additional first year depreciation deduction is allowable, the 100-percent additional first year depreciation deduction and any § 179 deduction for this property is limited to \$18,000 under § 280F(a)(1)(A)(i) (see Table 2 of [Rev. Proc. 2018-25](#)) and the excess amount of \$32,000 is recovered by the taxpayer beginning in 2024, subject to the annual limitation of \$5,760 under § 280F(a)(1)(B)(ii).

To avoid this result, the revenue procedure provides a safe harbor method of accounting for determining depreciation deductions for passenger automobiles that qualify for 100 percent bonus depreciation under § 168(k). The safe harbor method permits taxpayers to deduct a portion of the vehicle’s cost in each year of the recovery period. The IRS issued a similar ruling, [Rev. Proc. 2011-](#)

26, 2011-16 I.R.B. 664, in response to Congress's enactment of 100 percent bonus depreciation for 2010.

Bonus Depreciation Under § 168(k) as Amended by the 2017 Tax Cuts and Jobs Act. The [2017 Tax Cuts and Jobs Act](#), § 13201, amended Code § 168(k)(1) and 168(k)(6) to permit taxpayers to deduct 100 percent of the cost of qualified property for the year in which the property is placed in service. This change applies to property *acquired and placed in service* after September 27, 2017, and before 2023. The percentage of the property's adjusted basis that can be deducted is reduced from 100 percent to 80 percent in 2023, 60 percent in 2024, 40 percent in 2025, and 20 percent in 2026. (These periods are extended by one year for certain aircraft and certain property with longer production periods). Property *acquired before September 28, 2017* and placed in service on or after that date is eligible for bonus depreciation of 50 percent if placed in service before 2018, 40 percent if placed in service in 2018, 30 percent if placed in service in 2019, and is ineligible for bonus depreciation if placed in service after 2019. The legislation also amended Code § 168(k)(2)(A) and (E) to make used property eligible for bonus depreciation under § 168(k).

Section 280F \$8,000 increase in first-year depreciation. For passenger automobiles that qualify, § 168(k)(2)(F) increases by \$8,000 in the first year the § 280F limitation on the amount of depreciation deductions allowed. The [2017 Tax Cuts and Jobs Act](#) continues this \$8,000 increase for passenger automobiles *acquired and placed in service after September 27, 2017*, and before 2023. (For passenger automobiles *acquired before September 28, 2017*, and placed in service on or after that date, the previously scheduled phase-down of the \$8,000 increase applies as follows: \$6,400 if placed in service in 2018, \$4,800 if placed in service in 2019, and \$0 after 2019.) According to [Rev. Proc. 2018-25](#), 2018-18 I.R.B. 543 (4/17/18), the § 280F depreciation limits for business use of small vehicles placed in service during 2018 are as follows:

Passenger Automobiles acquired before 9/28/18 and placed in service during 2018 with § 168(k) first year recovery:

1st Tax Year	\$16,400
2nd Tax Year	\$16,000
3rd Tax Year	\$ 9,600
Each Succeeding Year	\$ 5,760

Passenger Automobiles acquired after 9/27/17 and placed in service during 2018 with § 168(k) first year recovery:

1st Tax Year	\$18,000
2nd Tax Year	\$16,000
3rd Tax Year	\$ 9,600
Each Succeeding Year	\$ 5,760

Passenger Automobiles placed in service during 2018 with no § 168(k) first year recovery:

1st Tax Year	\$10,000
2nd Tax Year	\$16,000
3rd Tax Year	\$ 9,600
Each Succeeding Year	\$ 5,760

Safe Harbor of Rev. Proc. 2019-13. The revenue procedure provides a safe harbor method of accounting for determining depreciation deductions for passenger automobiles (other than leased vehicles) that are acquired after September 27, 2017, qualify for 100 percent bonus depreciation under § 168(k), have a cost (before any § 179 deduction) that exceeds the first-year § 280F limitation, and

for which the taxpayer does *not* elect to take a § 179 deduction. A taxpayer adopts this safe harbor method by applying it on its federal tax return for the first taxable year succeeding the year in which a passenger automobile is placed in service. To use the safe harbor, a taxpayer must: (1) use the appropriate optional depreciation table (available in IRS Publication 946) to calculate depreciation deductions for the passenger automobile, (2) deduct the § 280F first-year limitation amount in the year the vehicle is placed in service (a figure published annually by the IRS), (3) calculate depreciation for the passenger automobile for each succeeding taxable year in the recovery period by multiplying the remaining adjusted depreciable basis (the vehicle's cost before any § 179 deduction less the § 280F first-year limitation amount) by the percentage specified in the appropriate optional depreciation table, subject to the § 280F limitation amounts, and (4) deducting any remaining basis of the vehicle in the first taxable year succeeding the end of the recovery period, subject to the limitation of § 280F(a)(1)(B)(ii) (\$5,760 in the tables above) and carrying forward any excess to the succeeding taxable year to deduct in a similar manner. If § 280F(b) applies to the vehicle, i.e., if it is not predominantly used in a qualified business use, then the safe harbor ceases to apply in the first taxable year in which § 280F(b) applies. The revenue procedure is effective on February 13, 2019.

Examples. The revenue procedure gives the following examples.

Example 1 - Application of § 280F(a) safe harbor method of accounting. In 2018, X, a calendar-year taxpayer, purchased and placed in service for use in its business a new passenger automobile that costs \$60,000. The passenger automobile is 5-year property under § 168(e), is qualified property under § 168(k) for which the 100-percent additional first year depreciation deduction is allowable, and is used 100 percent in X's trade or business. X does not claim a § 179 deduction for the passenger automobile and does not make an election under § 168(b), (g)(7), or (k). X depreciates the passenger automobile under the general depreciation system by using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. X adopts the safe harbor method of accounting provided in section 4.03 of this revenue procedure. As a result:

(a) X must use the applicable optional depreciation table that corresponds with the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention, for determining the depreciation deductions for the passenger automobile (see Table A-1 in Appendix A of IRS Publication 946);

(b) For 2018, X deducts depreciation of \$18,000 for the passenger automobile, which is the depreciation limitation for 2018 under § 280F(a)(1)(A)(i) (see Table 2 in Rev. Proc. 2018-25). As a result, the remaining adjusted depreciable basis of the passenger automobile as of January 1, 2019, is \$42,000 (\$60,000 unadjusted depreciable basis less \$18,000 depreciation deduction claimed for 2018);

(c) For 2019 through 2023, the total depreciation allowable for the passenger automobile for each taxable year is determined by multiplying the annual depreciation rate in the applicable optional depreciation table by the remaining adjusted depreciable basis of \$42,000, subject to the limitation under § 280F(a)(1)(A) for that year. Accordingly, for 2019, the total depreciation allowable for the passenger automobile is \$13,440 (32 percent multiplied by the remaining adjusted depreciable basis of \$42,000). Because this amount is less than the depreciation limitation of \$16,000 for 2019 (see Table 2 in Rev. Proc. 2018-25), X deducts \$13,440 as depreciation on its federal income tax return for the 2019 taxable year. For 2020, the total depreciation allowable for the passenger automobile is \$8,064 (19.20 percent multiplied by \$42,000). Because this amount is less than the depreciation limitation of \$9,600 for 2020 (see Table 2 in Rev. Proc. 2018-25), X deducts \$8,064 as depreciation on its federal income tax return for the 2020 taxable year. Below is a table showing the depreciation allowable for the passenger automobile under the safe harbor

method of accounting for the 2018 through 2023 taxable years. X deducts these amounts.

Taxable Year	Depreciation limitations under Table 2 of Rev. Proc. 2018-25	Depreciation deduction under the safe harbor
2018	\$18,000	\$18,000
2019	\$16,000	\$13,440 (\$42,000 x .32)
2020	\$9,600	\$8,064 (\$42,000 x .1920)
2021	\$5,760	\$4,838 (\$42,000 x .1152)
2022	\$5,760	\$4,838 (\$42,000 x .1152)
2023	\$5,760	\$2,419 (\$42,000 x .0576)
TOTAL		\$51,599

(d) As of January 1, 2024 (the beginning of the first taxable year succeeding the end of the recovery period), the adjusted depreciable basis of the passenger automobile is \$8,401 (\$60,000 unadjusted depreciable basis less the total depreciation allowable of \$51,599 for 2018-2023 (see above table)). Accordingly, for the 2024 taxable year, X deducts depreciation of \$5,760 for the passenger automobile (the lesser of the adjusted depreciable basis of \$8,401 as of January 1, 2024, or the § 280F(a)(1)(B)(ii) limitation of \$5,760).

(e) As of January 1, 2025, the adjusted depreciable basis of the passenger automobile is \$2,641 (\$8,401 adjusted depreciable basis as of January 1, 2024, less the depreciation claimed of \$5,760 for 2024). Accordingly, for the 2025 taxable year, X deducts depreciation of \$2,641 for the passenger automobile (the lesser of the adjusted depreciable basis of \$2,641 as of January 1, 2025, or the § 280F(a)(1)(B)(ii) limitation of \$5,760).

Example 2 – Section 179 deduction claimed. The facts are the same as in [Example 1](#), except X elects to treat \$18,000 of the cost of the passenger automobile as an expense under § 179. As a result, this passenger automobile is not within the scope of this revenue procedure pursuant to section 3.01(4) of this revenue procedure. Accordingly, the safe harbor method of accounting in section 4.03 of this revenue procedure does not apply to the passenger automobile. For 2018, the 100-percent additional first year depreciation deduction and the § 179 deduction for this passenger automobile is limited to \$18,000 under § 280F(a)(1)(A)(i) (see Table 2 of Rev. Proc. 2018-25). Therefore, for 2018, X deducts \$18,000 for the passenger automobile under § 179, and X deducts the excess amount of \$42,000 beginning in 2024, subject to the annual limitation of \$5,760 under § 280F(a)(1)(B)(ii).

Example 3 – Section 168(k)(7) election made. The facts are the same as in [Example 1](#), except X makes an election under § 168(k)(7) to not claim the 100-percent additional first year depreciation deduction for 5-year property placed in service during 2018. As a result, the 100-percent additional first year depreciation deduction is not allowable for the passenger automobile. Accordingly, the passenger automobile is not within the scope of this revenue procedure pursuant to section 3.01(2) of this revenue procedure, and the safe harbor method of accounting in section 4.03 of this revenue procedure does not apply to the passenger automobile. For 2018 and subsequent taxable years, X determines the depreciation deductions for the passenger automobile in accordance with the general depreciation system of § 168(a), subject to the § 280F(a) limitations.

F. Credits

G. Natural Resources Deductions & Credits

H. *Loss Transactions, Bad Debts, and NOLs*

1. *Those NOLs are not worth what they used to be (at least until 2026).* The [2017 Tax Cuts and Jobs Act](#), § 11012, amended § 461 by adding § 461(l), which disallows “excess business losses” for noncorporate taxpayers for taxable years beginning in 2018. Such “excess business losses” are determined after application of the passive loss rules of § 469. Essentially, as the authors read the statute, losses disallowed for a taxable year under § 461(l) are carried over to the next taxable year and become NOL carryforwards subject to revised § 172(a) (discussed below). Thus, the practical effect of § 461(l) appears to be a one-year deferral of “excess business losses.” An “excess business loss” is defined as the amount by which a noncorporate taxpayer’s aggregate trade or business deductions exceed aggregate gross income from those trades or businesses, plus \$250,000 (\$500,000 for joint filers). The term “aggregate trade or business deductions” apparently does not include § 172 carryforwards, so NOLs carried forward from 2017 and prior taxable years are not limited by new § 461(l). Such carryforwards are, however, limited by the changes made to § 172(a) (as discussed below). For partnerships and S corporations, new § 461(l) applies at the partner or shareholder level, and for farmers, the prior limitation on “excess farm losses” under § 461(j) is suspended so that only § 461(l) applies to limit such losses. After 2018, the cap on “excess business losses” is adjusted annually for inflation. Mercifully, new § 461(l) sunsets for taxable years beginning on or after January 1, 2026.

a. *Surely you jest . . . there’s even more bad news for NOLs?* The [2017 Tax Cuts and Jobs Act](#), § 13302(a), amended § 172(a) such that, for taxable years beginning in 2018, NOLs (except “farming losses” and NOLs of non-life insurance companies) no longer may be carried back two years, and any carried forward NOLs are capped at 80 percent of taxable income (computed without regard to NOLs). This change to § 172(a) is permanent.

b. *The good news: NOLs now are like BFFs; they stick with you until you die!* The [2017 Tax Cuts and Jobs Act](#), § 13302(b), amended § 172(b)(1)(A)(ii) so that NOLs may be carried forward indefinitely (except by non-life insurance companies) rather than being limited to 20 years as under pre-TCJA law. This change to § 172(b) is permanent.

c. *Wait for it . . . wait for it . . .* [IR-2018-254](#) (12/18/18). Treasury and the Service have yet to release any official administrative guidance concerning the above changes to the rules for NOLs. The only new information we have regarding the above-described changes is the foregoing news release.

I. *At-Risk and Passive Activity Losses*

1. *California taxpayer with “trashy” tenants qualifies as real estate professional, but another with a bogus calendar that conflicted with bank statements does not.* [Franco v. Commissioner](#), T.C. Summary Op. 2018-9 (03/06/18); and [Pourmirzaie v. Commissioner](#), 115 T.C.M. (CCH) 1101, 2018 T.C.M. (RIA) ¶ 2018-26 (03/08/18). These two recent cases issued just days apart somewhat humorously demonstrate what it takes to avoid the passive loss rules by establishing real estate professional status under § 469(c)(7). Rental activity is per se passive under § 469(c)(2); however, pursuant to § 469(c)(7), certain taxpayers may qualify for the so-called “real estate professional” exception to the passive loss rules. A taxpayer qualifies as a real estate professional if the taxpayer adequately establishes that (i) more than half of the personal services the taxpayer performed in trades or businesses during the year were performed in real property trades or businesses, and (ii) the taxpayer performed more than 750 hours of services in real property trades or businesses in which the taxpayer materially participated during the year. Contemporaneous daily time reports, logs, or similar documents are the best way to prove hours worked and material participation, but Reg. § 1.469-5T(f)(4) also provides that hours worked and material participation may be established by any “reasonable means.” In *Franco v. Commissioner*, Special Trial Judge Guy ruled that a California taxpayer who testified that his tenants “were not attentive to trash disposal matters” and that he therefore had made weekly trips to his rental properties to ensure that “trash bins were set out for collection” and who could produce an activity log, numerous emails, and home improvement store receipts relating to his rental properties qualified under § 469(c)(7). On the other hand, in *Pourmirzaie v. Commissioner*, a California couple who attempted to establish material participation through testimony and by producing a calendar that was reconstructed from memory during the course of the

audit did not qualify as a real estate professional. Although the couple's testimony and reconstructed calendar in *Pourmirzaie* would have established material participation, the Service pointed the Tax Court to the couple's bank statements. The bank statements showed purchases in London, Dallas, Philadelphia, Boca Raton, and New York on the same dates that the couple's reconstructed calendar showed work at their rental properties. Judge Halpern held the couple did not qualify for the § 469(c)(7) exception because "[s]imply stated, we do not believe" their testimony or the reconstructed calendar.

2. *No passivity here; taxpayer's active and involved management of multiple rental properties establishes her as a real estate professional for purposes of § 469.* [Birdsong v. Commissioner](#), 116 T.C.M. (CCH) 274, 2018 T.C.M. (RIA) ¶ 2018-148 (9/10/18). The taxpayers were a married couple. The Tax Court (Judge Vasquez) concluded that the wife's activities indicated that she was a real estate professional under § 469(c)(7)(B) and materially participated and thus did not have a passive activity loss under § 469(c)(2). Section 469(a) generally disallows passive activity losses. Under § 469(c)(1) a passive activity is any trade or business in which the taxpayer does not materially participate. A rental activity is generally treated as a per se passive activity regardless of whether the taxpayer materially participates pursuant to § 469(c)(2), but the rental activities of a taxpayer who qualifies as a real estate professional are not per se passive activities according to § 469(c)(7). Instead such activities are treated as a trade or business subject to the material participation requirements of § 469(c)(1). A taxpayer is a real estate professional if: "(i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and (ii) such taxpayer performs more than 750 hours of services during the taxable year [in such real property trades or businesses]." § 469(c)(7)(B). The Tax Court cited Reg. § 1.469-5T(f)(4) for the requirements to establish the taxpayer's hours of participation. This provision states in part that the "extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means." Moreover, Judge Vasquez noted that other Tax Court decisions "have held that the regulations do not allow a post-event, 'ballpark guesstimate'" (citing *Bailey v. Commissioner*, T.C. Memo. 2001-296; *Goshorn v. Commissioner*, T.C. Memo. 1993-578). With that in mind, the Tax Court found the taxpayers' narrative summary alongside the "thorough time logs," which indicated the wife spent 1,136.25 hours managing the rental properties in 2014, "convincing because [taxpayers] owned numerous rental units that [the] wife operated alone" (citing *Hailstock v. Commissioner*, T.C. Memo. 2016-146, at *21 for its holding that the "taxpayer's credible testimony regarding time spent operating multiple properties alone satisfied the section 469(c)(2) requirements."). Thus, the Tax Court held that the wife "materially participated and is a real estate professional" (meeting both requirements under § 469(c)(7)(B)), and accordingly held that the taxpayers' "loss attributable to their rental real estate [was] not limited by the passive activity loss rules of section 469," which meant that the taxpayers had no tax underpayment and no accuracy-related penalty.

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. *The Service searched unsuccessfully for sale or exchange treatment on Monster.com.* [Estate of McKelvey v. Commissioner](#), 148 T.C. 312 (4/19/17). The decedent in this case was the founder and CEO of Monster Worldwide, Inc. (Monster), known for its job-search website, monster.com. In 2008, the decedent entered into variable prepaid forward contracts (VPFC) with two investment banks. Pursuant to the terms of each VPFC, the decedent received a cash payment from each investment bank in exchange for his agreement to deliver Monster shares or their cash equivalents over the course of several future settlement dates. The number of shares of Monster that the decedent was obligated to deliver varied and was determined by a formula that took into account the closing price of Monster shares on the settlement dates. In connection with each VPFC, the decedent pledged a specified number of shares of Monster stock to secure his obligations but could substitute other collateral with the bank's consent. In the same year, prior to the first settlement date, the decedent entered into an agreement with each investment bank pursuant to which the decedent made a cash payment to each bank in exchange for the bank's agreement to extend the settlement dates. Following the decedent's death, his estate delivered the requisite number of Monster shares to the banks. The

Service acknowledged that the initial VPFCs qualified for open transaction reporting under Rev. Rul. 2003-7, 2003-1 C.B. 363. However, the Service took the position that the agreements pursuant to which the settlement dates were extended: (1) were taxable exchanges of the original VPFCs for the extended VPFCs that resulted in short-term capital gain of \$88 million, and (2) resulted in constructive sales of the underlying Monster shares under § 1259 that gave rise to long-term capital gain of \$112.8 million. The Tax Court (Judge Ruwe) held that the extension agreements did not result in taxable exchanges and that the extensions did not constitute constructive sales under § 1259. The court reasoned that, in order for the extensions to constitute taxable exchanges of the VPFCs, “two conditions must be satisfied: (1) the original VPFCs must constitute property to decedent at the time of the extensions and (2) the property must be exchanged for other property differing materially either in kind or in extent.” The first condition, the court concluded, was not satisfied. The VPFCs were not property of the decedent, but rather obligations of the decedent. Once the decedent had received the cash payments under the VPFCs, the decedent had only the obligation to deliver a specified number of Monster shares or their cash equivalent. The court also rejected the government’s argument that the extensions resulted in constructive sales of the underlying Monster shares under § 1259. Section 1259(a)(1) provides that, if there is a constructive sale of an appreciated financial position, the taxpayer must recognize gain as if that position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. Under § 1259(c)(1)(C), a constructive sale of an appreciated financial position occurs if a taxpayer “enters into a future or forward contract to deliver the same or substantially identical property,” but according to the provision’s legislative history, a forward contract does not result in a constructive sale of stock if it calls for the delivery of “an amount of property, such as shares of stock, that is subject to significant variation under the contract terms.” The court reasoned that the Service’s acceptance of open transaction reporting for the initial VPFCs meant that the Service acknowledged that the initial VPFCs did not trigger a constructive sale under § 1259. Accordingly, the Service’s argument that the extensions resulted in constructive sales under § 1259 “is predicated upon a finding that there was an exchange of the extended VPFCs for the original VPFCs,” a finding that the court had already declined to make.

a. *But the Second Circuit has determined that the Service’s search for taxes is not yet finished.* [Estate of McKelvey v. Commissioner](#), 906 F.3d 26 (2d Cir. 9/26/18), *rev’g and remanding* 148 T.C. No. 13. The Second Circuit, in an opinion by Judge Newman, reversed the Tax Court’s decision against the Service and in favor of the decedent-taxpayer and remanded the case for a determination of both the potential short-term capital gain and long-term capital gain to be recognized in 2008 prior to the decedent-taxpayer’s death. Although the Second Circuit agreed with the Tax Court that the extension of the VPFCs in 2008 did not equate to a taxable exchange of the VPFCs because the contracts were obligations, not property, the Second Circuit sided with the Service that the extensions could be “terminations” of the VPFCs resulting in gain under § 1234A. Section 1234A provides that “[g]ain . . . attributable to the cancellation . . . or other termination of . . . a right or obligation . . . with respect to property which is . . . a capital asset in the hands of the taxpayer . . . shall be treated as gain . . . from the sale of a capital asset.” The Service had not argued the application of § 1234A in the Tax Court; however, for reasons that are not clear from the opinion both the decedent-taxpayer and the Service agreed that the issue could be raised on appeal. The Second Circuit reasoned that although the 2008 extension of the original VPFCs was not a sale or exchange giving rise to gain, the 2008 extension did rise to the level of a *new contract*, not merely a “continuation” of the original VPFCs as the Tax Court had held. Therefore, the Second Circuit decided that with respect to the issue of recognition of short-term capital gain in 2008 and the amount thereof (if any), the case should be remanded to Tax Court to determine if the extension amounted to a “termination” of the original VPFCs within the meaning of § 1234A. With respect to the issue of long-term capital gain recognizable by the decedent-taxpayer in 2008, the Service made the same argument that it had made in the Tax Court. Namely, that a constructive sale occurred with respect to the decedent-taxpayer’s Monster.com shares in 2008 under § 1259 when the VPFCs were extended. Section 1259 provides for constructive sale treatment if a taxpayer holds an “appreciated financial position” in stock and enters into a “forward contract to deliver the same or substantially identical property.” § 1259(c)(1)(C). A “forward contract” is defined for this purpose as “a contract to deliver a *substantially fixed amount of property* (including cash) at a substantially fixed price.” § 1259(d)(1) (emphasis added). Neither the Service nor the estate disputed that on the date the original VPFCs were extended the decedent-taxpayer’s Monster.com stock

was in an “appreciated financial position.” The dispute centered upon whether the decedent-taxpayer’s Monster.com shares were a “substantially fixed amount of property.” Under the original VPFCs, the Monster.com shares to be delivered under the VPFCs were not substantially fixed because fluctuations in the value would affect the shares ultimately delivered to the banks. Nonetheless, the Service argued that in 2008 when the original VPFCs were extended, new contracts were created under § 1259 and the amount of Monster.com shares to be delivered to the banks under the new VPFCs became “substantially fixed” before the decedent-taxpayer’s death. The amount of Monster.com shares to be delivered became substantially fixed, according to the Service, because of a dramatic drop in the market value of the Monster.com shares. Specifically, and based upon expert testimony, the Service asserted that there was a probability of over 85 percent that all the Monster.com shares pledged under the VPFCs would be required to be delivered upon eventual settlement scheduled for 2010. The Second Circuit first agreed with the Service that the extended VPFCs were new contracts for the purpose of IRC § 1259, not merely “continuations” as the Tax Court had held. Next, acknowledging that no court had addressed whether probability analysis can be used to determine if an amount of property is “substantially fixed” for purposes of finding a constructive sale under § 1259, the Second Circuit decided (citing a deep-in-the-money option case, *Progressive Corp. v. United States*, 970 F.2d 188 (6th Cir. 1992), as precedent) that using probability analysis was appropriate in this case. On this basis, the Second Circuit decided that the 85 percent plus probability of all Monster.com shares being used to settle the amended VPFCs as found by the Service’s expert was sufficient to substantially fix the amount of property within the meaning of § 1259. Accordingly, the Second Circuit agreed with the Service that under § 1259 a constructive sale of the decedent-taxpayer’s Monster.com took place in 2008 before the decedent-taxpayer’s death; however, the Second Circuit remanded the case to the Tax Court to determine the amount of long-term capital gain that the decedent-taxpayer should recognize in 2008. Judge Cabranes wrote a concurring opinion to clarify that the Second Circuit’s analysis does not affect the application of Reg. § 1.1001-3 to holders and issuers of *debt* instruments.

2. 🎵 *We’re off to see the wizard, the wonderful wizard of QOZ!* 🎵 The [2017 Tax Cuts and Jobs Act](#), § 13823, added §§ 1400Z-1 and 1400Z-2 to the Code relating to qualified opportunity zones (“QOZs”) and qualified opportunity funds (“QOFs”). New §§ 1400Z-1 and 1400Z-2 are designed to encourage economic growth and investment in designated distressed communities (i.e., QOZs) by providing federal income tax benefits to taxpayers who invest in certain funds (i.e., QOFs) that in turn invest in businesses and real estate located in these designated communities. Generally, two main tax incentives are provided: deferral of inclusion in gross income for certain gains to the extent that corresponding amounts are reinvested in a QOF; and exclusion from gross income of the post-acquisition gains on investments in QOFs that are held for at least 10 years. We will not attempt to summarize the extensive rules and limitations here; however, we alert our readers to the several 2018 items concerning new §§ 1400Z-1 and 1400Z-2.

- [Rev. Proc. 2018-16](#), 2018-9 I.R.B. 383 (2/18/18), provides guidance to states on the procedures for nominating areas within those states as QOZs.
- [Notice 2018-48](#), 2018-28 I.R.B. 9 (6/20/18), provides a complete list of all QOZs.
- [REG-115420-18, Investing in Qualified Opportunity Funds](#), 83 FR 54279 (10/29/18), sets forth proposed regulations regarding §§ 1400Z-1 and 1400Z-2.
- [REG-115420-18, Investing in Qualified Opportunity Funds; Correction](#), 83 FR 67171 (12/28/18), sets forth certain minor corrections to the proposed regulations.

3. *Taxpayer restores money-pit mansion to its former glory, but due to taxpayer’s failure to rent or hold out for rental, gets “hammered” by capital loss.* [Keefe v. Commissioner](#), 115 T.C.M. (CCH) 1113, 2018 T.C.M. (RIA) ¶ 2018-28 (3/15/18). These married taxpayers, neither of whom was an architect or contractor, acquired and restored Wrentham House, a historic mansion in Newport, Rhode Island. From May of 2000 until May of 2008 the taxpayers spent approximately \$10 million repairing and restoring the mansion with the ultimate goal of turning it into a luxury vacation rental property. Notwithstanding taxpayers’ \$10 million investment in the mansion, structural and other problems prevented the property from being marketable as a rental property until June of 2008. At that time, of course, the “Great Recession” was in full swing, and there was virtually no market and no prospect for luxury rentals. Consequently, the mansion was never rented or even seriously marketed

for rental, and in August of 2009, the mansion was sold in a short sale for approximately \$6 million. The taxpayers claimed that the mansion was § 1231 property used in a trade or business thereby entitling them to ordinary loss treatment. The Service contended that the mansion was not used in a trade or business but instead was a capital asset, so the loss on the short sale was a capital loss subject to the \$3,000 per year limitation of § 1211(b). The Tax Court (Chief Judge Marvel) held for the Service. Citing *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953) because the case would be appealable to the Second Circuit Court of Appeals, Judge Marvel explained that the taxpayers failed to show that their alleged rental activities were “sufficient, continuous, and substantial enough to constitute a trade or business with respect to rental of the property.” Accordingly, § 1231 did not apply to the mansion, so the mansion was a capital asset subject to the capital loss limitation of § 1211(b). The court also upheld the Service’s imposition of accuracy-related penalties.

B. *Interest, Dividends, and Other Current Income*

C. *Profit-Seeking Individual Deductions*

1. *Say it ain't so! Miscellaneous itemized deductions are no longer deductible beginning in 2018.* The 2017 Tax Cuts and Jobs Act, § 11045, amended Code § 67 by adding § 67(g), which disallows as deductions all miscellaneous itemized deductions for taxable years beginning after 2017 and before 2026. Miscellaneous itemized deductions are defined in § 67(b) and, prior to the Tax Cuts and Jobs Act, were deductible to the extent that, in the aggregate, they exceeded 2 percent of the taxpayer’s adjusted gross income. The largest categories of miscellaneous itemized deductions are: (1) investment-related expenses such as fees paid for investment advice or for a safe deposit box used to store investment-related items, (2) unreimbursed employee business expenses, and (3) tax preparation fees.

a. *But estates and non-grantor trusts can breathe a sigh of relief.* Notice 2018-61, 2018-31 I.R.B. 278 (7/13/18). Under § 67(e), the adjusted gross income of an estate or trust generally is computed in the same manner as that of an individual. Furthermore, prior to the Tax Cut and Jobs Act, estates and non-grantor trusts were subject to the 2 percent floor on miscellaneous itemized deductions like individuals *unless* a cost paid or incurred by the estate or non-grantor trust “would not have been incurred if the property were not held in such estate or trust.” Put differently, estates and non-grantor trusts avoided the 2 percent floor on miscellaneous itemized deductions if they paid or incurred a cost that “commonly or customarily” would not have been paid or incurred by a hypothetical individual holding the same property as the estate or non-grantor trust. For example, Reg. § 1.67-4(b)(3) provides as follows:

Tax preparation fees. Costs relating to all estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent’s final individual income tax returns are not subject to the 2-percent floor. The costs of preparing all other tax returns (for example, gift tax returns) are costs commonly and customarily incurred by individuals and thus are subject to the 2-percent floor.

If a fee (such as a tax preparation fee) paid or incurred by an estate or non-grantor trust was bundled so that it included costs that were both subject to the 2 percent floor (e.g., gift tax return) and not subject to the 2 percent floor (e.g., fiduciary income tax return), then the estate or non-grantor trust must allocate the bundled fee appropriately.

The enactment of new § 67(g), which states that “no miscellaneous itemized deduction” is allowed until 2026, left many estates and trusts wondering whether their investment-related and tax-related expenses (e.g., return preparation fees, trustee fees, financial advisor fees, etc.) peculiar to the administration of an estate or trust remain deductible either in whole or in part. Notice 2018-61 announces that Treasury and the Service do not read new § 67(g) to disallow all investment- and tax-related expenses of estates and non-grantor trusts. Thus, the Treasury Department and the Service intend to issue regulations clarifying that estates and non-grantor trusts may continue to deduct investment- and tax-related expenses just as they could prior to the enactment of new § 67(g). Notice 2018-61 also announces that Treasury and the Service are aware of concerns surrounding whether new § 67(g) impacts a beneficiary’s ability to deduct investment- and tax-related expenses pursuant to

§ 642(h) (unused loss carryovers and excess deductions) upon termination of an estate or non-grantor trust. Treasury and the Service intend to issue regulations addressing these concerns as well.

D. *Section 121*

E. *Section 1031*

F. *Section 1033*

G. *Section 1035*

H. *Miscellaneous*

IV. COMPENSATION ISSUES

A. *Fringe Benefits*

1. *Ministers pray this “crabby” case gets reversed (again!) on appeal.* [Gaylor v. Mnuchin](#), 278 F.Supp.3d 1081 (W.D. Wis. 10/6/17). In a case that previously was overturned on appeal to the Seventh Circuit, the U.S. District Court for the Western District of Wisconsin (Judge Crabb) held that § 107(2) is unconstitutional because it violates the First Amendment’s establishment clause. Section 107(2) excludes from gross income a “rental allowance” paid to a minister as part of his or her compensation. Section 107(1) excludes the “rental value of a home” furnished to a minister as part of his or her compensation. For technical reasons, only § 107(2)’s “rental allowance” exclusion was at issue in this case. The named plaintiff, Gaylor, is co-president of the true plaintiff, Freedom from Religion Foundation, Inc. (“FFRF”). In a prior iteration of the case, *Freedom from Religion Foundation, Inc. v. Lew*, 773 F.2d 815 (7th Cir. 2014), the Seventh Circuit vacated Judge Crabb’s prior ruling striking down § 107(2) by determining that FFRF lacked standing to sue; however, the Seventh Circuit essentially instructed FFRF on how it might obtain standing. FFRF dutifully followed the Seventh Circuit’s directions and then refiled its claim with Judge Crabb that § 107(2) violates the First Amendment’s establishment clause. FFRF argued that § 107(2) violates the establishment clause because it “demonstrates a preference for ministers over secular employees.” Judge Crabb agreed and ruled that § 107(2) is unconstitutional and ordered the IRS to cease enforcing the statute. In a subsequent decision, though, Judge Crabb ordered that the court’s injunction prohibiting enforcement of the statute be stayed until 180 days after resolution of any appeal. *See Gaylor v. Mnuchin*, 2017 U.S. Dist. LEXIS 209746, 2017 WL 6375819 (12/13/17). In other words, stay tuned . . .

a. *Prayers answered!* [Gaylor v. Mnuchin](#), 919 F.3d 420 (7th Cir. 3/15/19), *rev’g* 278 F.Supp.3d 1081 (W.D. Wis. 10/6/17). On appeal, the Seventh Circuit reversed and upheld the constitutionality of § 107(2). Treasury and the IRS argued before the Seventh Circuit that although § 107(2) seems to advance a religious purpose by excluding rental allowances paid to “ministers of the gospel,” the history of § 107(2) reveals a secular purpose. To wit, Congress enacted § 107 in 1923 as a response to the IRS’s original position in 1921 that the “convenience of the employer” exception for employer-providing housing (now codified at § 119(a)(2)) did not apply to ministers. Treasury and IRS argued that § 107(2) was merely an extension of the “convenience of the employer” exception to gross income, not an impermissible government “establishment” of a religious preference. Writing for the court, Judge Brennan agreed, stating:

Reading § 107(2) in isolation from the other convenience-of-the-employer provisions, and then highlighting the term “minister,” could make the challenged statute appear to provide a government benefit exclusively to the religious. But reading it in context, as we must, we see § 107(2) is simply one of many per se rules that provide a tax exemption to employees with work-related housing requirements.

Moreover, Judge Brennan explained that although § 107(2) has broader application than the “convenience of the employer” exception of § 119(a)(2), the breadth of § 107(2) does not render the statute unconstitutional. In fact, Judge Brennan reasoned that § 107(2) is broadly written to avoid excessive government entanglement with the internal operations of a church. Otherwise, without § 107(2), § 119(a)(2) would require the IRS to interrogate ministers as to the use of their homes for religious purposes. Further, § 119(a)(2) would require the IRS to determine the scope of the “business” of the church and where and how far the “premises” of the church extend. As written, § 107(2) avoids

such excessive entanglement of government into the affairs of the church. Similarly, the court determined that § 107(2) does not unconstitutionally “advance” religion over secular purposes because providing a tax exemption does not “connote[] sponsorship, financial support, and active involvement of the [government] in religious activity.” Finally, the court ruled that § 107(2) passes the “historical significance” test under the establishment clause because tax exemptions have been provided to religious and religious-affiliated organizations by Congress almost since the Sixteenth Amendment authorized the federal income tax in 1913.

2. *Those who move for work-related reasons now have a higher tax bill. Is this really good for the economy?* Provided that certain requirements are met, Code § 217 allows a taxpayer to deduct moving expenses paid or incurred in connection with the taxpayer’s commencement of work (either as an employee or as a self-employed individual) at a new principal place of work. Section 132(g) of the Code excludes from an employee’s gross income a “qualified moving expense reimbursement,” defined as an employer’s reimbursement of moving expenses that, if paid by the employee, would be deductible under § 217. The [2017 Tax Cuts and Jobs Act](#) amended both provisions. Section 11049 of the TCJA amended Code § 217 by adding § 217(k), which provides that the deduction for moving expenses shall not apply to any taxable year beginning after 2017 and before 2026. Section 11048 of the TCJA amended Code § 132(g) by adding § 132(g)(2), which provides that the exclusion from gross income for a qualified moving expense reimbursement shall not apply to any taxable year beginning after 2017 and before 2026. Both amendments contain an exception for members of the armed forces on active duty who move pursuant to a military order and incident to a permanent change of station, i.e., such individuals can still deduct moving expenses and exclude moving expense reimbursements.

a. *Individuals can exclude from gross income reimbursements received from employers in 2018 for expenses incurred in connection with moves that occurred before 2018.* [Notice 2018-75](#), 2018-41 I.R.B. 556 (9/21/18). Prior to the [2017 Tax Cuts and Jobs Act](#), § 132(a)(6) permitted individuals to exclude from gross income a “qualified moving expense reimbursement,” defined in § 132(g) as an employer’s reimbursement of moving expenses that, if paid by the individual, would be deductible under § 217. In the Tax Cuts and Jobs Act, Congress suspended this exclusion (except with respect to members of the armed forces on active duty who move pursuant to military orders) for taxable years beginning after 2017 and before 2026. This notice provides that the suspension of the exclusion does not apply to individuals who receive reimbursements from employers in 2018 for expenses incurred in connection with moves that occurred before 2018. The notice provides as follows:

Thus, if an individual moved in 2017 and the expenses for the move would have been deductible by the individual under section 217 as in effect prior to the amendments made by the Act if they had been paid directly by the individual in 2017, and the individual did not deduct the moving expenses, then the amount received (directly or indirectly) in 2018 by the individual from an employer as payment for or reimbursement of the expenses will be a qualified moving expense reimbursement under section 132(g)(1).

An individual therefore can exclude such payments by employers from gross income regardless of whether the employer paid the moving expense directly or instead reimbursed the individual. The notice provides that employers who have included such amounts in an individual’s wages or compensation for purposes of federal employment taxes (and therefore have withheld and paid federal employment taxes on these amounts) can use the adjustment process under § 6413 or the refund claim process under § 6402 to correct the overpayment of federal employment taxes.

B. *Qualified Deferred Compensation Plans*

1. *Relief for certain closed defined benefit pension plans.* [Notice 2014-5](#), 2014-2 I.R.B. 276 (12/13/13). This notice provides temporary nondiscrimination relief for certain “closed” defined benefit pension plans (i.e., those that provide ongoing accruals but that have been amended to limit those accruals to some or all of the employees who participated in the plan on a specified date). Typically, new hires are offered only a defined contribution plan, and the closed defined benefit plan has an increased proportion of highly compensated employees.

a. *The relief is extended to plan years beginning before 2017.* [Notice 2015-28](#), 2015-14 I.R.B. 848 (3/19/15). This notice extends for an additional year the temporary nondiscrimination relief originally provided in Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13), by applying that relief to plan years beginning before 2017. The notice cautions that all remaining provisions of the nondiscrimination regulations under § 401(a)(4) (including the rules relating to the timing of plan amendments under Reg. § 1.401(a)(4)-5) continue to apply. Treasury and the Service anticipate issuing proposed amendments to the § 401(a)(4) regulations that would be finalized and apply after the relief under Notice 2014-5 and this notice expires.

b. *Proposed regulations provide nondiscrimination relief for certain closed plans and formulas and make other changes.* [REG-125761-14, Nondiscrimination Relief for Closed Defined Benefit Pension Plans and Additional Changes to the Retirement Plan Nondiscrimination Requirements](#), 81 F.R. 4976 (1/29/16). The Treasury Department and the Service have published proposed amendments to the regulations under § 401(a)(4), which provides generally that a plan is a qualified plan only if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees. The proposed regulations modify a number of provisions in the existing regulations under § 401(a)(4) to address situations and plan designs that were not contemplated in the development of the existing regulations. Many of the changes in the proposed regulations provide nondiscrimination relief for certain closed plans and formulas, but the proposed regulations also include other changes that are not limited to closed plans and formulas. The proposed amendments generally would apply to plan years beginning on or after the date of publication of final regulations and, subject to some significant exceptions, taxpayers are permitted to apply the provisions of the proposed regulations for plan years beginning on or after 1/1/14.

c. *The relief is extended to plan years beginning before 2018.* [Notice 2016-57](#), 2016-40 I.R.B. 432 (9/19/16). This notice extends for an additional year the temporary nondiscrimination relief originally provided in Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13), by applying that relief to plan years beginning before 2018. The Service has done so because it anticipates that the proposed regulations ([REG-125761-14, Nondiscrimination Relief for Closed Defined Benefit Pension Plans and Additional Changes to the Retirement Plan Nondiscrimination Requirements](#), 81 F.R. 4976 (1/29/16)) will not be published as final regulations in time for plan sponsors to make plan design decisions based on the final regulations before expiration of the relief provided under Notice 2014-5 (as extended by Notice 2015-28). Therefore, the Service has extended the relief for an additional year.

d. *The relief is extended to plan years beginning before 2019.* [Notice 2017-45](#), 2017-38 I.R.B. 232 (8/31/17). This notice extends for an additional year the temporary nondiscrimination relief originally provided in Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13), by applying that relief to plan years beginning before 2019. The Service has done so because it anticipates that the proposed regulations ([REG-125761-14, Nondiscrimination Relief for Closed Defined Benefit Pension Plans and Additional Changes to the Retirement Plan Nondiscrimination Requirements](#), 81 F.R. 4976 (1/29/16)) will not be published as final regulations in time for plan sponsors to make plan design decisions based on the final regulations before expiration of the relief provided under Notice 2014-5 (as last extended by Notice 2016-57). Therefore, the Service has extended the relief for an additional year.

e. *The relief is extended to plan years beginning before 2020.* [Notice 2018-69](#), 2018-37 I.R.B. 426 (8/24/18). This notice extends for an additional year the temporary nondiscrimination relief originally provided in Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13), by applying that relief to plan years beginning before 2020. The Service has done so because it anticipates that the proposed regulations ([REG-125761-14, Nondiscrimination Relief for Closed Defined Benefit Pension Plans and Additional Changes to the Retirement Plan Nondiscrimination Requirements](#), 81 F.R. 4976 (1/29/16)) will not be published as final regulations in time for plan sponsors to make plan design decisions based on the final regulations before expiration of the relief provided under Notice 2014-5 (as last extended by Notice 2017-45). Therefore, the Service has extended the relief for an additional year.

2. *Some inflation-adjusted numbers for 2019.* Notice 2018-83, 2018-47 I.R.B. 774 (11/1/18).

- Elective deferral in §§ 401(k), 403(b), and 457 plans are increased from \$18,500 to \$19,000 with a catch-up provision for employees aged 50 or older that remains unchanged at \$6,000.

- The limit on contributions to an IRA is increased to \$6,000 (from \$5,500). The AGI phase-out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to \$64,000 to \$74,000 (from \$63,000-\$73,000) for single filers and heads of household, increased to \$103,000-\$123,000 (from \$101,000-\$121,000) for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, and increased to \$189,000-\$199,000 (from \$193,000-\$203,000) for an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered. The phase-out range for contributions to a Roth IRA is increased to \$193,000-\$203,000 (from \$189,000-\$199,000) for married couples filing jointly, and increased to \$122,000-\$175,000 (from \$120,000-\$135,000) for singles and heads of household.

- The annual benefit from a defined benefit plan under § 415 is increased to \$225,000 (from \$220,000).

- The limit for defined contribution plans is increased to \$56,000 (from \$55,000).

- The amount of compensation that may be taken into account for various plans is increased to \$280,000 (from \$275,000), and is increased to \$415,000 (from \$405,000) for government plans.

- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to \$64,000 (from \$63,000) for married couples filing jointly, increased to \$48,000 (from \$47,250) for heads of household, and increased to \$32,000 (from \$31,500) for singles and married individuals filing separately.

3. *They were just kidding! Treasury and the IRS no longer plan to amend the regulations under § 401(a)(9) to prohibit giving retirees receiving annuity payments the option to receive a lump sum payment.* Notice 2019-18, 2019-13 I.R.B. 915 (3/6/19). A number of sponsors of defined benefit plans have amended their plans to provide a limited period during which certain retirees who are currently receiving lifetime annuity payments from those plans may elect to convert their annuities into lump sums that are payable immediately. These arrangements are sometimes referred to as retiree lump-sum windows. In Notice 2015-49, 2015-30 I.R.B. 79 (7/9/15), the IRS announced that Treasury and the IRS planned to amend the required minimum distribution regulations under § 401(a)(9) to provide that qualified defined benefit plans generally are not permitted to replace any joint and survivor, single life, or other annuity currently being paid with a lump sum payment or other accelerated form of distribution. With certain exceptions, the amendments to the regulations were to apply as of July 9, 2015. Notice 2019-18 provides that Treasury and the IRS no longer intend to propose the amendments to the regulations under § 401(a)(9) that were described in Notice 2015-49. The notice indicates that Treasury and the IRS will continue to study the issue of retiree lump-sum windows. The notice further provides:

Until further guidance is issued, the IRS will not assert that a plan amendment providing for a retiree lump-sum window program causes the plan to violate § 401(a)(9), but will continue to evaluate whether the plan, as amended, satisfies the requirements of §§ 401(a)(4), 411, 415, 417, 436, and other sections of the Code. During this period, the IRS will not issue private letter rulings with regard to retiree lump-sum windows. However, if a taxpayer is eligible to apply for and receive a determination letter, the IRS will no longer include a caveat expressing no opinion regarding the tax consequences of such a window in the letter.

C. *Nonqualified Deferred Compensation, Section 83, and Stock Options*

1. *Employees of privately owned corporations can elect to defer income from “qualified equity grants” for up to five years.* The [2017 Tax Cuts and Jobs Act](#), § 13603, amended Code § 83 by adding § 83(i), which allows a “qualified employee” to elect to defer income attributable to “qualified stock” transferred to the employee by the employer. The election must be made no later than 30 days after the first time the employee’s right to the stock is substantially vested or is transferable, whichever occurs earlier. Generally, the effect of this provision is to allow the employee to defer including in income the amount that the employee normally would be required to include under the rules of § 83(a). Under the rules of § 83(h), the employer’s deduction for the value of the stock should be deferred until the employee includes the value in gross income. If the employee does *not* make the § 83(i) election, then the normal rules of § 83 apply. If the employee *does* make the § 83(i) election, then the employee must include in gross income the amount determined under § 83(a) (normally the fair market value of the stock less whatever the employee paid for it, *determined when the rights of the employee in the stock first become transferable or not subject to substantial risk of forfeiture*) upon the first to occur of the following: (1) the first date the qualified stock becomes transferable (including transferable to the employer); (2) the date the employee first becomes an “excluded employee;” (3) the first date on which any stock of the employer becomes readily tradable on an established securities market; (4) the date five years after the first date the employee’s right to the stock becomes substantially vested; or (5) the date on which the employee revokes his or her election. The statute contains many definitions. A “qualified employee” generally is any employee other than an “excluded employee.” Excluded employees are defined as a 1 percent owners (currently or during the ten preceding calendar years), those who have been at any prior time the Chief Executive Officer or the Chief Financial Officer, and those who are one of the four highest compensated officers (currently or during any of the ten preceding taxable years) determined on the basis of the shareholder disclosure rules for compensation under the Securities Exchange Act of 1934. “Qualified stock” is generally defined as stock transferred by an “eligible corporation” that is an employer of an employee in connection with the employee’s performance of services if the employee receives the stock either in connection with the exercise of an option or in settlement of a restricted stock unit. A corporation is an “eligible corporation” if (1) no stock of the corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year, and (2) the corporation has a written plan under which not less than 80 percent of all employees who provide services to the corporation in the United States (or any U.S. possession) are granted stock options, or are granted restricted stock units, with the same rights and privileges to receive qualified stock. A corporation that transfers qualified stock to an employee must provide notice to the employee that the stock is qualified stock and that the employee may be eligible to elect to defer income on such stock. This provision applies to options exercised, or restricted stock units settled, after 2017.

a. *Initial guidance on the income deferral of § 83(i).* [Notice 2018-97](#), 2018-52 IRB 1052 (12/7/18). The Service has provided initial guidance on the application of § 83(i). According to the notice, Treasury and the Service anticipate that further guidance on § 83(i) will be issued in the form of proposed regulations that will incorporate the guidance provided in the notice and will apply to any taxable year ending on or after December 7, 2018. Generally, the notice addresses the following issues: (1) application of the requirement in § 83(i)(2)(C)(i)(II) that grants be made to not less than 80 percent of all employees who provide services to the corporation in the United States, (2) application of federal income tax withholding to the deferred income related to the qualified stock, and (3) the ability of an employer to opt out of permitting employees to elect the deferred tax treatment even if the requirements under § 83(i) are otherwise met.

2. *The economic benefits resulting from an S corporation’s payment of premiums on a shareholder-employee’s life insurance policy under a compensatory split-dollar arrangement are treated as distributions to the shareholder, not as compensation.* [Machacek v. Commissioner](#), 906 F.3d 429 (6th Cir. 10/12/18), *rev’g* T.C. Memo. 2016-55 (3/28/16). The taxpayer and his wife were the sole shareholders of a subchapter S corporation. The taxpayer also was an employee of the S corporation. Pursuant to a benefit plan adopted by the S corporation, the corporation paid the \$100,000 annual premium on a life insurance policy on the taxpayer’s life under an arrangement that the parties agreed was a compensatory split-dollar arrangement. The Tax Court (Judge Laro) had held that the taxpayers

had to include in income the economic benefit of the arrangement. In an opinion by Judge White, the Sixth Circuit reversed and remanded and held that the economic benefits of the arrangement must instead be treated as distributions of property by the S corporation. The court relied on Reg. § 1.301-1(q)(1)(i), which provides:

the provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement, as defined in § 1.61-22(b)(1) or (2), of economic benefits described in § 1.61-22(d) . . . is treated as a distribution of property.

This provision, the court stated, applies whether the split-dollar arrangement is a shareholder arrangement or a compensatory arrangement and is dispositive. Thus, according to the court, when a shareholder-employee receives benefits under a compensatory arrangement, the “benefits are treated as a distribution of property and are thus deemed to have been paid to the shareholder in his capacity as a shareholder.”

D. *Individual Retirement Accounts*

V. **PERSONAL INCOME AND DEDUCTIONS**

A. *Rates*

B. *Miscellaneous Income*

1. *Provisions of the 2017 Tax Cuts and Jobs Act that affect ABLE accounts.*

a. *Designated beneficiaries of ABLE accounts can contribute an additional amount and are eligible for the saver’s credit.* Code § 529A, enacted by the Stephen Beck, Jr., Achieving a Better Life Experience (ABLE) Act of 2014 (which became Division A of the Tax Increase Prevention Act of 2014), provides a tax-favored savings account for certain individuals with disabilities—the ABLE account. ABLE accounts permit certain individuals who became disabled before reaching age 26 and their families to contribute amounts to meet expenses related to the designated beneficiary’s disability without affecting the beneficiary’s eligibility for Supplemental Security Income, Medicaid, and other public benefits. ABLE accounts are modeled on § 529 accounts that are used to save for college education. Like § 529 accounts, ABLE accounts must be established pursuant to a state program, contributions to ABLE accounts are not tax deductible, the earnings of the ABLE account are not subject to taxation, and distributions from ABLE accounts are not included in the designated beneficiary’s income to the extent they are used for qualified expenses related to the disability. Aggregate contributions to an ABLE account from all contributors cannot exceed the annual per-donee gift tax exclusion (\$15,000 in 2018). The [2017 Tax Cuts and Jobs Act](#), § 11024, amended Code § 529A to increase this contribution limit for contributions made before 2026. Under the increased limit, once the overall limitation on contributions is reached, an ABLE account’s designated beneficiary who is an employee (as defined) can contribute an additional amount equal to the lesser of: (1) the compensation includible in the beneficiary’s income for the year, or (2) the federal poverty line for a one-person household as determined for the immediately preceding year (\$12,486 for a single individual under age 65 in 2016). A designated beneficiary is considered to be an employee for this purpose only if the person is an employee with respect to whom no contribution is made to a defined contribution plan, an annuity contract described in § 403(b), or an eligible deferred compensation plan described in § 527. The legislation also makes designated beneficiaries of ABLE accounts who contribute eligible for the saver’s credit of § 25B for contributions made before 2026. Both amendments are effective for taxable years beginning after December 22, 2017, the date of enactment.

b. *Tax-free rollovers are permitted from a § 529 college savings account to an ABLE account.* The [2017 Tax Cuts and Jobs Act](#), § 11025, amends Code § 529 to permit amounts in a § 529 account to be rolled over without penalty to an ABLE account if the owner of the ABLE account is the designated beneficiary of the § 529 account or a member of the designated beneficiary’s family. Amounts rolled over pursuant to this provision, together with any other contributions to the ABLE account, are taken into account for purposes of the limit on aggregate contributions to the ABLE account. Any amount rolled over that exceeds this limitation is included in the gross income of the distributee in the manner provided by § 72. This provision applies to distributions from a § 529 account

after December 22, 2017 (the date of enactment) that are transferred within 60 days and before 2026 to an ABLE account.

c. *Guidance is forthcoming on tax-free rollovers from a § 529 college savings account to an ABLE account.* Notice 2018-58, 2018-33 I.R.B. 305 (07/30/18). In this notice, the Service has announced that Treasury and the Service intend to issue proposed regulations that will provide, pursuant to the 2017 amendment of § 529, that distributions from a § 529 account made after December 22, 2017, and before January 1, 2026, to the ABLE account of the designated beneficiary of that § 529 account (or family member of that designated beneficiary) are not subject to income tax if two requirements are met. First, the distributed funds must be contributed to the ABLE account within 60 days after their withdrawal from the § 529 account. Second, the distributed funds, when added to all other contributions made to the ABLE account for the taxable year that are subject to the limitation under § 529A(b)(2)(B) must not exceed that limitation. Generally, the limitation under § 529A(b)(2)(B) is the annual gift tax exclusion under § 2503(b) plus, for beneficiaries who are employed, the lower of the beneficiary's taxable compensation or the federal poverty line for a one-person household as determined for the immediately preceding year. The notice provides that taxpayers, beneficiaries, and administrators of § 529 accounts and ABLE accounts can rely on this guidance before the proposed regulations are issued.

d. *More guidance is forthcoming on the increased contribution limits for beneficiaries of ABLE accounts who are employed or self-employed.* Notice 2018-62, 2018-34 I.R.B. 316 (08/03/18). The 2017 Tax Cuts and Jobs Act, § 11024, amended Code § 529A to increase the contribution limit under § 529A(b)(2)(B) for contributions made to an ABLE account before 2026. Under the increased limit, once the overall limitation on contributions is reached, an ABLE account's designated beneficiary who is an employee (as defined) can contribute an additional amount equal to the lesser of: (1) the compensation includible in the beneficiary's income for the year, or (2) the federal poverty line for a one-person household as determined for the immediately preceding year (\$12,486 for a single individual under age 65 in 2016). In this notice, the Service has announced that Treasury and the Service intend to issue proposed regulations that will (1) confirm that the employed designated beneficiary, or the person acting on his or her behalf, is solely responsible for ensuring that the requirements for additional contributions are met and for maintaining adequate records for that purpose; (2) provide that ABLE programs may allow a designated beneficiary to certify under penalties of perjury that he or she is a designated beneficiary described in § 529A(b)(7) and that his or her contributions do not exceed the increased limit set forth in § 529A(b)(2)(B)(ii); (3) clarify that the relevant federal poverty guidelines for purposes of the increased contribution limit are those updated periodically in the Federal Register by the U.S. Department of Health and Human Services for the state in which the beneficiary resides, and (4) provide that a program will not be treated as a qualified ABLE program if it accepts contributions that are not in cash or that exceed the contribution limits in § 529A(b)(2)(B). Because ABLE programs may need to adjust their systems and account documents to be in compliance with regulatory requirements, and because some necessary changes might require state legislative action, Treasury and the Service anticipate that final regulations will provide transition relief to allow adequate time for any necessary changes.

2. *Who would have thought that selling your life insurance policy to a stranger was a good idea anyway?* Notice 2018-41, 2018-20 I.R.B. 584 (4/26/18) The 2017 Tax Cuts and Jobs Act, §§ 13520-13522, has modified the rules concerning the exclusion of life insurance proceeds upon the death of the insured as well as the determination of basis in a life insurance contract. The modified rules primarily impact the tax treatment of so-called life settlements (where a stranger purchases a life insurance policy on a healthy insured) and viatical settlements (where a stranger purchases a life insurance policy on a terminally-ill insured). Particularly, as explained in detail below, amended § 101 now contains a special carve-out to the normal life insurance policy transfer-for-value rules. See § 101(a)(3). This special carve-out applies to "reportable policy sales," which generally will include life settlement and viatical settlement transactions. Furthermore, § 13520 adds new § 6050Y to impose unique reporting requirements on the transferor and the insurer with respect to "reportable policy sales." In part, new § 6050Y will require disclosure of "reportable death benefits," as defined, but essentially meaning death benefits paid on an insurance policy that has been transferred in a "reportable policy sale." Finally, § 13521 adds a new subsection "(B)" to § 1016(a)(1) to clarify (and reverse the

Service's position in Rev. Rul. 2009-13, 2009-1 C.B. 1029 (05/01/09)) that basis in an annuity or life insurance contract includes premiums and other costs paid without reduction for mortality expenses or other reasonable charges incurred under the contract (also known as "cost of insurance"). Notice 2018-41 states that the Service will issue proposed regulations providing guidance concerning the new rules and that otherwise required reporting under § 6050Y will be delayed until after final regulations are published. We commend Notice 2018-41 for careful study by those readers advising clients on life settlement and viatical settlement transactions. The changes made by TCJA to § 101 and the addition of § 6050Y (which are the focus of the Notice) apply to taxable years beginning after 2017. The amendment adding new § 1016(a)(1)(B) applies retroactively to transactions entered into after August 25, 2009. For additional background, see below.

Some background. Section 101 generally excludes from gross income the proceeds of a life insurance policy payable by reason of the death of the insured. If, however, a life insurance policy is transferred for valuable consideration prior to the death of the insured (i.e., "a transfer for value"), then death benefit proceeds (to the extent they exceed the transferee-owner's basis in the policy) are includable in gross income by the transferee-owner of the policy upon the insured's death *unless an exception applies*. These exceptions provide that, notwithstanding a transfer for value, death benefit proceeds remain excludable if (i) the transferee-owner's basis in the policy is determined in whole or in part by reference to the transferor's basis (e.g., a carryover basis transaction) or (ii) the transferee-owner is the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation of which the insured is a shareholder or officer. If a transfer-for-value exception does not apply, then Rev. Rul. 2009-14, 2009-1 C.B. 1031 (5/2/09) sets out the Service's position that any death benefit payable to the transferee-owner is ordinary income (to the extent it exceeds the transferee-owner's basis in the policy) while a subsequent sale of the policy by the transferee-owner before the death of the insured can produce capital gain.

Why new rules? Life settlement and viatical settlement transactions have increased over the last several years. The increase in the estate and gift tax exemption has contributed in part to this market because some previously purchased life insurance policies are no longer to pay anticipated estate taxes. Changes to restrictive state laws concerning so-called "stranger-owned" life insurance also have contributed to an increase in these transactions. In a typical *life settlement* transaction, the policyholder, often the individual insured under the life insurance contract, sells his or her life insurance contract to an unrelated person. The consideration paid generally is a lump-sum cash payment that is less than the death benefit on the policy, but more than the amount that would be received by the policyholder upon surrender of the life insurance contract. The Service previously announced its position regarding the tax treatment of life settlement transactions in Rev. Rul. 2009-13, 2009-1 C.B. 1029 (05/01/09). Oversimplifying somewhat, Revenue Ruling 2009-13 provides that the seller of a policy in a life settlement transaction recognizes capital gain except with respect to the "inside buildup" in the policy (e.g., growth in cash surrender value of whole life insurance) over prior premium payments. This latter amount attributable to the inside buildup in the policy is characterized as ordinary income. The Service also took the position in Rev. Rul. 2009-13 that the seller's basis in a transferred policy must be adjusted downward by the cost of insurance separate from the investment in the contract. As discussed above, TCJA's addition of new § 1016(a)(1)(B) reverses the Service's position in this regard. A *viatical settlement*, a special type of life settlement transaction, may involve the sale of a life insurance contract by the owner, but under § 101(g) may not necessarily be taxed like a life settlement transaction. Under a viatical settlement, a policyholder may sell or assign a life insurance contract after the insured has become terminally ill or chronically ill. If any portion of the death benefit under a life insurance contract on the life of an insured who is terminally ill or chronically ill (within the meaning of § 101(g)) is sold (through the sale of the life insurance contract) or assigned in a viatical settlement to a "viatical settlement provider" (as defined), the amount paid for the sale or assignment of that portion is treated as an amount paid under the life insurance contract by reason of the death of the insured (which may be excludable under § 101), rather than gain from the sale or assignment (which generally would not be excludable under § 101 unless a transfer-for-value exception applied). A viatical settlement provider for purposes of these rules is a person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts insuring the lives of terminally ill or chronically ill individuals (provided certain requirements are met). See Rev. Rul. 2002-82, 2002-2 C.B. 978 (12.23/02).

So, what's in the new rules? Under new § 101(a)(3), the longstanding transfer-for-value exceptions described above do not apply if the transfer of the life insurance policy is a “reportable policy sale.” A reportable policy sale is defined as “the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer’s interest in such life insurance contract.” Pursuant to § 101(a)(3)(B), the term “indirectly” as used in this context applies to the acquisition of an interest in a life insurance contract via a partnership, trust, or other entity. Beyond the above statutory language, however, new § 101(a)(3) provides no further guidance as to specifics, such as the “substantial family, business, or financial relationships” (including ownership via partnerships, trusts, or other entities) that exempt an otherwise reportable policy sale from the special inclusion rule of new § 101(a)(3). In effect, then, Notice 2018-41 is the Service’s means of telling insurers and those engaged in life settlement and viatical settlement transactions that the Service knows the statutes are unclear and that the necessary guidance to comply with the new rules is forthcoming.

a. *Proposed regulations provide guidance on information reporting obligations under § 6050Y related to reportable policy sales of life insurance contracts and payments of reportable death benefits.* REG-103083-18, [Information Reporting for Certain Life Insurance Contract Transactions and Modifications to the Transfer for Valuable Consideration Rules](#), 84 F.R. 11009 (3/25/19). The Treasury Department and the IRS have issued proposed regulations that provide guidance on the information reporting obligations created by § 6050Y related to reportable policy sales of life insurance contracts and payments of reportable death benefits. Section 6050Y was enacted as part of the [2017 Tax Cuts and Jobs Act](#). The proposed regulations also provide guidance on the amount of death benefits excluded from gross income under § 101 following a reportable policy sale. Certain provisions of the proposed regulations are proposed to apply to reportable policy sales made and reportable death benefits paid after December 31, 2017. Transition rules apply to reportable policy sales made and reportable death benefits paid before the date on which final regulations are published in the Federal Register. Other provisions of the proposed regulations are proposed to apply on and after the date final regulations are published in the Federal Register.

3. *Taxpayers feel the pain after this Tax Court decision, and that pain is not on account of any physical injury or physical sickness.* [Smith v. Commissioner](#), 116 T.C.M. (CCH) 154, 2018 T.C.M. (RIA) ¶ 2018-127 (8/3/18). The taxpayers were Dr. George Lakner—a doctor, psychiatrist, and U.S. Army colonel—and his wife, Martha Smith. They failed to report income on their 2007 to 2011 joint tax returns, including their receipt of a \$328,000 settlement from the Veterans Administration (VA). The Tax Court (Judge Lauber) held that the taxpayers could not exclude the settlement payment from gross income under 104(a)(2) because the payment did not constitute damages received on account of personal, physical injury. Section 104(a)(2) provides that “gross income does not include damages received on account of personal physical injuries or physical sickness,” but emotional distress is not treated as a physical injury or physical sickness for this purpose. The Tax Court noted that Dr. Lakner’s EEOC complaints alleged that the VA Medical Center in Loma Linda, California fired him “because of his Jewish ancestry and religion and as reprisal for his advocacy on behalf of veterans with psychological illness.” Moreover, the Tax Court pointed out that the original and amended EEOC complaints were filed in 2002, and thus “did not mention (nor could they possibly have mentioned) [an] injury he sustained in 2003” while deployed in Bosnia. In general, the EEOC complaints did not allege any physical injury. Instead the VA settlement agreement made clear that the VA settled the case in consideration of Dr. Lakner’s “agreement to withdraw ‘all discrimination complaints’ he had made.” The Tax Court focused on the intent of the payor, the VA, and found that under the terms of the settlement agreement the VA intended to settle and settled Dr. Lakner’s claims of discrimination based on religion, national origin, and reprisal. Therefore, the court held that the “\$328,000 VA settlement payment was not received ‘on account of personal physical injuries or physical sickness’ and therefore was not excludable from gross income under section 104(a)(2).” The Tax Court also held that the taxpayers could not take certain deductions and upheld late-filing penalties under § 6651(a)(1) and accuracy-related penalties under § 6662(a) for underpayment of tax due to negligence.

4. *Church’s blue-envelope system for collecting pastor’s “shake-hand” money nevertheless results in green gross income, not excludable gifts.* [Felton v. Commissioner](#), 116 T.C.M.

(CCH) 365, 2018 T.C.M. (RIA) ¶ 2018-168 (10/10/18). The taxpayer was the pastor of a sizeable church in Minnesota. The church had an envelope system for collecting offerings. White, gold, and blue envelopes were used. White envelopes were for tax-deductible contributions to the operating funds of the church. White envelopes included a line-item entry (“pastoral donations”) for a congregant to indicate the portion of any contribution which the congregant desired to be paid by the church to the taxpayer-pastor. Under this system, the taxpayer-pastor was paid by the church and reported as gross income approximately \$40,000 annually in compensation for the years 2008 and 2009. Gold envelopes were for tax-deductible contributions to special programs and retreats conducted by the church. Blue envelopes ostensibly were for nondeductible “gifts” made by congregants to the taxpayer-pastor. After the end of each church service, the blue envelopes were delivered directly to the taxpayer-pastor. The church did not collect or account for blue envelope monies. [In some churches, these “gifts” to pastors are known as “shake-hand” contributions because they are often given to the pastor upon shaking his or her hand while leaving church. The taxpayer objected to this (*underhanded?*) method of collecting “gifts” for pastors, so the taxpayer caused the church to institute the blue-envelope system.] The taxpayer-pastor as well as the church had announced during a business meeting that blue-envelope contributions were not tax deductible and were solely for the pastor’s benefit; however, the distinction between blue-envelope and other contributions was not emphasized during church services. Upon audit, the Service determined that the blue envelope monies provided to the taxpayer for the years 2008 (\$258,001) and 2009 (\$234,826) was gross income under § 61(a)(1) (“compensation for services”). The taxpayer-pastor argued that the blue envelope funds were excludable gifts under § 102(a). Essentially, the taxpayer’s position was that the \$40,000 paid by the church annually to the taxpayer in “pastoral donations” was his salary, while the blue-envelope monies were excludable gifts because congregants knew those amounts were not tax deductible. The Service argued, of course, that the blue-envelope monies were not gifts but disguised compensation. To support this argument, the Service emphasized that the taxpayer had reported zero taxable income for 2008 or 2009, yet had claimed for each year a parsonage allowance of \$80,000, mortgage interest deductions of more than \$50,000, and charitable contribution deductions of \$50,000. The Tax Court (Judge Holmes) held that the blue-envelope monies were not excludable gifts but instead were gross income to the taxpayer for his services as pastor. Judge Holmes pointed to four factors supporting the court’s conclusion: (1) the average congregant made blue-envelope donations in large part to keep the taxpayer-pastor preaching at the church; (2) the lack of emphasis in church services that blue-envelope monies were “gifts” to the pastor; (3) the routinized structure of the blue-envelope system for the taxpayer’s benefit; and (4) the ratio of the taxpayer’s salary to the purported blue-envelope “gifts.” Judge Holmes also upheld the Service’s assertion of accuracy-related penalties under § 6662(a).

C. *Hobby Losses and § 280A Home Office and Vacation Homes*

D. *Deductions and Credits for Personal Expenses*

1. *Let’s hope new withholding tables are issued soon. The deduction for personal exemptions has disappeared.* The 2017 Tax Cuts and Jobs Act, § 11041, amended Code § 151(d) by adding § 151(d)(5), which reduces the exemption amount to zero for taxable years beginning after 2017 and before 2026. The effect of this amendment is to eliminate the deduction for personal exemptions. The reduction of the exemption amount to zero required conforming amendments to other Code provisions that make use of the exemption amount. For example, under § 6012, an individual taxpayer generally does not need to file a return if the taxpayer’s gross income does not exceed the sum of the basic standard deduction plus the exemption amount under § 151(d). The legislation addresses this by amending § 6012 to provide that an individual need not file a return if the taxpayer’s gross income does not exceed the standard deduction. Similarly, § 642(b)(2)(C) allows a qualified disability trust to deduct an amount equal to the exemption amount under § 151(d), and § 6334(d) exempts from levy an amount of weekly wages equal to 1/52 of the sum of the standard deduction and the aggregate amount of the taxpayer’s deductions for personal exemptions under § 151. The legislation addresses this issue by amending those provisions to refer to \$4,105 (to be adjusted for inflation), the exemption amount that had been scheduled to take effect in 2018 before the Tax Cuts and Jobs Act. The legislation also directs Treasury to develop rules to determine the amount of tax that employers are required to withhold from an employee’s wages but gives Treasury the discretion to apply current wage withholding rules for 2018.

a. *Now that the exemption amount in § 151(d) is zero, how do we determine who is a qualifying relative?* Notice 2018-70, 2018-38 I.R.B. 441 (8/28/18). The 2017 Tax Cuts and Jobs Act, § 11041, amended Code § 151(d) by adding § 151(d)(5), which reduces the exemption amount to zero for taxable years beginning after 2017 and before 2026. The intended effect of this amendment is to eliminate the deduction for personal exemptions authorized by § 151(a). Nevertheless, it is still necessary to determine for various purposes whether an individual is a “dependent” within the meaning of § 152. These purposes include determining eligibility for the earned income tax credit and for head-of-household filing status. The two basic categories of dependents under § 152 are a (1) qualifying child, and (2) qualifying relative. To be a qualifying relative, one of the requirements, set forth in § 152(d)(1)(B), is that the individual’s gross income for the calendar year must be less than the exemption amount as defined in § 151(d). By virtue of the Tax Cuts and Jobs Act, the exemption amount in § 151(d) is now zero. This notice addresses this conundrum. According to the notice, “because it would be highly unusual for an individual to have gross income less than zero, virtually no individuals would be eligible as qualifying relatives.” The notice provides that Treasury and the Service intend to issue proposed regulations that will clarify that the zero exemption amount of § 151(d)(5)(A) for taxable years 2018-2025 does not apply to the gross income limitation in the definition of a qualifying relative in § 152(d)(1)(B). Instead, the proposed regulations will provide that,

in defining a qualifying relative for purposes of various provisions of the Code that refer to the definition of dependent in § 152, including, without limitation, for purposes of the new credit under § 24(h)(4) and head of household filing status under § 2(b), the § 151(d) exemption amount referenced in § 152(d)(1)(B) will be treated as \$4,150 (adjusted for inflation), for taxable years in which the § 151(d)(5)(A) exemption amount is zero.

Thus, in determining eligibility for head-of-household filing status and for the new \$500 credit authorized by § 24(h)(4) for dependents other than a qualifying child, an individual can be treated as a qualifying relative in 2018 if the individual’s gross income does not exceed \$4,150. The notice provides that taxpayers can rely on the notice before the issuance of the proposed regulations.

2. *Has the federal deduction for your high property or state income taxes made them easier to bear? Brace yourself! The deduction for state and local taxes not paid or accrued in carrying on a trade or business or an income-producing activity is limited to \$10,000.* The 2017 Tax Cuts and Jobs Act, § 11042, amended Code § 164(b) by adding § 164(b)(6). For individual taxpayers, this provision generally (1) eliminates the deduction for foreign real property taxes, and (2) limits to \$10,000 (\$5,000 for married individuals filing separately) a taxpayer’s itemized deductions on Schedule A for the aggregate of state or local property taxes, income taxes, and sales taxes deducted in lieu of income taxes. This provision applies to taxable years beginning after 2017 and before 2026. The provision does *not* affect the deduction of state or local property taxes or sales taxes that are paid or accrued in carrying on a trade or business or an income-producing activity (i.e., an activity described in § 212) that are properly deductible on Schedules C, E, or F. For example, property taxes imposed on residential rental property will continue to be deductible. With respect to income taxes, an individual can deduct only *foreign* income taxes paid or accrued in carrying on a trade or business or an income-producing activity. As under current law, an individual cannot deduct state or local income taxes as a business expense even if the individual is engaged in a trade or business as a sole proprietor. See Reg. § 1.62-1T(d).

a. *The Service is not going to give blue states a pass on creative workarounds to the new \$10,000 limitation on the personal deduction for state and local taxes.* Notice 2018-54, 2018-24 I.R.B. 750 (05/23/18). In response to new § 164(b)(6), many states—including Connecticut, New Jersey, and New York—have enacted workarounds to the \$10,000 limitation. For instance, New Jersey reportedly has enacted legislation giving property owners a special tax credit against otherwise assessable property taxes if the owner makes a contribution to charitable funds designated by local governments. Connecticut reportedly has enacted a new provision that taxes the income of pass-through entities such as S corporations and partnerships, but allows the shareholders or members a corresponding tax credit against certain state and local taxes assessed against them individually. Notice 2018-54 announces that the Service and Treasury are aware of these workarounds and that proposed regulations will be issued to “make clear that the requirements of the Internal Revenue Code, informed

by substance-over-form principles, govern the federal income tax treatment of such transfers.” In other words, blue states, don’t bank on a charitable contribution or a flow-through income tax substituting for otherwise assessable state and local taxes to avoid new § 164(b)(6). The authors predict that this will be an interesting subject to watch over the coming months.

b. *And like Rameses II in The Ten Commandments, Treasury says, “So let it be written; so let it (finally!) be done.”* REG-112176-18, *Contributions in Exchange for State and Local Tax Credits*, 83 F.R. 43563 (8/27/18). Moving swiftly, Treasury has published proposed regulations under § 170 that purport to close the door on any state-enacted workarounds to new § 164(b)(6). Prop. Reg. § 1.170A-1(h)(3) generally requires taxpayers to reduce the amount of any federal income tax charitable contribution deduction by the amount of any corresponding state or local tax *credit* the taxpayer receives or expects to receive. The proposed regulations further provide that a corresponding state or local tax *deduction* normally will not reduce the taxpayer’s federal deduction provided the state and local deduction does not exceed the taxpayer’s federal deduction. To the extent the state and local charitable deduction exceeds the taxpayer’s federal deduction, the taxpayer’s federal deduction is reduced. Finally, the proposed regulations provide an exception whereby the taxpayer’s federal charitable contribution deduction is not reduced if the corresponding state or local credit does not exceed 15 percent of the taxpayer’s federal deduction. Three examples illustrate the application of the proposed regulation:

- *Example 1.* A, an individual, makes a payment of \$1,000 to X, an entity listed in section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70% of the amount of A’s payment to X. Under paragraph (h)(3)(i) of this section, A’s charitable contribution deduction is reduced by \$700 (70% × \$1,000). This reduction occurs regardless of whether A is able to claim the state tax credit in that year. Thus, A’s charitable contribution deduction for the \$1,000 payment to X may not exceed \$300.
- *Example 2.* B, an individual, transfers a painting to Y, an entity listed in section 170(c). At the time of the transfer, the painting has a fair market value of \$100,000. In exchange for the painting, B receives or expects to receive a state tax credit equal to 10% of the fair market value of the painting. Under paragraph (h)(3)(vi) of this section, B is not required to apply the general rule of paragraph (h)(3)(i) of this section because the amount of the tax credit received or expected to be received by B does not exceed 15% of the fair market value of the property transferred to Y. Accordingly, the amount of B’s charitable contribution deduction for the transfer of the painting is not reduced under paragraph (h)(3)(i) of this section.
- *Example 3.* C, an individual, makes a payment of \$1,000 to Z, an entity listed in section 170(c). In exchange for the payment, under state M law, C is entitled to receive a state tax deduction equal to the amount paid by C to Z. Under paragraph (h)(3)(ii)(A) of this section, C is not required to reduce its charitable contribution deduction under section 170(a) on account of the state tax deduction.

The proposed regulation is effective for charitable contributions made after August 27, 2018.

• *On the other hand . . .* The looming trouble spot here is how taxpayers and the Service discern the difference between abusive “workarounds” enacted in response to new § 164(b)(6) and legitimate state and local tax credit programs such as the Georgia Rural Hospital Tax Credit that preceded TCJA. The Georgia Rural Hospital Tax Credit program was enacted in 2017 to combat the closure of many rural hospitals in Georgia due to financial difficulties. Under the program, individuals and corporations making contributions to designated rural hospitals receive a 90% dollar-for-dollar tax credit against their Georgia state income tax liability. Is the Georgia Rural Hospital Tax Credit program adversely affected by proposed regulations under § 164(b)(6)? In our view, the answer is “yes” and a Georgia taxpayer’s federal charitable contribution deduction for a donation to a Georgia rural hospital is reduced by 90 percent. This follows because the proposed regulations do not condition the reduction in a taxpayer’s federal charitable contribution deduction on whether the taxpayer’s state and local deduction otherwise would exceed the \$10,000 cap of new § 164(b)(6). We note, however, that it may be possible under state or local law for a taxpayer to waive any corresponding state or local tax credit and thereby

claim a full charitable contribution for federal income tax purposes. See Rev. Rul. 67-246, 1967-2 C.B. 104.

c. *Speaking of looming trouble spots: The availability of a business expense deduction under § 162 for payments to charities is not affected by the recently issued proposed regulations, says the Service.* [IRS News Release IR-2018-178](#) (9/5/18). This news release clarifies that the availability of a deduction for ordinary and necessary business expenses under § 162 for businesses that make payments to charities or government agencies and for which the business receives state tax credits is not affected by the proposed regulations issued in August 2018 that generally disallow a federal charitable contribution deduction under § 170 for charitable contributions made by an individual for which the individual receives a state tax credit. See [REG-112176-18, Contributions in Exchange for State and Local Tax Credits](#), 83 F.R. 43563 (8/27/18). Thus, if a payment to a government agency or charity qualifies as an ordinary and necessary business expense under § 162(a), it is not subject to disallowance in the manner in which deductions under § 170 are subject to disallowance. This is true, according to the news release, regardless of whether the taxpayer is doing business as a sole proprietor, partnership or corporation. According to a “[frequently asked question](#)” posted on the Service website, “a business taxpayer making a payment to a charitable or government entity described in § 170(c) is generally permitted to deduct the entire payment as an ordinary and necessary business expense under § 162 if the payment is made with a business purpose.”

d. *More about trouble spots: The Service must be thinking, “Will this ever end?”* [Rev. Proc. 2019-12](#), 2019-04 I.R.B. 401 (12/29/18). Notwithstanding the above guidance, Treasury and the Service obviously have continued to receive questions regarding the deductibility of business expenses that may indirectly bear on the taxpayer’s state and local tax liability. In response, Rev. Proc. 2019-12 provides certain safe harbors. For C corporations that make payments to or for the use of § 170(c) charitable organizations and that receive or expect to receive corresponding tax credits against state or local taxes, the C corporation nevertheless may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of § 162(a). A similar safe harbor rule applies for entities other than C corporations, but only if the entity is a “specified passthrough entity.” A specified passthrough entity for this purpose is one that meets four requirements. First, the entity must be a business entity other than a C corporation that is regarded for all federal income tax purposes as separate from its owners under Reg. § 301.7701-3 (i.e., it is not single-member LLC). Second, the entity must operate a trade or business within the meaning of § 162. Third, the entity must be subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity. Fourth, in return for a payment to a § 170(c) charitable organization, the entity receives or expects to receive a state or local tax credit that the entity applies or expects to apply to offset a state or local tax imposed upon the entity. The revenue procedure applies to payments made on or after January 1, 2018.

- *C corporation example state and local income tax credit:* A, a C corporation engaged in a trade or business, makes a payment of \$1,000 to a § 170(c) charitable organization. In return for the payment, A receives or expects to receive a dollar-for-dollar state tax credit to be applied to A’s state corporate income tax liability. Under the revenue procedure, A may treat the \$1,000 payment as meeting the requirements of an ordinary and necessary business expense under § 162.
- *C corporation example state and local property tax credit:* B, a C corporation engaged in a trade or business, makes a payment of \$1,000 to a § 170(c) charitable organization. In return for the payment, B receives or expects to receive a tax credit equal to 80 percent of the amount of this payment (\$800) to be applied to B’s local real property tax liability. Under the revenue procedure, B may treat \$800 as meeting the requirements of an ordinary and necessary business expense under § 162. The treatment of the remaining \$200 will depend upon the facts and circumstances and is not affected by the revenue procedure. (In other words, the \$200 could be a charitable contribution deductible under § 170, or the \$200 could be a business expense deductible under § 162.)
- *Specified passthrough example state and local excise tax credit:* P is a limited liability company (LLC) classified as a partnership for federal income tax purposes under Reg.

§ 301.7701-3 and is owned by individuals A and B. P is engaged in a trade or business within the meaning of § 162 and makes a payment of \$1,000 to a § 170(c) charitable organization. In return for the payment, P receives or expects to receive a dollar-for-dollar state tax credit to be applied to P's state excise tax liability incurred by P in carrying on its trade or business. Under applicable state law, the state's excise tax is imposed at the entity level (not the owner level). Under the revenue procedure, P may treat the \$1,000 payment as meeting the requirements of an ordinary and necessary business expense under § 162.

- *Specified passthrough example state and local property tax credit:* S is an S corporation engaged in a trade or business and is owned by individuals C and D. S makes a payment of \$1,000 to a § 170(c) charitable organization. In return for the payment, S receives or expects to receive a state tax credit equal to 80 percent of the amount of this payment (\$800) to be applied to S's local real property tax liability incurred by S in carrying on its trade or business. Under applicable state and local law, the real property tax is imposed at the entity level (not the owner level). Under the revenue procedure, S may treat \$800 of the payment as meeting the requirements of an ordinary and necessary business expense under § 162. The treatment of the remaining \$200 will depend upon the facts and circumstances and is not affected by this revenue procedure. (In other words, the \$200 could be a charitable contribution deductible under § 170 by the owners of the specified passthrough entity, or the \$200 could be a business expense deductible at the entity level under § 162.)

e. *Like the Energizer Bunny, the issues surrounding the new \$10,000 limit on the personal deduction for state and local taxes just keep going . . . and going . . . and going . . .* **Rev. Rul. 2019-11**, 2019-17 I.R.B. 1041 (3/29/19). The tax benefit rule has long required taxpayers to include in gross income amounts deducted in a prior tax year that are recovered in the current tax year; however, under § 111(a), the amount so includible in gross income is limited to the amount deducted that resulted in a reduction of the taxpayer's tax liability for the prior year. In other words, the inclusion in gross income of the amount recovered is limited to the "tax benefit" of the amount previously deducted. *See* Rev. Rul. 93-75, 1993-2 C.B. 63 (inclusion not required for that portion of a taxpayer's state and local tax refund for which a deduction previously was disallowed under the former 3 percent/80 percent limitation on itemized deductions of § 68(a)). Likewise, if a taxpayer's deduction for personal state and local taxes was limited to \$10,000 for a prior year (e.g., 2018) by new § 164(b)(6), then a portion of the taxpayer's personal state and local tax refund received in the current year (e.g., 2019) should be excludable from gross income for the current year under § 111. The question, of course, is determining exactly how much of a taxpayer's personal state and local tax refund is excludable for the current year under § 111, especially where the \$12,000 standard deduction might have been used by the taxpayer had he or she paid the proper amount of personal state and local taxes due for the prior year instead of making an overpayment. Rev. Rul. 2019-11 holds that the proper amount includible in gross income in these circumstances under § 111 is the *lesser of* (1) the difference between the taxpayer's total itemized deductions taken in the prior year and the amount of itemized deductions the taxpayer would have taken in the prior year had the taxpayer paid the proper amount of state and local tax, or (2) the difference between the taxpayer's itemized deductions taken in the prior year and the standard deduction amount for the prior year, if the taxpayer was not precluded from taking the standard deduction in the prior year. The above holding applies to the recovery of any state or local tax, including state or local income tax and state or local real or personal property tax. To assist taxpayers in determining the proper amount excludable from gross income under § 111 with respect to a refund of personal state and local taxes subject to the § 164(b)(6) \$10,000 limit for a prior year, Rev. Rul. 2019-11 provides several helpful examples. In each example, it is assumed that the taxpayers are unmarried individuals whose filing status is "single" and who itemized deductions on their federal income tax returns for 2018 in lieu of using their standard deduction of \$12,000. It is further assumed that the taxpayers did not pay or accrue the taxes in carrying on a trade or business or an activity described in § 212. Moreover, it is assumed that for 2018 the taxpayers were not subject to alternative minimum tax under § 55 and were not entitled to any credit against income tax. Finally, it is assumed that the taxpayers use the cash receipts and disbursements method of accounting.

- *Situation 1 (State income tax refund fully includable).*

Facts: Taxpayer A paid local real property taxes of \$4,000 and state income taxes of \$5,000 in 2018. A's state and local tax deduction was not limited by section 164(b)(6) because it was below \$10,000. Including other allowable itemized deductions, A claimed a total of \$14,000 in itemized deductions on A's 2018 federal income tax return. In 2019, A received a \$1,500 state income tax refund due to A's overpayment of state income taxes in 2018.

Held: In 2019, A received a \$1,500 refund of state income taxes paid in 2018. Had A paid only the proper amount of state income tax in 2018, A's state and local tax deduction would have been reduced from \$9,000 to \$7,500 and as a result, A's itemized deductions would have been reduced from \$14,000 to \$12,500, a difference of \$1,500. A received a tax benefit from the overpayment of \$1,500 in state income tax in 2018. Thus, A is required to include the entire \$1,500 state income tax refund in A's gross income in 2019.

- *Situation 2 (State income tax refund not includable)*

Facts: Taxpayer B paid local real property taxes of \$5,000 and state income taxes of \$7,000 in 2018. Section 164(b)(6) limited B's state and local tax deduction on B's 2018 federal income tax return to \$10,000, so B could not deduct \$2,000 of the \$12,000 state and local taxes paid. Including other allowable itemized deductions, B claimed a total of \$15,000 in itemized deductions on B's 2018 federal income tax return. In 2019, B received a \$750 state income tax refund due to B's overpayment of state income taxes in 2018.

Held: In 2019, B received a \$750 refund of state income taxes paid in 2018. Had B paid only the proper amount of state income tax in 2018, B's state and local tax deduction would have remained the same (\$10,000) and B's itemized deductions would have remained the same (\$15,000). B received no tax benefit from the overpayment of \$750 in state income tax in 2018. Thus, B is not required to include the \$750 state income tax refund in B's gross income in 2019.

- *Situation 3 (State income tax refund partially includable)*

Facts: Taxpayer C paid local real property taxes of \$5,000 and state income taxes of \$6,000 in 2018. Section 164(b)(6) limited C's state and local tax deduction on C's 2018 federal income tax return to \$10,000, so C could not deduct \$1,000 of the \$11,000 state and local taxes paid. Including other allowable itemized deductions, C claimed a total of \$15,000 in itemized deductions on C's 2018 federal income tax return. In 2019, C received a \$1,500 state income tax refund due to C's overpayment of state income taxes in 2018.

Held: In 2019, C received a \$1,500 refund of state income taxes paid in 2018. Had C paid only the proper amount of state income tax in 2018, C's state and local tax deduction would have been reduced from \$10,000 to \$9,500 and as a result, C's itemized deductions would have been reduced from \$15,000 to \$14,500, a difference of \$500. C received a tax benefit from \$500 of the overpayment of state income tax in 2018. Thus, C is required to include \$500 of C's state income tax refund in C's gross income in 2019.

- *Situation 4 (Standard deduction)*

Facts: Taxpayer D paid local real property taxes of \$4,250 and state income taxes of \$6,000 in 2018. Section 164(b)(6) limited D's state and local tax deduction on D's 2018 federal income tax return to \$10,000, so D could not deduct \$250 of the \$10,250 state and local taxes paid. Including other allowable itemized deductions, D claimed a total of \$12,500 in itemized deductions on D's 2018 federal income tax return. In 2019, D received a \$1,000 state income tax refund due to D's overpayment of state income taxes in 2018.

Held: In 2019, D received a \$1,000 refund of state income taxes paid in 2018. Had D paid only the proper amount of state income tax in 2018, D's state and local tax deduction would have been reduced from \$10,000 to \$9,250, and, as a result, D's itemized deductions would have been reduced from \$12,500 to \$11,750, which is less than the standard deduction of \$12,000 that D would have taken in 2018. The difference between D's claimed itemized

deductions (\$12,500) and the standard deduction D could have taken (\$12,000) is \$500. D received a tax benefit from \$500 of the overpayment of state income tax in 2018. Thus, D is required to include \$500 of D's state income tax refund in D's gross income in 2019.

3. *Standard deduction for 2019.* [Rev. Proc. 2018-57](#), 2018-49 I.R.B. 827 (11/15/18). The standard deduction for 2019 will be \$24,400 for joint returns and surviving spouses (increased from \$24,000), \$12,200 for unmarried individuals and married individuals filing separately (increased from \$12,000), and \$18,350 for heads of households (increased from \$18,000).

4. *In determining eligibility for the § 36B premium tax credit, a taxpayer's modified adjusted gross income includes lump-sum Social Security benefits attributable to a prior year, even if the taxpayer has made an election under § 86(e).* [Johnson v. Commissioner](#), 152 T.C. No. 6 (3/11/19). Section 86(e) permits a taxpayer who receives a lump-sum Social Security payment that is attributable to a prior year to limit the portion that is taxed by electing to include in gross income only the portion of the payment equal to the increase in gross income that would have occurred had the taxpayer taken the payment into account in the prior year to which the payment is attributable. For example, assume that (1) a taxpayer receives a \$100 lump-sum Social Security payment this year that is attributable to last year, (2) \$60 of the payment would be included in gross income this year, and (3) if the taxpayer had taken the payment into account last year, only \$40 would have been included in gross income. The taxpayer in this example could elect under § 86(e) to include in gross income this year only \$40 of the payment. The issue in this case is the effect of a § 86(e) election on the calculation of a taxpayer's modified adjusted gross income (MAGI) for purposes of determining eligibility for the premium tax credit authorized by § 36B for individuals who meet certain eligibility requirements and purchase health insurance coverage under a qualified health plan through an Affordable Insurance Exchange. Generally, under § 36B(c)(1), the premium tax credit is available to taxpayers whose household income is at least 100 percent but not more than 400 percent of the federal poverty line. For this purpose, § 36B(d)(2)(A) provides that household income is the sum of the MAGI of the taxpayer and all family members required to file a tax return who are taken into account in determining family size. MAGI is defined in relevant part by § 36B(d)(2)(B) as adjusted gross income increased by certain items, including:

an amount equal to the portion of the taxpayer's social security benefits (as defined in section 86(d)) which is not included in gross income under section 86 for the taxable year.

The taxpayer in this case received total Social Security benefits in 2014 of \$26,180, of which \$11,092 was attributable to a lump-sum payment relating to 2013. By making a § 86(e) election, the taxpayer limited the taxable portion of the total benefits received in 2014 to \$6,687. The taxpayer argued that his MAGI for 2014 as defined in § 36B(d)(2)(B) should include none of the \$11,092 of Social Security benefits attributable to 2013 or, at most, should include only the portion of his 2013 benefits included in his gross income for 2014. The taxpayer focused on the statutory phrase "under section 86 for the taxable year" in § 36B(d)(2)(B) and argued that the statute required inclusion in MAGI for 2014 only benefits attributable to *the taxable year* (2014) for which the determination was being made, and not those attributable to 2013. The Tax Court (Judge Gerber) held that the taxpayer's § 86(e) election had no effect on the determination of the taxpayer's MAGI for 2014. According to the court:

We hold that the text of the statute is not ambiguous and that petitioner must include in his MAGI all of the Social Security benefits received in 2014, irrespective of the section 86(e) election. As a result, petitioner's adjusted gross income is increased by the amount of Social Security benefits not included in gross income and, as explained below, his MAGI exceeds the established threshold for PTC eligibility by a relatively small amount.

5. *Although the IRS treats Medicaid waiver payments as excludable from gross income, such payments are earned income for purposes of the earned income credit and the child tax credit, says the Tax Court.* [Feigh v. Commissioner](#), 152 T.C. No. 15 (5/15/19). Medicaid waiver payments are payments to individual care providers for the care of eligible individuals under a state Medicaid Home and Community-Based Services waiver program described in section 1915(c) of the Social Security Act. Generally, these payments are made by a state that has obtained a Medicaid waiver

that allows the state to include in the state’s Medicaid program the cost of home or community-based services (other than room and board) provided to individuals who otherwise would require care in a hospital, nursing facility, or intermediate care facility. In Notice 2014-7, 2014-4 I.R.B. 445, the Service concluded that Medicaid waiver payments qualify as “difficulty of care payments” within the meaning of § 131(c) and therefore can be excluded from the recipient’s gross income under § 131(a), which excludes amounts received by a foster care provider as qualified foster care payments. Generally, difficulty of care payments are compensation for providing additional care to a qualified foster individual that is required by reason of the individual’s physical, mental, or emotional handicap and that is provided in the home of the foster care provider. In this case, the taxpayers, a married couple, received Medicaid waiver payments in 2015 in the amount of \$7,353, which were reflected on Form W-2, for the care of their disabled adult children. The taxpayers reported this amount as wages on their 2015 return but excluded the payments from gross income. They received no other income during 2015 that would qualify as earned income. The taxpayers claimed an earned income credit of \$3,319 and an additional child tax credit of \$653. The IRS asserted that the Medicaid waiver payment was not earned income and therefore disallowed the taxpayers’ earned income credit and child tax credit. The Tax Court (Judge Goeke) held that the Medicaid waiver payments in the amount of \$7,353 did qualify as earned income for purposes of both the earned income credit and the additional child tax credit. For this purpose, section 32(c)(2)(A)(i) defines “earned income” as

wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income for the taxable year.

The court reasoned that, even though the taxpayers did not *include* in gross income the Medicaid waiver payments they received, the payments were *includible* in gross income. The court engaged in a lengthy analysis of Notice 2014-7, in which the Service had concluded that such payments could be excluded from gross income under § 131(a) and determined that the notice was entitled to so-called *Skidmore* deference (*Skidmore v. Swift & Co.*, 323 U.S. 134 (1944)), under which a government agency’s interpretation is accorded respect befitting “the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those facts which give it the power to persuade, if lacking power to control.” The Tax Court concluded that Notice 2014-7 was “entitled to little, if any, deference.” In other words, the court concluded that the Service got it wrong when it determined that the taxpayers’ Medicaid waiver payments were excludable from gross income. Based on its analysis, the court accepted the taxpayers’ argument that the Service could not reach a result contrary to the Code by reclassifying the taxpayers’ earned income as unearned for purposes of determining eligibility for the tax credits in question. The Service argued that no statutory provision demonstrated that Congress intended to allow a double benefit, i.e., both an exclusion of the Medicaid waiver payment from gross income and eligibility for the earned income credit and child tax credit. The court responded: “Respondent’s argument, however, misses that he, not Congress, has provided petitioners with a double tax benefit.”

- The taxpayers were represented by the Low Income Taxpayer Clinic at the University of Minnesota Law School.

E. *Divorce Tax Issues*

F. *Education*

1. *Private elementary and secondary schools have a new incentive to raise tuition: up to \$10,000 per year can be withdrawn tax-free from § 529 accounts to pay it.* The **2017 Tax Cuts and Jobs Act**, § 11032, amended Code § 529(c) by adding § 529(c)(7), which permits tax-free distributions from § 529 accounts to pay “expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school.” The limit on distributions for this purpose is \$10,000 during the taxable year, which applies per student, not per account. Thus, if a student is a designated beneficiary of more than one § 529 account, the student can receive only \$10,000 free of tax for this purpose in a given year regardless of whether the funds are distributed from multiple accounts. This provision applies to distributions occurring after 2017.

- a. *Breaking news! “Elementary or secondary” school means kindergarten through grade 12.* **Notice 2018-58**, 2018-33 I.R.B. 305 (7/30/18). In this notice, the Service has

announced that Treasury and the Service intend to issue proposed regulations regarding § 529 accounts that will provide, pursuant to the 2017 enactment of new § 529(c)(7), that (1) tuition in connection with a designated beneficiary's enrollment or attendance at an elementary or secondary public, private, or religious school constitutes a qualified higher education expense, and therefore amounts can be withdrawn tax-free to pay it, but that such tax-free distributions are limited to a total of \$10,000 per year per designated beneficiary, regardless of whether the funds are distributed from multiple § 529 accounts, and (2) the term "elementary or secondary" means kindergarten through grade 12 as determined under state law, which is consistent with the definition set forth in § 530(b)(3)(B) for Coverdell education savings accounts. The notice also provides that the proposed regulations will address the recontribution of refunded qualified higher education expenses, which might occur, for example, if a student drops a class and receives a refund of tuition. Under § 529(c)(3)(D) (enacted by the 2015 PATH Act), the portion of a distribution that is refunded to an individual who is the beneficiary of a § 529 account by an eligible educational institution is not subject to income tax to the extent the refund is recontributed to a § 529 account of which that individual is the beneficiary not later than 60 days after the date of the refund and does not exceed the refunded amount. The proposed regulations will provide that the entire recontributed amount will be treated as principal (rather than earnings), which is a rule of administrative convenience that avoids certain complexities that otherwise would arise under the rules governing rollovers previously set forth in Notice 2001-81, 2001-52 I.R.B. 617. The notice provides that taxpayers, beneficiaries, and administrators of § 529 accounts can rely on this guidance before the proposed regulations are issued.

G. *Alternative Minimum Tax*

VI. **CORPORATIONS**

A. *Entity and Formation*

B. *Distributions and Redemptions*

C. *Liquidations*

D. *S Corporations*

1. *In line with the continuing expansion of eligible shareholders of subchapter S corporations, ESBTs now may have non-U.S. individuals as current beneficiaries.* The [2017 Tax Cuts and Jobs Act](#), § 13541, makes a technical change to § 1361(c)(2)(B)(v) such that for 2018 and future years an "electing small business trust" (an "ESBT," as particularly defined in § 1361(e)) may have as a current beneficiary of the ESBT a "nonresident alien" individual. Under § 7701(b)(1)(B), a nonresident alien individual is someone who is neither a citizen nor a resident of the U.S. This change to § 1361 is permanent.

a. *Proposed regulations address the treatment of ESBTs that are S corporation shareholders and have nonresident aliens as beneficiaries.* [REG-117062-18, Electing Small Business Trusts With Nonresident Aliens as Potential Current Beneficiaries](#), 84 F.R. 16415 (4/19/19). The Treasury Department and the IRS have issued proposed regulations addressing the treatment of electing small business trusts that are S corporation shareholders and have nonresident aliens as beneficiaries. The preamble to the proposed regulations notes the apparent assumption in the legislative history of the 2017 Tax Cuts and Jobs Act that an ESBT is subject to tax and therefore would be subject to tax on the ESBT's share of the S corporation's income. The preamble notes, however, that ESBTs can be grantor trusts for federal tax purposes with the result that the beneficiaries of the ESBT, not the ESBT itself, are subject to tax on the S corporation's income. If a nonresident alien is a beneficiary of an ESBT, this could lead to the S corporation's income not being subject to U.S. taxation (e.g., if the income is foreign-source). Therefore, according to the preamble, the proposed regulations generally

would modify the allocation rules under § 1.641(c)-1 to require that the S corporation income of the ESBT be included in the S portion of the ESBT if that income otherwise would have been allocated to an NRA deemed owner under the grantor trust rules. Accordingly, such income would be taxed to the domestic ESBT by providing that, if the deemed owner is an NRA, the grantor portion of net income must be reallocated from the grantor portion of the ESBT to the ESBT's S portion.

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

2. *If you're a cash-method S corp pining to be a C corp, here's your chance!* The 2017 Tax Cuts and Jobs Act, § 13543, added new § 481(d) and new § 1371(f) to make it easier for cash-method S corporations to convert to C corporations (which typically, but not always, especially after TCJA's revisions to § 448, are accrual-method taxpayers). Specifically, new § 481(d) provides that any adjustment (such as changing from the cash to the accrual method) otherwise required under § 481(a)(2) with respect to an S to C conversion may be taken into account ratably over six years starting with the year of the change (instead of taking into account the adjustment entirely in the year of change) if three conditions are met: (i) the converting S corporation existed prior to December 22, 2017 (the date of TCJA's enactment); (ii) the conversion from S to C status takes place prior to December 22, 2019 (two years from the date of TCJA's enactment); and (iii) all of the shareholders of the S corporation on December 22, 2017, are "in identical proportions" the shareholders of the C corporation. New § 1371(f) further provides that "money" distributed by the above-described converted S corporations *after* the "post-termination transition period" (generally one year) is allocable to and chargeable against the former S corporation's accumulated adjustments account ("AAA") in the same ratio as AAA bears to accumulated earnings and profits ("E&P"). Thus, new § 1371(f) is more favorable to S corporations converting to C status than the normal rule of § 1371(e), which allows distributions of money *during* the "post-termination transition period," but not after, to be allocable to and chargeable against AAA. As a practical matter, then, S corporations converting to C corporations within the confines of new § 481(d) and § 1371(f) may make nontaxable, stock-basis reducing distributions of money out of their AAA during the one-year period following the conversion (pursuant to § 1371(e)) as well as wholly or partially (depending upon AAA as compared to E&P) nontaxable, basis-reducing distributions of money after the normal one-year, post-termination transition period. These changes to § 481 and § 1371 are permanent, but of course, will apply only to S to C conversions that meet the criteria of § 481(d) (i.e., pre-TCJA existing S corporations that convert to C status before December 22, 2019, and that have the same shareholders in the same proportions post-conversion).

a. *Guidance concerning the adjustments required under new § 481(d).* Rev. Proc. 2018-44, 2018-37 I.R.B. 426 (9/10/18) modifies Rev. Proc. 2018-31, 2018-22 I.R.B. 637, to provide that an eligible terminated S corporation, as defined in § 481(d)(2), required to change from the overall cash method of accounting to an overall accrual method of accounting as a result of a revocation of its S corporation election, and that makes this change in method of accounting for the C corporation's first taxable year after such revocation, is required to take into account the resulting positive or negative adjustment required by § 481(a)(2) ratably during the six-year period beginning with the year of change. Rev. Proc. 2018-44 also provides that an eligible terminated S corporation permitted to continue to use the cash method after the revocation of its S corporation election, and that changes to an overall accrual method for the C corporation's first taxable year after such revocation, may take into account the resulting positive or negative adjustment required by § 481(a)(2) ratably during the six-year period beginning with the year of change.

3. 🎵 "Oh when will they ever learn, oh when will they ever learn?" 🎵 Debt of an S corporation to third parties does not increase the basis of shareholders. [Hargis v. Koskinen](#), 893 F.3d 540 (8th Cir. 6/22/18). The taxpayers, a married couple, bought and operated nursing homes through several entities. Some of the entities were subchapter S corporations, of which the husband was the sole shareholder, that operated the nursing homes. The others were limited liability companies classified as tax partnerships in which the wife had an interest. The LLCs owned the nursing homes and leased them to the S corporations. The Service disallowed losses of the S corporations and the LLCs on the ground that the husband and wife had insufficient basis in their interests to deduct the losses. The S corporations had borrowed money from commercial lenders, from the LLCs, and from each other. The husband was a co-borrower or guarantor on the loans. The taxpayers acknowledged that the loans made to the S corporations were not indebtedness of the S corporations to the husband. Nevertheless, they argued that the husband had made an "economic outlay" that entitled him to a basis increase because, among other reasons, the husband was co-borrower on at least some of the loans. Citing *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985), they also argued that the lenders looked primarily to the husband for repayment of the loans, and therefore the loans should be treated as having

been made to him followed by his contribution of the proceeds to the S corporations. In an opinion by Judge Benton, the U.S. Court of Appeals for the Eighth Circuit rejected all of these arguments:

None of the other facts demonstrates that, in substance, [the husband] borrowed the funds and subsequently advanced them to the Operating Corporations. The lenders advanced the funds directly to the Operating Corporations; they directly paid the lenders; and [the husband] did not pledge any personal assets as collateral.

The court also held that the wife had failed to prove that she had sufficient basis in her interests in the LLCs to deduct her share of the LLCs' losses.

4. *A § 267 “looptrap” snares an accrual-method subchapter S corporation with an ESOP shareholder.* [Petersen v. Commissioner](#), 148 T.C. 463 (6/13/17). The taxpayers, a married couple, owned stock in an accrual-method S corporation with many employees. As permitted by § 1361(c)(7), an ESOP benefitting the employees also owned stock in the S corporation. The S corporation had accrued and deducted the following amounts with respect to its ESOP participants as of the end of its 2009 and 2010 tax years: for 2009, unpaid wages of \$1,059,767 (paid by January 31, 2010) and vacation pay of \$473,744 (paid by December 31, 2010); for 2010, unpaid wages of \$825,185 (paid by January 31, 2011) and vacation pay of \$503,896 (paid by December 31, 2011). Notwithstanding the fact that the S corporation was an accrual-method taxpayer, the IRS asserted under § 267(a)(2) (forced-matching) that the corporation was not entitled to deduct the foregoing accrued amounts until the year of actual payment and inclusion in gross income by the ESOP's cash-method, employee-participants. In a case of first impression, the Tax Court (Judge Lauber) agreed with the IRS based upon a plain reading of §§ 67(a)(2), (b), and (e), as well as a determination that the S corporation's ESOP is a “trust” within the meaning of § 267(c). Specifically, § 267(a)(2) generally requires so-called “forced matching” of an accrual-method taxpayer's deductions with the gross income of a cash-method taxpayer to whom a payment is to be made if the taxpayer and the person to whom the payment is to be made are related persons as defined by § 267(b). For an S corporation, pursuant to § 267(e), all shareholders are considered related persons under § 267(b) regardless of how much or how little stock such shareholders actually *or constructively* own. Furthermore, under § 267(c) beneficiaries of a trust are deemed to own any stock held by the trust. Because the assets held by an ESOP are owned by a trust (as required by ERISA, *see* 29 U.S.C. § 1103(a)), the participating employees of the ESOP are treated as shareholders of the S corporation. Hence, the forced-matching rule of § 267(a)(2) applies to accrued but unpaid wages and vacation pay owed to the S corporation's ESOP participants at the end of the year. Judge Lauber noted that this odd situation probably was a “drafting oversight”—in our words, a *looptrap*—because § 318, which defines related parties for certain purposes under subchapter C, excepts tax-exempt employee trusts from its constructive ownership rules. Nevertheless, Judge Lauber wrote, the Tax Court is “not at liberty to revise section 267(c) to craft an exemption that Congress did not see fit to create.” Mercifully, however, the Tax Court declined to impose § 6662 negligence or substantial understatement penalties on the taxpayers because the case was one where “the issue was one not previously considered by the Court and the statutory language was not clear” (even though the court obviously relied upon the plain language of § 267 to reach its decision).

a. *This accrual-method S corporation was properly snared, says the Tenth Circuit.* [Petersen v. Commissioner](#), ___ F.3d ___ (10th Cir. 5/15/19), *aff'g* 148 T.C. 463 (6/13/17). In an opinion by Judge Hartz, the U.S. Court of Appeals for the Tenth Circuit has affirmed the Tax Court's decision that an accrual-method S corporation's deductions for amounts payable to cash-method participants in an ESOP that held shares of the S corporation were deferred by the forced matching rule of § 267(a)(2). Section 267(a)(2) provides that the deductions of an accrual-method taxpayer for amounts payable to a related cash-method taxpayer must be deferred until the year in which the amounts are included in the related taxpayer's gross income. Under § 267(c), beneficiaries of a trust are treated as constructively owning any stock held by the trust. Further, under § 267(e), all shareholders of an S corporation are treated as “related persons” within the meaning of § 267(b) regardless of how much or how little stock such shareholders actually *or constructively* own. The Tenth Circuit agreed with the Tax Court that the effect of these provisions is that employees of an S corporation who participate in an ESOP that holds shares of the S corporation are “related persons” with respect to the S corporation within the meaning of § 267(b), and therefore an accrual-method S

corporation's deductions for amounts payable to such employees are subject to deferral under the forced-matching rule of § 267(a)(2). In reaching this conclusion, the court rejected several arguments made by the taxpayers and held that an ESOP is a "trust" within the meaning of § 267(c), and therefore the ESOP's participants are treated as constructively holding proportionately the stock held by the ESOP.

E. *Mergers, Acquisitions and Reorganizations*

1. *Don't despair! If TCJA's incredibly generous bonus depreciation is messing up your RBIG and RBIL calculations, the Service feels your pain and provides relief.* Notice 2018-30, 2018-21 I.R.B. 610 (5/8/18) modifying Notice 2003-65, 2003-2 C.B. 747. Section 382, perhaps one of the most complicated provisions in the entire Internal Revenue Code, can limit an acquiring corporation's use of an acquired corporation's net operating losses to certain specified amounts calculated with reference to the federal long-term interest rate determined under § 1274. Section 382 also requires affected taxpayers to identify so-called recognized built-in gain ("RBIG") or recognized built-in loss ("RBIL") for this purpose. Bonus depreciation allowed by § 168 could affect these calculations for purposes of § 382; however, Notice 2003-65 provides certain safe-harbor methods that disregard § 168(k) purposes of making RBIG and RBIL calculations. Under TCJA, § 168(k) bonus depreciation was increased to 100 percent, thereby unintentionally impacting determinations of RBIG and RBIL under § 382 and Notice 2003-65. Notice 2018-30 therefore modifies Notice 2003-65 to take into account revised § 168(k) and to continue ignoring bonus depreciation for RBIG and RBIL calculations under § 382.

F. *Corporate Divisions*

G. *Affiliated Corporations and Consolidated Returns*

H. *Miscellaneous Corporate Issues*

1. *After almost 200 pages, how about next time we just flip a coin? Surely the answer cannot be as simple as the outcome: Owning related-party DISC stock via a Roth IRA is OK, but owning related-party FSC stock via a Roth IRA is not OK?* The following recent cases dramatically illustrate the uncertainties faced by advisors, the Service, and the courts when deciding between transactions that constitute creative but legitimate tax planning and those that are considered "abusive." Both cases centered on taxpayers using statutorily-sanctioned tax-planning devices in tandem (Roth IRAs coupled with a DISC or a FSC). Nonetheless, a Sixth Circuit panel unanimously held for the taxpayer while a majority of the Tax Court held for the Service (even after considering the Sixth Circuit's decision). Moreover, the Sixth Circuit and the Tax Court reached conflicting conclusions notwithstanding the fact that the taxpayers and the Service agreed there was *no significant difference* between the cases in either the relevant facts or the controlling law. If this is no surprise to you, you can stop here. If you are intrigued, read further.

a. *Form is substance, says the Sixth Circuit. The Service is precluded from recharacterizing a corporation's payments to a DISC held by a Roth IRA.* [Summa Holdings, Inc. v. Commissioner](#), 848 F.3d 779 (6th Cir. 2/16/17), rev'g T.C. Memo 2015-119 (6/29/15). Two members of the Benenson family each established a Roth IRA by contributing \$3,500. Each Roth IRA paid \$1,500 for shares of a Domestic International Sales Corporation (DISC). These members of the Benenson family were the beneficial owners of 76.05 percent of the shares of Summa Holdings, Inc., the taxpayer in this case and a subchapter C corporation. Summa Holdings paid (and deducted) commissions to the DISC, which paid no tax on the commissions. The DISC distributed dividends to each of the Roth IRAs, which paid unrelated business income tax on the dividends (at roughly a 33 percent rate according to the court) pursuant to § 995(g). (The structure involved a holding company between the Roth IRA and the DISC, but the presence of the holding company appears not to have affected the tax consequences.) This arrangement allowed the balance of each Roth IRA to grow rapidly. From 2002 to 2008, the Benensons transferred approximately \$5.2 million from Summa Holdings to the Roth IRAs through this arrangement, including \$1.5 million in 2008, the year in issue. By 2008, each Roth IRA had accumulated over \$3 million. The Service took the position that the arrangement was an impermissible way to avoid the contribution limits that apply to Roth IRAs. The Service disallowed the deductions of Summa Holdings for the commissions paid to the DISC and

asserted that, under the substance-over-form doctrine, the arrangement should be recharacterized as the payment of dividends by Summa Holdings to its shareholders, followed by contributions to the Roth IRAs by the two members of the Benenson family who established them. The Service determined that each Roth IRA had received a deemed contribution of \$1.1. By virtue of their level of income, the two Benenson family members were ineligible to make any Roth IRA contributions. Pursuant to § 4973, the Service imposed a 6 percent excise tax on the excess contributions.

The Tax Court's decision (Summa I). The Tax Court (Judge Kerrigan) upheld the Service's recharacterization. Judge Kerrigan relied upon *Repetto v. Commissioner*, T.C. Memo 2012-168 and Notice 2004-8, 2004-1 C.B. 333, both of which addressed using related-party businesses and Roth IRAs in tandem to circumvent excess contribution limits. Foreshadowing its argument in *Repetto*, the Service had announced in Notice 2004-8 that these arrangements were listed transactions and that it would attack the arrangements on several grounds, including "that the substance of the transaction is that the amount of the value shifted from the Business to the Roth IRA Corporation is a payment to the Taxpayer, followed by a contribution by the Taxpayer to the Roth IRA and a contribution by the Roth IRA to the Roth IRA Corporation." Importantly, subsequent Tax Court decisions, *Polowniak v. Commissioner*, T.C. Memo 2016-31 and *Block Developers, LLC v. Commissioner*, T.C. Memo 2017-142, adopted the Service's position in Notice 2004-8 and struck down tandem Roth IRA/related-party business arrangements like the one under scrutiny in *Summa I*.

The Sixth Circuit's decision (Summa II). In an opinion by Judge Sutton, the U.S. Court of Appeals for the Sixth Circuit reversed.¹ The court emphasized that "[t]he Internal Revenue Code allowed Summa Holdings and the Benensons to do what they did." The issue was whether the Service's application of the substance-over-form doctrine was appropriate. The court first expressed a great deal of skepticism about the doctrine:

Each word of the "substance-over-form doctrine," at least as the Commissioner has used it here, should give pause. If the government can undo transactions that the terms of the Code expressly authorize, it's fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is. "Form" is "substance" when it comes to law. The words of law (its form) determine content (its substance). How odd, then, to permit the tax collector to reverse the sequence—to allow him to determine the substance of a law and to make it govern "over" the written form of the law—and to call it a "doctrine" no less.

Although the court expressed the view that application of the substance-over-form doctrine makes sense when a "taxpayer's formal characterization of a transaction fails to capture economic reality and would distort the meaning of the Code in the process," this was not such a case. The substance-over-form doctrine as applied by the Service in this case, the court stated, was a "distinct version" under which the Service claims the power to recharacterize a transaction when there are two possible options for structuring a transaction that lead to the same result and the taxpayer chooses the lower-tax option. The court concluded that the Service's recharacterization of Summa Holding's transactions as dividends followed by Roth IRA contributions did not capture economic reality any better than the taxpayer's chosen structure of DISC commissions followed by dividends to the DISC's shareholders.

b. *Not so fast, says the Tax Court. The Service can still win a Roth IRA case if a tax-saving corporation's stock is in substance owned by individual shareholders instead of their Roth IRAs.* [Mazzei v. Commissioner](#), 150 T.C. No. 7 (3/5/18). The taxpayers in this case were members of the Mazzei family (husband, wife, and adult daughter). They owned 100 percent of the stock of Mazzei Injector Corp., an S corporation. The taxpayers established separate Roth IRAs that each invested \$500 in a Foreign Sales Corporation ("FSC"). Under prior law and somewhat like DISCs, FSCs provided a

¹ Although the Tax Court had both disallowed Summa Holdings' deductions for the commissions paid to the DISC and upheld imposition of the 6 percent excise tax of § 4973 on the deemed excess Roth IRA contributions made by Summa Holdings' shareholders, Summa Holdings appealed to the Sixth Circuit only the disallowance of its deductions. The shareholders have appealed to the First and Second Circuits the issue whether they made excess Roth IRA contributions. Those appeals are currently pending.

Code-sanctioned tax benefit because they were taxed at much lower rates than regular corporations pursuant to an express statutory regime. After the taxpayers' Roth IRAs invested in the FSC, Mazzei Injector Corp. paid the FSC a little over \$500,000 in deductible commissions from 1998 to 2002. These deductible payments exceeded the amounts the taxpayers could have contributed to their Roth IRAs over these years, and just as in *Summa Holdings*, the Service argued that substance over form principles applied to recharacterize the entire arrangement as distributions by the S corporation to its shareholders, followed by excess Roth IRA contributions subject to the § 4973 excise tax and related penalties. Because the case is appealable to the Ninth Circuit, the Tax Court was not bound by the Sixth Circuit's decision in *Summa Holdings*. Thus, the Tax Court could have followed its own decision in *Summa Holdings* to agree with the Service that in substance the entire arrangement amounted to an end-run around Roth IRA contribution limits; however, the Tax Court did not adopt this *Summa Holdings*-inspired approach. Instead, in a reviewed opinion (12-0-4) by Judge Thornton, relying upon Ninth Circuit precedent as well as the U.S. Supreme Court's decision in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), the Tax Court reasoned that the Roth IRAs had no real downside risk or exposure with respect to holding the FSC stock and thus were not the true owners of the stock. Judge Thornton determined that, for federal income tax purposes, the taxpayers should be considered the owners of the stock, stating:

[B]ecause petitioners (through various passthrough entities) controlled every aspect of the transactions in question, we conclude that they, and not their Roth IRAs, were the owners of the FSC stock for Federal tax purposes at all relevant times. The dividends from the FSC are therefore properly recharacterized as dividends from the FSC to petitioners, followed by petitioners' contributions of these amounts to their respective Roth IRAs. All of these payments exceeded the applicable contribution limits and were therefore excess contributions. We therefore uphold respondent's determination of excise taxes under section 4973.

Notably, though, the Tax Court declined to impose penalties on the taxpayers because they relied on independent professional advice in connection with setting up the FSC and their Roth IRAs.

- *Dissenting opinion.* Four Judges (Holmes, Foley, Buch, and Morrison) dissented, with some joining only parts of the dissenting opinion written by Judge Holmes. Judge Holmes reasoned that the majority should have followed the Sixth Circuit's decision in *Summa Holdings* instead of engaging in "judge-made doctrine." In our view, Judge Holmes's dissenting opinion is both entertaining and insightful, summing up the conflicting opinions in *Summa I*, *Summa II*, and *Mazzei* as follows: "What's really going on here is that the Commissioner doesn't like that the Mazzeis took two types of tax-advantaged entities and made them work together." Judge Holmes also aptly observed:

After the Sixth Circuit released *Summa II* we told the parties here to submit supplemental briefs. The Mazzeis and the Commissioner agreed that the only difference between these cases and *Summa II* was that the Mazzeis used a FSC instead of a DISC. The Commissioner said this difference shouldn't affect our analysis, and he admitted that the Mazzeis followed all of the necessary formalities. He nevertheless said we should ignore *Summa II* because it's from a different circuit and only the commission payments' deductibility was properly before the court there. He said we should instead follow *Court Holding*, look at the transaction as a whole, and decide the cases based on his views of the statute's intent, not the Code's plain language.

The Mazzeis urged us to follow *Summa II*'s reasoning. They said they should get the FSC and Roth IRA tax benefits the Code explicitly provides and that the Commissioner shouldn't get to rewrite statutes based on his musings about congressional intent. And they said that their use of an FSC instead of a C corporation was enough to distinguish these cases from Repetto.

c. *The First Circuit has agreed with the Sixth Circuit and declined to recharacterize a corporation's payments to a DISC held by a Roth IRA.* Benenson v. Commissioner, 887 F.3d 511 (1st Cir. 4/6/18), rev'g T.C. Memo 2015-119 (6/29/15). In an opinion by Judge Stahl, the U.S. Court of Appeals for the First Circuit has upheld the same Roth IRA-DISC transaction

considered by the Sixth Circuit in *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2/16/17). In that transaction, members of the Benenson family established Roth IRAs that acquired shares of a Domestic International Sales Corporation (DISC), to which a subchapter C corporation (Summa Holdings) paid (and deducted) commissions to the DISC. The Tax Court upheld the Service's recharacterization of the transaction under the substance over form doctrine. Under the Service's view of the transaction, the C corporation's payments of commissions to the DISC should be recharacterized as nondeductible distributions by the C corporation to its shareholders, followed by the shareholders' contributions of those amounts to their Roth IRAs in excess of applicable limits, which triggered the 6 percent excise tax of § 4973. The Sixth Circuit addressed the C corporation's deductions and rejected the Service's argument that the C corporation's deductions should be disallowed under the substance over form doctrine. In this case, the First Circuit considered the appeal of the Tax Court's decision by shareholders who were residents of Massachusetts, who appealed the Tax Court's decision that they should be treated as having made excess Roth IRA contributions. Like the Sixth Circuit, the First Circuit declined to apply the substance over form doctrine, which the court characterized as "not a smell test," but rather a tool of statutory interpretation. The court reasoned that Congress appeared to contemplate ownership of DISCs by IRAs when it enacted relevant statutory provisions such as § 995(g), which imposes unrelated business income tax on distributions that a DISC makes to tax-exempt organizations that own shares of the DISC. The court concluded:

The Benensons used DISCs, a unique, congressionally designed corporate form their family's business was authorized to employ, and Roth IRAs, a congressionally designed retirement account all agree they were qualified to establish, to engage in long-term saving with eventual tax-free distribution. Such use violates neither the letter nor the spirit of the relevant statutory provisions.

...

Some may call the Benensons' transaction clever. Others may call it unseemly. The sole question presented to us is whether the Commissioner has the power to call it a violation of the Tax Code. We hold that he does not. ... When, as here, we find that the transaction does not violate the plain intent of the relevant statutes, we can push the doctrine no further.

- In a dissenting opinion, Judge Lynch argued that the Service's application of the substance over form doctrine should be upheld. In Judge Lynch's view, the parties had not used the DISC for the purpose intended by Congress, but rather to evade the Roth IRA contribution limits. Judge Lynch also disagreed with the majority that the relevant statutory provisions contemplated a Roth IRA holding stock in a DISC. At most, Judge Lynch noted, Congress might have intended to allow traditional IRAs to own DISC stock, but taxpayers have not used DISCs as a way to circumvent the contribution limits on traditional IRAs because, in contrast to Roth IRAs, distributions from a traditional IRA are not tax-free.

d. *The Second Circuit has jumped on the bandwagon and declined to apply the substance-over-form doctrine to recharacterize a corporation's payments to a DISC held by a Roth IRA.* [Benenson v. Commissioner](#), 910 F.3d 690 (2d Cir. 12/14/18). In an opinion by Judge Raggi, the U.S. Court of Appeals for the Second Circuit has agreed with the First and Sixth Circuits that the government could not apply the substance-over-form doctrine to recharacterize as nondeductible dividends the commissions paid by Summa Holdings, Inc. to a DISC, the stock of which was held (indirectly) by Roth IRAs formed by some of Summa Holdings' shareholders. The court first rejected the taxpayers' argument that the Sixth Circuit's decision, which refused to uphold application of the substance-over-form doctrine with respect to Summa Holdings, precluded the government from relitigating the issue of recharacterization. The court observed that offensive collateral estoppel can preclude the government from relitigating an issue only when the parties opposing the government in the prior and subsequent action are the same. This requirement can be satisfied, the court stated, when the litigant in the subsequent action (the shareholders in this case) totally controlled and financed the litigant in the prior action (the corporation, Summa Holdings). According to the court, however, the taxpayers had failed to make this showing, and therefore the government was not precluded from litigating the issue of recharacterization. With respect to the issue of recharacterizing Summa Holdings'

payment of commissions to the DISC, the court held that “the substance-over-form doctrine does not support recharacterization of Summa’s payment of tax-deductible commissions to a DISC as taxable constructive dividends to Summa shareholders and, thus, cannot support the tax deficiency attributed to petitioners. The court also held that the step-transaction doctrine, when applied together with the substance-over-form doctrine, did not warrant a different conclusion.

2. *Back to the future: Remember the good ole days before 1986 when C corporations were tax shelters? By introducing a flat corporate tax rate of 21 percent, Congress has given new life to C corporations and will force us to relearn personal holding company, accumulated earnings tax, and other anti-abuse rules (e.g., § 269A) we’ve long ignored.* The centerpiece of the **2017 Tax Cuts and Jobs Act** is a permanent reduction in corporate tax rates. Section 13001 of the legislation amended § 11(b) to impose tax on taxable income of corporations, including personal service corporations, at a flat rate of 21 percent. Prior to this amendment, § 11(b) provided graduated rates with a top rate of 35 percent (which top rate applied to the first dollar of personal service corporation income). For personal service corporations and companies with significant profit from U.S. operations, the reduction in the corporate rate is a huge benefit. In fact, this rate reduction is estimated to reduce corporate income taxes by roughly \$1.3 trillion over the next ten years. Prior to this change, most businesses avoided C corporation status unless they were (or planned to be) publicly traded, were so-called “blocker” corporations, or, in some cases, were taken private by investment funds. Venture capital backed companies also tended to choose C corporation status to simplify their capital structure and tax compliance obligations. Now, however, C corporation status may be a sensible choice for some personal service and other closely-held corporations, especially if the business will be held for the life of the major shareholders (thereby benefiting from the step-up in basis at death) or the shareholders will exit via a stock sale at some indeterminate time in the future. One of the authors has heard anecdotally that many older, highly compensated law firm partners (drawing \$1 million or more annually and thus excluded from new § 199A) who expect to retire soon are considering incorporating as old-fashioned personal service corporations, especially those in states with high income tax rates. No doubt, the accumulated earnings tax (§§ 535-537) and the Service’s power to reallocate income between a shareholder and his or her personal service corporation (§ 269) will come into play to deter such strategies, but a 21 percent rate as compared to a 37 percent rate is tempting. Nevertheless, despite the reduced rate, subchapter C is still a double-tax regime. In particular, asset sales (or deemed asset sales at liquidation) by C corporations will continue to suffer a big tax bite notwithstanding the reduced corporate rate. Furthermore, new § 199A must be considered for any flow-through entities. *Bottom line:* Although the authors believe that flow-through status remains the best option in most situations, the choice-of-entity analysis just got more complicated and will require even more crystal-ball gazing.

a. *Although we will have to relearn some old C corporation anti-abuse provisions, here’s something we can forget: the corporate AMT.* The **2017 Tax Cuts and Jobs Act**, § 12001, repealed the corporate alternative minimum tax (by amending Code § 55) effective for taxable years beginning after 2017. Corporations that incurred AMT in past years will want to be sure to claim that amount as a credit against regular tax going forward. A special rule regarding the refundable portion of the AMT credit is designed to allow a corporation to use fully in 2018 through 2021 any AMT credits carried forward. Also, corporations that have had other credits (e.g, the R&D credit) limited in past years by the AMT may be able to claim those credits going forward.

b. *But wait! Nothing about federal income taxation is ever simple, right?* **Notice 2018-38**, 2018-18 I.R.B. 522 (04/16/18). The Service has provided guidance to non-calendar taxable year C corporations with regard to the **2017 Tax Cuts and Jobs Act’s** reduction in the corporate rate and repeal of the AMT effective as of December 31, 2017. Essentially, in the case of a C corporation with a fiscal taxable year that includes (but does not start with) January 1, 2018, § 15 mandates that a blended rate apply for purposes of calculating regular income tax and the AMT for such fiscal taxable year. Notice 2018-38 provides the following examples of the application of § 15:

Example. Corporation X, a subchapter C corporation, uses a June 30 taxable year. For its taxable year beginning July 1, 2017, and ending June 30, 2018, X’s taxable income is \$1,000,000, and its [alternative minimum taxable income or “AMTI”] in excess of its AMT exemption amount is \$2,000,000.

Computation under § 11

Corporation X's corporate tax under § 11 of the Code is computed by applying § 15(a) as follows:

1) Taxable income (Line 30, Form 1120)	\$ 1,000,000
2) Tax on Line 1 amount using § 11(b) rates before the Act	340,000
3) Number of days in Corporation X's taxable year before January, 1, 2018	184
4) Multiply Line 2 by Line 3	<u>62,560,000</u>
5) Tax on Line 1 amount using § 11(b) rate after the Act	210,000
6) Number of days in the taxable year after December 31, 2017	181
7) Multiply Line 5 by Line 6	<u>38,010,000</u>
8) Divide Line 4 by total number of days in the taxable year	171,397
9) Divide Line 7 by total number of days in the taxable year	<u>104,137</u>
10) Sum of Line 8 and Line 9	<u>\$ 275,534</u>

Under § 15(a), Corporation X's corporate tax for its taxable year ending June 30, 2018 is \$275,534.

Computation under § 55

Corporation X's [tentative minimum tax or "TMT" under § 55] and resulting AMT under § 55 of the Code is computed by applying § 15(a) as follows:

1) AMTI in excess of AMT exemption amount (Line 9, Form 4626)	\$2,000,000
2) TMT on Line 1 amount using § 55(b)(1)(B) rate before the Act	400,000
3) Number of days in Corporation X's taxable year before January, 1, 2018	184
4) Multiply Line 2 by Line 3	73,600,000
5) Divide Line 4 by total number of days in the taxable year	<u>\$ 201,644</u>

It is unnecessary to compute a TMT for the portion of the taxable year beginning on and after the effective date of § 12001 of the Act because the TMT is repealed as of the effective date for purposes of applying § 15(a). Corporation X's TMT for its taxable year ending June 30, 2018 is \$201,644. Because this TMT amount for the taxable year does not exceed Corporation X's corporate tax amount of \$275,534, Corporation X does not have an AMT liability for its taxable year ending June 30, 2018.

3. 🎵 “Shed a tear ’cause I’m missin’ you ... All we need is just a little patience” 🎵
Treasury and the Service propose to withdraw the final regulations regarding documentation issued under § 385, but they may be back in modified form. REG-130244-17, Proposed Removal of Section 385 Documentation Regulations, 83 F.R. 48265 (9/24/18). Treasury and the Service have issued a notice of proposed rulemaking that would remove the final regulations issued in 2016 setting forth minimum documentation requirements that ordinarily must be satisfied for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes.

Documentation Regulations. In 2016, Treasury and the Service published Reg. § 1.385-2, which provides detailed requirements for documentation and financial analysis of instruments issued as indebtedness between related parties similar to what generally would be expected on issuance of debt instruments between unrelated parties. *See* T.D. 9790, Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 F.R. 72858 (10/21/16). Under this regulation, for an instrument to be treated as debt, documentation and information must be developed at the time an instrument is issued to demonstrate (1) a binding obligation to repay a fixed or determinable sum certain on demand or at

one or more fixed dates, (2) that the creditor has the typical legal rights of a creditor to enforce the terms of the instrument including rights to trigger a default and accelerate payments, (3) a reasonable expectation that the issuer intends and would be able to repay, such as cash flow projections, financial statements, business forecasts, asset appraisals, determinations of debt-to-equity and other relevant financial ratios of the issuer (compared to industry averages), and (4) timely evidence of an on-going debtor-creditor relationship. Reg. § 1.385-2(c)(2). The documentation rules generally apply only to interests among members of an “expanded group” (very generally, an affiliated group within the meaning of § 1504(a) connected through stock possessing 80 percent of *either* voting power *or* value) if, on the date the interest is created, (1) the stock of any member of the expanded group is publicly traded, (2) all or any portion of the expanded group’s financial results are reported on financial statements with total assets exceeding \$100 million, or (3) the expanded group’s financial results are reported on financial statements that reflect annual total revenue that exceeds \$50 million. The documentation rules do not apply to intercompany obligations among members of a consolidated group. Reg. § 1.385-2 originally was to apply to interests issued or deemed issued on or after January 1, 2018. In Notice 2017-36, 33 I.R.B. 208 (7/28/17), due to concerns expressed by taxpayers that the applicability date of the proposed regulations did not give taxpayers sufficient time to develop processes to comply with the documentation requirements, the Service announced that Reg. § 1.385-2 would be amended to apply only to interests issued or deemed issued on or after January 1, 2019.

Withdrawal of the Documentation Regulations. On April 21, 2017, President Trump issued Executive Order 13789 directing the Secretary of the Treasury to review “all significant tax regulations” issued on or after January 1, 2016, that “impose an undue financial burden,” “add undue complexity,” or “exceed [the Service’s] statutory authority,” and to submit two reports to the President. The second report, issued by Treasury Secretary Mnuchin on October 2, 2017, recommended certain actions with respect to eight sets of regulations, one of which was the documentation rules set forth in the regulations under § 385. Treasury and the Service now have proposed to withdraw the documentation rules, which are found primarily in Reg. § 1.385-2. The preamble to these proposed regulations states that Treasury and the Service will continue to study the issues addressed by the documentation rules and may propose a modified version of them. Any revised regulation setting forth documentation requirements “would be substantially simplified and streamlined to reduce the burden on U.S. corporations and yet would still require sufficient documentation and other information for tax administration purposes.” The proposed withdrawal will be effective on the date these proposed regulations are published as final regulations.

4. *Cash grants from the State of New Jersey were nontaxable contributions to capital, says the Tax Court.* [Brokertec Holdings, Inc. v. Commissioner](#), T.C. Memo. 2019-32 (4/9/19). The taxpayer in this case was the common parent of a consolidated corporate group. Two members of the group were inter-dealer brokers with offices in or near the World Trade Center in New York City on September 11, 2001. Following the destruction of the World Trade Center in the September 11 terrorist attack, these members searched for new office space. They both applied for and received cash grants from the State of New Jersey’s Economic Development Plan. Both members relocated to areas of New Jersey adjacent to New York City. On the consolidated group’s returns for 2010 through 2013, a total of approximately \$55.7 million of the cash grants were treated as nontaxable, nonshareholder contributions to capital under § 118. The IRS asserted that the group was required to include the grants in gross income. The Tax Court (Judge Jacobs) held that the grants were nontaxable contributions to capital. The court engaged in a lengthy review of prior cases that had addressed the issue of what constitutes a contribution to capital, including the U.S. Supreme Court’s decision in *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950), and the Third Circuit’s decision in *Commissioner v. McKay Prods. Corp.*, 178 F.2d 639 (3d Cir. 1949). Based on this review, the court concluded that “the key to determining whether payments from a nonshareholder (here the State of New Jersey) are taxable to the recipient (here petitioner’s affiliates) or nontaxable as a contribution to capital is the intent or motive of the nonshareholder donor.” In this case, the court concluded, the intent of the State of New Jersey in making the grants was not to pay for services, but rather to induce the consolidated group members to establish their offices in a targeted area (known as an urban-aid municipality) both to bring in new jobs and to revitalize the area. “The facts in this case fall squarely within the four corners of section 1.118-1, Income Tax Regs., and are strikingly similar to those of [Brown Shoe Co.](#) and [McKay Prods.](#)”

Corp. ...” Accordingly, the court held, the grants were nontaxable, nonshareholder contributions to capital.

- The [2017 Tax Cuts and Jobs Act](#), § 13312, amended Code § 118 effective after December 22, 2017, such that nonshareholder contributions to the capital of corporations made by governmental entities or civic groups no longer are excludable from the recipient corporation’s gross income. Accordingly, the result in this case would have been different if the years involved were subject to amended § 118.

- Any appeal of the Tax Court’s decision by the government will be heard by the U.S. Court of Appeals for the Third Circuit, the same court that issued the opinion in *McKay Prods. Corp.*

VII. PARTNERSHIPS

A. Formation and Taxable Years

B. Allocations of Distributive Share, Partnership Debt, and Outside Basis

1. *They were just kidding! Treasury and the Service have proposed to remove temporary regulations regarding the allocation of partnership liabilities for purposes of the § 707 disguised sale rules.* [REG-131186-17, Proposed Removal of Temporary Regulations on a Partner’s Share of a Partnership Liability for Disguised Sale Purposes](#), 83 F.R. 28397 (6/19/18). In 2016, Treasury and the Service published temporary regulations (707 Temporary Regulations) regarding the allocation of partnership liabilities for purposes of applying the disguised sale rules of § 707. T.D. 9788, *Liabilities Recognized as Recourse Partnership Liabilities Under Section 752*, 81 F.R. 69282 (10/5/16). On April 21, 2017, President Trump issued Executive Order 13789 directing the Secretary of the Treasury to review “all significant tax regulations” issued on or after January 1, 2016, that “impose an undue financial burden,” “add undue complexity,” or “exceed [the Service’s] statutory authority,” and to submit two reports to the President. The second report, issued by Treasury Secretary Mnuchin on October 2, 2017, recommended certain actions with respect to eight sets of regulations, one of which was the 707 Temporary Regulations. The second report stated that the novel approach implemented in the 707 Temporary Regulations should be studied systematically and that the Treasury Department and the Service therefore would consider removing the 707 Temporary Regulations and reinstating prior regulations. Treasury and the Service now have proposed to do so.

The 707 Temporary Regulations Issued in 2016. Temp. Reg. § 1.707-5T(a)(2), published in 2016, provides that, for purposes of the disguised sale rules, a partner’s share of any partnership liabilities, regardless of whether they are recourse or nonrecourse under Reg. § 1.752-1 through 1.752-3, must be allocated by applying the same percentage used to determine the partner’s share of “excess nonrecourse liabilities” under Reg. § 1.752-3(a)(3), “but such share shall not exceed the partner’s share of the partnership liability under section 752 and applicable regulations (as limited in the application of § 1.752-3(a)(3) to this paragraph (a)(2)).” Reg. § 1.752-3(a)(3) (as amended in T.D. 9787, 81 F.R. 69291 (10/5/16)), provides that, for purposes of the disguised sale rules of Reg. § 1.707-5(a)(2), a partner’s share of an excess nonrecourse liability is determined solely in accordance with the partner’s interest in partnership profits and that the significant item method, alternative method, and additional method do not apply. The combined effect of these rules is that, for purposes of the disguised sale rules, and regardless of whether a liability is recourse or nonrecourse, (1) a contributing partner’s share of a partnership liability is determined solely by the partner’s share of partnership profits and cannot be determined either under the other methods normally authorized for allocating excess nonrecourse liabilities or with reference to that partner’s economic risk of loss under Reg. § 1.752-2, and (2) no portion of any partnership liability for which another partner bears the risk of loss can be allocated to the contributing partner under the profit-share method. Treasury and the Service expressed the belief that, for purposes of the disguised sale rules, this allocation method reflects the overall economic arrangement of the partners. According to the preamble to the 707 Temporary Regulations, “[i]n most cases, a partnership will satisfy its liabilities with partnership profits, the partnership’s assets do not become worthless, and the payment obligations of partners or related persons are not called upon.” These rules were designed to be the death knell of leveraged partnership disguised sale transactions ala *Canal Corp. v. Commissioner*, 135 T.C. 199 (2010), to which reference is made in the 2016 preamble.

The Proposed Withdrawal of the 707 Temporary Regulations. The Treasury Department and the Service have proposed to remove the 707 Temporary Regulations and to reinstate the regulations under § 1.707-5(a)(2) as in effect prior to the 707 Temporary Regulations. Under those prior rules, (1) a partner's share of a partnership's recourse liability is the partner's share of the liability under § 752 and the regulations thereunder, i.e., recourse liabilities are allocated for purposes of the disguised sale rules under the normal rules for allocating recourse liabilities, and (2) nonrecourse liabilities are allocated by applying the same percentage used to determine the partner's share of "excess nonrecourse liabilities" under Reg. § 1.752-3(a)(3), which means that a contributing partner's share of a nonrecourse liability is determined for purposes of the disguised sale rules solely by the partner's share of partnership profits and that the significant item method, alternative method, and additional method do not apply. The proposed regulations also would reinstate the rule in former Reg. § 1.707-5(a)(2)(i) and (ii) for so-called § 1.752-7 contingent liabilities that a partnership liability is a recourse or nonrecourse liability to the extent that the obligation would be a recourse liability under Reg. § 1.752-1(a)(1) or a nonrecourse liability under § 1.752-1(a)(2), respectively, if the liability was treated as a partnership liability for purposes of section 752. The preamble to the proposed regulations indicates that "[t]he Treasury Department and the Service continue to study the issue of the effect of contingent liabilities with respect to section 707, as well as other sections of the Code." Finally, the proposed regulations would reinstate Examples 2, 3, 7, and 8 under Reg. § 1.752-1-5(f) with a modification to the language in Example 3 to reflect an amendment made in 2016 to Reg. § 1.707-5(a)(3) regarding an anticipated reduction in a partner's share of a liability that is not subject to the entrepreneurial risks of partnership operations.

Temporary Regulations on Bottom Dollar Guarantees Unaffected. The proposed regulations do not propose to withdraw Temp. Reg. § 1.752-2T(b)(3), issued in 2016, which addresses so-called bottom-dollar guarantees. Under Reg. § 1.752-2, a partnership liability is recourse to the extent that any partner or related person bears the economic risk of loss (EROL) for the liability. A partner or related person bears the EROL to the extent the partner or related person would have a payment obligation if the partnership liquidated in a worst-case scenario in which all partnership liabilities are due and all partnership assets generally are worthless. In 2016, along with the 707 Temporary Regulations, Treasury and the Service issued Temp. Reg. § 1.752-2T(b)(3), which (like the final regulation that preceded it) provides that "[t]he determination of the extent to which a partner or related person has an obligation to make a payment under [Reg. § 1.752-2(b)(1)] is based on the facts and circumstances at the time of the determination," and that "[a]ll statutory and contractual obligations relating to the partnership liability are taken into account." However, the Temp. Reg. § 1.752-2T(b)(3) carves out an exception under which "bottom dollar" guarantees and indemnities (or their equivalent, termed "bottom dollar payments") will not be recognized. The second report mentioned earlier, issued by Treasury Secretary Mnuchin on October 2, 2017, stated that Treasury and the Service believe that Temp. Reg. § 1.752-2T(b)(3) concerning bottom dollar payment obligations does not meaningfully increase regulatory burdens and should be retained to prevent abuses. Accordingly, the proposed regulations do not propose to withdraw Temp. Reg. § 1.752-2T(b)(3).

Effective Date. The 707 Temporary Regulations are proposed to be removed thirty days following the date that these proposed regulations are published as final regulations. The amendments to Reg. § 1.707-5 are proposed to apply to any transaction with respect to which all transfers occur on or after thirty days following the date these proposed regulations are published as final regulations. Nevertheless, taxpayers can apply these proposed regulations instead of the 707 Temporary Regulations to any transaction with respect to which all transfers occur on or after January 3, 2017.

C. Distributions and Transactions Between the Partnership and Partners

1. *No, you "May" not.* T.D. 9833, [Partnership Transactions Involving Equity Interests of a Partner](#), 83 F.R. 26580 (6/8/18). The Treasury Department and the Service have finalized, with only minor, nonsubstantive changes, Temp. Reg. § 1.337(d)-3T, Temp. Reg. § 1.732-1T(c), and corresponding proposed regulations issued in 2015. See T.D. 9722, [Partnership Transactions Involving Equity Interests of a Partner](#), 80 F.R. 33402 (6/12/15). These regulations are intended to prevent a corporate partner from avoiding recognition under § 311(b) of corporate-level gain through transactions with a partnership involving equity interests of the corporate partner. An example of the type of transaction—commonly called a "May Company" transaction—is as follows: A corporation

enters into a partnership and contributes appreciated property. The partnership then acquires stock of that corporate partner, and later makes a liquidating distribution of this stock to the corporate partner. Under § 731(a), the corporate partner does not recognize gain on the partnership's distribution of its stock. By means of this transaction, the corporation has disposed of the appreciated property it formerly held and acquired its own stock, permanently avoiding its gain in the appreciated property. If the corporation had directly exchanged the appreciated property for its own stock, § 311(b) would have required the corporation to recognize gain upon the exchange. Under the regulations, if a transaction has the effect of an exchange by a corporate partner of its interest in appreciated property for an interest in stock of the corporate partner owned, acquired, or distributed by a partnership (a "Section 337(d) Transaction"), the corporate partner must recognize gain under a "deemed redemption" rule.

Deemed Redemption Rule. Under the deemed redemption rule, a corporate partner in a partnership that engages in a Section 337(d) Transaction must recognize gain at the time, and to the extent, that the corporate partner's interest in appreciated property (other than stock of the corporate partner) is reduced in exchange for an increased interest in stock of the corporate partner. The complicated deemed redemption rule is triggered by the partnership's purchase of stock of a corporate partner (or stock or other equity interests of any corporation that controls the corporate partner within the meaning of § 304(c), except that § 318(a)(1) and (3) do not apply for that purpose); gain recognition can be triggered without a subsequent distribution. The regulations provide general principles that apply in determining the amount of appreciated property effectively exchanged for stock of the corporate partner. The corporate partner's economic interest with respect to both the stock of the corporate partner and all other appreciated property of the partnership must be determined based on all facts and circumstances, including the allocation and distribution rights set forth in the partnership agreement. The gain from the hypothetical sale used to compute gain under the deemed redemption rule is determined by applying the principles of § 704(c). The corporate partner's recognition of gain from a Section 337(d) Transaction triggers two basis adjustments. First, the partnership increases its adjusted basis in the appreciated property that is treated as the subject of a Section 337(d) Transaction by the amount of gain that the corporate partner recognizes with respect to that property as a result of the Section 337(d) Transaction regardless of whether the partnership has a § 754 election in effect. Second, the basis of the corporate partner's interest in the partnership is increased by the amount of gain the corporate partner recognizes. In limited circumstances, a partnership's acquisition of stock of the corporate partner does not have the effect of an exchange of appreciated property for that stock. For example, if a partnership with an operating business uses the cash generated in that business to purchase stock of the corporate partner, the deemed redemption rule does not apply because the corporate partner's share in appreciated property has not been reduced, and thus no exchange has occurred. The rules also do not apply if all interests in the partnership's capital and profits are held by members of an affiliated group (defined in § 1504(a)) that includes the corporate partner.

Distribution of Corporate Partner's Stock. A distribution of the corporate partner's stock to the corporate partner by the partnership also can trigger gain recognition. In addition to any gain previously recognized under the deemed redemption rule, if stock of a corporate partner is distributed to the corporate partner, the corporate partner must recognize gain to the extent that the partnership's basis in the distributed stock exceeds the corporate partner's basis in its partnership interest (as reduced by any cash distributed in the transaction) immediately before the distribution.

De Minimis Exception. The rules described above do not apply if a de minimis exception is satisfied. The de minimis exception applies if three conditions are met: (1) the corporate partner and any related persons own less than 5 percent of the partnership, (2) the partnership holds stock of the corporate partner worth less than 2 percent of the value of the partnership's gross assets, including stock of the corporate partner, and (3) the partnership has never, at any time, held more than \$1 million in stock of the corporate partner or more than 2 percent of any particular class of stock of the corporate partner.

Effective Date. The final regulations apply to transactions that occur on or after June 12, 2015.

D. Sales of Partnership Interests, Liquidations and Mergers

1. *The Tax Court gives the Service a lesson on the intersection of partnership and international taxation: subject to the exception in § 897(g), a foreign partner's gain from the*

redemption of its interest in a U.S. partnership was not income effectively connected with the conduct of a U.S. trade or business. [Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner](#), 149 T.C. No. 3 (7/13/17). The taxpayer, a corporation organized under the laws of Greece, held a 15 percent interest (later reduced to 12.6 percent) in Premier Chemicals, LLC, an LLC organized under Delaware law and classified for federal tax purposes as a partnership. The taxpayer accepted Premier's offer to redeem its partnership interest and received a total of \$10.6 million, half of which was paid in 2008 and half in January 2009. The taxpayer and Premier agreed that the payment in January 2009 was deemed to have been paid on December 31, 2008, and that the taxpayer would not share in any profits or losses in 2009. The taxpayer realized \$1 million of gain from the 2008 redemption payment and \$5.2 million from the 2009 redemption payment. The taxpayer filed a return on Form 1120-F for 2008 on which it reported its distributive share of partnership items, but did not report any of the \$1 million realized gain from the 2008 redemption payment. The taxpayer did not file a U.S. tax return for 2009 and thus did not report any of the \$5.2 million realized gain from the 2009 redemption payment. The Service issued a notice of deficiency in which it asserted that all of the \$6.2 million of realized gain was subject to U.S. tax because it was U.S.-source income effectively connected with the conduct of a U.S. trade or business. The taxpayer conceded that \$2.2 million of the gain was subject to U.S. taxation pursuant to § 897(g), which treats amounts received by a foreign person from the sale or exchange of a partnership interest as amounts received from the sale or exchange of U.S. real property to the extent the amounts received are attributable to U.S. real property interests. The taxpayer's concession left \$4 million of realized gain in dispute. The Tax Court (Judge Gustafson) held that the \$4 million of disputed gain was not income effectively connected with the conduct of a U.S. trade or business and therefore was not subject to U.S. taxation. (The court found it unnecessary to interpret the tax treaty in effect between the U.S. and Greece because U.S. domestic law did not impose tax on the gain and the Service did not contend that the treaty imposed tax beyond U.S. domestic law.) In reaching this conclusion, the court addressed several issues.

The court first analyzed the nature of the gain realized by the taxpayer. Under § 736(b)(1), payments made in liquidation of the interest of a retiring partner that are made in exchange for the partner's interest in partnership property are treated as a distribution to the partner. Treatment as a distribution triggers § 731(a)(1), which provides that a partner recognizes gain from a distribution to the extent the amount of money received exceeds the partner's basis in the partnership interest and directs that the gain recognized "shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner." Pursuant to § 741, gain recognized from the sale or exchange of a partnership interest is "considered as gain or loss from the sale or exchange of a capital asset" except to the extent provided by § 751. (The Service did not contend that § 751 applied.) The taxpayer asserted that these provisions lead to the conclusion that the taxpayer's gain must be treated as arising from the sale of a single asset, its partnership interest, which is a capital asset. The government argued that the taxpayer's gain must be treated as arising from the sale of separate interests in each asset owned by the partnership. Otherwise, the government argued, the rule in § 897(g), which imposes U.S. tax to the extent amounts received from the sale of a partnership interest are attributable to U.S. real property interests, would be rendered inoperable. The court agreed with the taxpayer. Section 897(g), the court explained,

actually reinforces our conclusion that the entity theory is the general rule for the sale or exchange of an interest in a partnership. Without such a general rule, there would be no need to carve out an exception to prevent U.S. real property interests from being swept into the indivisible capital asset treatment that section 741 otherwise prescribes.

The court noted that this conclusion is consistent with the court's prior decision in *Pollack v. Commissioner*, 69 T.C. 142 (1977).

The court next addressed whether the \$4 million of disputed gain was effectively connected with the taxpayer's conduct of a U.S. trade or business. Pursuant to § 875(1), the taxpayer was considered to be engaged in a U.S. trade or business because the partnership of which it was a partner, Premier, was engaged in a U.S. trade or business. Accordingly, the issue was narrowed to whether the disputed gain was effectively connected with that trade or business. Because foreign-source income is considered effectively connected with a U.S. trade or business only in narrow circumstances, which the Service acknowledged were not present, the taxpayer's disputed gain could be considered

effectively connected income only if it was U.S.-source income. Pursuant to the general rule of § 865(a), income from the sale of personal property by a nonresident is foreign-source income. The Service asserted that an exception in § 865(e)(2) applied. Under this exception, if a nonresident maintains an office or other fixed place of business in the United States, income from a sale of personal property is U.S.-source if the sale is attributable to that office or fixed place of business. The court assumed without deciding that Premier's U.S. office would be attributed to the taxpayer under § 864(c)(5). Accordingly, the issue was whether the gain was attributable to Premier's U.S. office. Under § 864(c)(5)(B), income is attributable to a U.S. office only if the U.S. office is a material factor in the production of the income and the U.S. office "regularly carries on activities of the type from which such income, gain, or loss is derived." The court concluded that neither of these requirements was satisfied. The court examined Reg. § 1.864-6(b)(2)(i) and concluded that, although Premier's business activities might have had the effect of increasing the value of the taxpayer's partnership interest, those business activities did not make Premier's U.S. office a material factor in the production of the taxpayer's gain. Further, the court concluded, even if the U.S. office was a material factor, Premier did not regularly carry on activities of the type from which the gain was derived because "Premier was not engaged in the business of buying or selling interests in itself and did not do so in the ordinary course of business." Because the disputed gain was not U.S.-source income, it was not effectively connected with the conduct of a U.S. trade or business and therefore not subject to U.S. taxation.

- In reaching its conclusion that the taxpayer's gain was not effectively connected with the conduct of a U.S. trade or business, the court rejected the Service's contrary conclusion in Rev. Rul. 91-32, 1991-1 C.B. 107. In that ruling, according to the court, the Service concluded

that gain realized by a foreign partner from the disposition of an interest in a U.S. partnership should be analyzed asset by asset, and that, to the extent the assets of the partnership would give rise to effectively connected income if sold by the entity, the departing partner's pro rata share of such gain should be treated as effectively connected income.

The court characterized the analysis in the ruling as "cursory" and declined to follow it.

- The taxpayer should have reported some of its gain in 2008, should have filed a 2009 U.S. tax return reporting gain in 2009, and should have paid tax with respect to both years because all of the gain realized from the 2008 distribution and some of the gain realized from the 2009 distribution was attributable to U.S. real property interests held by the U.S. partnership, Premier. Nevertheless, the court declined to impose either the failure-to-file penalty of § 6651(a)(1) or the failure-to-pay penalty of § 6651(a)(2) because the taxpayer had relied on the advice of a CPA and therefore, in the court's view, established a reasonable cause, good faith defense.

- a. *Grecian Magnesite may have won the battle, but the Service has won the war with respect to a non-U.S. partner's sale of an interest in a partnership doing business in the U.S. (thereby codifying the Service's position in Rev. Rul. 91-32).* The [2017 Tax Cuts and Jobs Act](#), § 13501, amended § 864(c) by adding § 864(c)(8). New § 864(c)(8) provides that, effective for dispositions after November 27, 2017, gain or loss on the sale or exchange of all (or any portion of) a partnership interest owned by a nonresident alien individual or a foreign corporation in a partnership engaged in any trade or business within the U.S. is treated as effectively connected with a U.S. trade or business (and therefore taxable by the U.S. unless provided otherwise by treaty) to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The amount of gain or loss treated as effectively connected under this rule is reduced by the amount of such gain or loss that is already taxable under § 897 (relating to U.S. real property interests). TCJA § 13501 makes corresponding changes to the withholding rules for effectively connected income under § 1446. These changes to § 864(c) and § 1446 statutorily reverse the Tax Court's recent decision in *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner*, 149 T.C. No. 3 (7/13/17) and effectively adopt the Service's position in Rev. Rul. 91-32, 1991-1 C.B. 107.

- b. *Temporary guidance on new withholding rules with respect to dispositions of partnership interests by non-U.S. partners, but publicly-traded partnerships get a "temporary" pass.*

[Notice 2018-8](#), 2018-7 I.R.B. 352 (1/2/18) and [Notice 2018-29](#), 2018-16 I.R.B. 495 (4/2/18). As mentioned above, TCJA § 13501 added new § 1446(f) to require that where § 864(c)(8) applies the transferee of a non-U.S. partner's partnership interest must withhold, report, and pay over a tax equal to 10 percent of the amount realized upon the disposition (unless specified exceptions apply) effective for transfers after December 31, 2017. Practitioners objected to immediate implementation of the new withholding rules, pointing out that without forms, instructions or other guidance, it was unclear when or how to deposit the withheld amounts. To address these concerns, Notice 2018-29 provides interim guidance on reporting and paying over the amount required to be withheld under section 1446(f)(1). For details, Notice 2018-29 should be consulted by taxpayers affected by new § 864(c)(8), but generally speaking, the temporary guidance adopts the forms and procedures relating to withholding on dispositions of U.S. real property interests under section 1445 and the regulations thereunder. With respect to publicly-traded partnerships, however, Notice 2018-8 announces that Treasury and the Service have determined that withholding under new section 1446(f) is not required with respect to any disposition of an interest in a publicly traded partnership (within the meaning of section 7704(b)) until regulations or other guidance have been issued. Notice 2018-8 emphasizes that this temporary suspension is limited to dispositions of interests that are publicly traded and does not extend to non-publicly traded interests.

c. *Proposed regulations implementing new § 864(c)(8) issued.* [REG-113604-18, Gain or Loss of Foreign Persons From Sale or Exchange of Certain Partnership Interests](#), 83 F.R. 66647 (12/27/18). Treasury and the Service have issued proposed regulations that implement new § 864(c)(8). As required by § 864(c)(8), the proposed regulations adopt a two-part analysis for determining effectively connected income or loss upon a foreign partner's sale or exchange of its partnership interest. First, § 864(c)(8)(A) requires a foreign partner to apply the normal rules of subchapter K to determine its overall gain or loss (including ordinary income or loss from "hot assets" under § 751) on the transfer of a partnership interest ("outside gain" and "outside loss"). Second, the outside gain or outside loss is compared to amounts determined under § 864(c)(8)(B), which can limit otherwise reportable effectively connected income or loss of the foreign partner. Consistent with the Service's position in *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner*, 149 T.C. No. 3 (7/13/17), and Rev. Rul. 91-32, 1991-1 C.B. 107, § 864(c)(8)(B) uses a hypothetical partnership level sale or exchange analysis to derive inside "aggregate deemed sale EC capital gain," "aggregate deemed sale EC capital loss," "aggregate deemed sale EC ordinary gain," and "aggregate deemed sale EC ordinary loss." Outside gain or loss determined under § 864(c)(8)(A) then is compared to inside gain or loss determined under § 864(c)(8)(B) to derive the amount ultimately reportable by the foreign partner as effectively connected income or loss upon the sale or exchange of its partnership interest. Thus, for example, a foreign partner would compare its outside capital gain to its aggregate deemed sale EC capital gain, treating the former as effectively connected gain only to the extent it does not exceed the latter. The proposed regulations provide several examples illustrating the application of new § 864(c)(8). The proposed regulations do not, however, address the corresponding modifications to the withholding rules in § 1446(f), stating only that the latter regulations are to be issued "expeditiously."

E. *Inside Basis Adjustments*

F. *Partnership Audit Rules*

1. *A disregarded LLC is a pass-thru partner for purposes of the small partnership exception to the TEFRA audit rules.* [Seaview Trading, LLC v. Commissioner](#), 858 F.3d 1281 (9th Cir. 6/7/17). Seaview Trading, LLC, a Delaware limited liability company that was classified as a partnership for federal tax purposes, had two members, each of which was a single-member LLC. One of these was AGK Investments LLC, which was wholly owned by Robert Kotick, and the other was KMC Investments LLC, wholly owned by Mr. Kotick's father. The Service audited Mr. Kotick's 2001 return and disallowed certain deductions with respect to his investment in Seaview, but did not disallow his share of a loss passed through from Seaview, which arose from Seaview's investment in a common trust fund. After the limitations period on assessment for 2001 with respect to Mr. Kotick had expired, the Service audited Seaview and issued a Final Partnership Administrative Adjustment (FPAA) in which the Service disallowed Seaview's loss from its trust investment. Mr. Kotick challenged the FPAA by filing a petition in the Tax Court. AGK, Mr. Kotick's wholly owned LLC, filed a separate

petition. Mr. Kotick argued that the FPAA was invalid because Seaview was not subject to the TEFRA audit rules pursuant to the small partnership exception of § 6231(a)(1)(B)(i). The Tax Court (Judge Foley) dismissed Mr. Kotick’s petition on the grounds that (1) Seaview did not fall within the § 6231(a)(1)(B)(i) small partnership exception to the TEFRA audit rules, and (2) AGK, rather than Mr. Kotick, was the TMP of Seaview and therefore the court lacked jurisdiction to consider the petition filed by Mr. Kotick. In an opinion by Judge Smith, the U.S. Court of Appeals for the Ninth Circuit affirmed. Absent a contrary election by the partnership, the § 6231(a)(1)(B)(i) small partnership exception excludes from the TEFRA audit rules “any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner.” However, pursuant to Reg. § 301.6231(a)(1)-1(a)(2), the small partnership exception does not apply “if any partner in the partnership during the taxable year is a pass-thru partner” as defined in § 6231(a)(9). Section 6231(a)(9) defines a pass-through partner as “a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership” The court acknowledged that the two single-member LLCs, AGK and KMC, were disregarded for federal tax purposes pursuant to the check-the-box regulations. Nevertheless, the court held, these LLCs were pass-thru partners. In reaching this conclusion, the court gave *Skidmore* deference to Rev. Rul. 2004-88, 2004-2 C.B. 165. *See Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). In Rev. Rul. 2004-88, the Service ruled that, because a disregarded LLC held legal title to a partnership interest it was “a similar person through whom other persons hold an interest in the partnership” and therefore a pass-thru partner. The court also held that Mr. Kotick lacked standing to file a Tax Court petition on behalf of Seaview because he was not Seaview’s TMP. Seaview had failed to designate a TMP for 2001, and therefore AGK, as the holder of the largest profits interest, was the TMP pursuant to § 6231(a)(7)(B). Accordingly, the court upheld the Tax Court’s dismissal of Mr. Kotick’s petition for lack of jurisdiction.

a. 🎵🎵*They call me mellow yellow.* 🎵🎵 *Well, actually, the D.C. Circuit calls it a TEFRA partnership.* [Mellow Partners v. Commissioner](#), 890 F.3d 1070 (D.C. Cir. 5/22/18). In an opinion by Judge Edwards, the U.S. Court of Appeals for the District of Columbia Circuit held that a partnership with two partners, each of which was a single-member LLC, was a TEFRA partnership that was subject to the TEFRA audit regime. The issue in the case was the same one presented in *Seaview Trading, LLC v. Commissioner*, 858 F.3d 1281 (9th Cir. 6/7/17), i.e., whether a partnership with a disregarded entity as a partner qualifies for the § 6231(a)(1)(B)(i) small partnership exception, which excludes from the TEFRA audit rules “any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner.” Pursuant to Reg. § 301.6231(a)(1)-1(a)(2), the small partnership exception does not apply “if any partner in the partnership during the taxable year is a pass-thru partner” as defined in § 6231(a)(9). Section 6231(a)(9) defines a pass-through partner as “a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership” Like the Ninth Circuit in *Seaview Trading*, the D.C. Circuit held that a single-member LLC that is a disregarded entity is a pass-thru partner as defined in § 6231(a)(9). Therefore, the partnership did not qualify for the small partnership exception and was subject to the TEFRA audit rules. The court also rejected the taxpayer’s challenge to the accuracy-related penalties that had been upheld by the Tax Court. The taxpayer challenged the penalties on the ground that the Service had not obtained the written supervisory approval of the penalties as required by § 6751(b)(1). *See Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 3/20/17). The court declined to consider this argument because the taxpayer had failed to raise it in the Tax Court and therefore had not preserved it for appeal.

2. *Liability for withholding taxes under §§ 1446 and 1461 is a partnership item and therefore properly before the Tax Court in a partnership-level proceeding.* [YA Global Investments v. Commissioner](#), 151 T.C. No. 2 (8/8/18). The Service issued both a notice of final partnership administrative adjustment and a notice of deficiency with respect to YA Global Investments, LP, a TEFRA partnership. The Service asserted that the partnership, which was based in the Cayman Islands, was engaged in the conduct of a trade or business in the U.S. and had failed to withhold on effectively connected taxable income allocable to its foreign partners as required by § 1446. Therefore, according to the Service, the partnership was liable for the taxes it had failed to withhold pursuant to § 1461, which provides that “[e]very person required to deduct and withhold any tax under . . . chapter [3] is hereby made liable for such tax.” The partnership’s tax matters partner filed a petition for readjustment

of the partnership items and the partnership filed a petition in response to the notice of deficiency. Both parties filed motions to dismiss for lack of jurisdiction in which they argued that liability for withholding taxes under §§ 1446 and 1461 is not a partnership item and therefore not properly before the court in a partnership-level proceeding. The Tax Court (Judge Buch) held that

A liability stemming from duty to withhold under section 1446 is a partnership liability and therefore properly before the Court in a partnership-level proceeding, as are penalties relating to the partnership-item adjustment.

The court reasoned that liability for the taxes required to be withheld under § 1446 is a partnership item because it is a liability imposed on the partnership. Under Reg. § 301.6231(a)(3)-1(a)(v), partnership liabilities are partnership items.

3. *The partnership audit rules do not apply to special enforcement matters.* Notice 2019-6, 2019-3 I.R.B. (12/20/18). In this notice, the Treasury Department and the IRS announced that proposed regulations will be issued to address certain “special enforcement matters” under § 6241(11). The notice also requests comments regarding other special enforcement matters that could be the subject of future proposed regulations. Congress added § 6241(11) to the Code as part of the [Consolidated Appropriations Act, 2018, Pub. L. No. 115-141](#), Division U, Title II, §§ 201-207, (“CAA 2018”), signed by the President on March 23, 2018, which enacted a number of technical corrections to the partnership audit rules that became effective for partnership taxable years beginning after 2017.

Section 6241(11). Section 6241(11) provides that, in the case of partnership-related items that involve special enforcement matters, the Secretary of the Treasury may issue regulations providing that (1) the partnership audit rules (or a portion of the rules) do not apply to the partnership-related items, and (2) the partnership-related items are subject to special rules (including rules related to assessment and collection) that the Secretary of the Treasury determines to be necessary for the effective and efficient enforcement of the Code. Section 6241(11) lists several specific special enforcement matters, including criminal investigations, indirect methods of proof of income, and foreign partners or partnerships, and also provides in § 6241(11)(vi) that special enforcement matters include “other matters that the Secretary determines by regulation present special enforcement considerations.”

Notice 2019-6. The notice provides that proposed regulations will be issued under § 6241(11)(vi) regarding two matters that present special enforcement considerations. The **first** matter is when an adjustment during an examination of a person other than the partnership requires a change to a partnership-related item. Specifically, the proposed regulations will provide that the IRS may determine that the partnership audit rules do not apply if the following three conditions are satisfied: (1) the examination being conducted is of a person other than the partnership, (2) a partnership-related item must be adjusted (or a determination regarding a partnership-related item must be made) as part of an adjustment to a non-partnership-related item of the person whose return is being examined, and (3) the treatment of the partnership-related item on the return of the partnership (or in the partnership’s books and records) was based in whole or in part on information provided by, or under the control of, the person whose return is being examined. The notice provides that this rule

will allow the IRS to effectively and efficiently focus on a single partner or a small group of partners with respect to a limited set of partnership-related items without unduly burdening the partnership and avoiding procedural concerns about the appropriate level at which such items must be examined.

The **second** matter is when a qualified subchapter S subsidiary (QSub) is a partner in a partnership. According to the notice, the proposed regulations will provide that the ability of partnerships with 100 or fewer partners to elect out of the partnership audit regime under § 6221(b) generally does not apply to a partnership with a QSub as a partner. Nevertheless, under the forthcoming proposed regulations, a partnership with a QSub as a partner will be able to elect out of the partnership audit regime if it meets certain requirements. The rule concerning the ability to elect out will be similar to the rule of § 6221(b)(2)(A) that currently applies to a partnership with an S corporation as a partner. Section 6221(b)(2)(A) provides that a partnership with an S corporation as a partner can elect out of the partnership audit regime only if it discloses with its return for the year the name and taxpayer

identification number of each person with respect to whom the S corporation is required to furnish a Schedule K-1 and counts each of the S corporation's Schedule K-1s in determining whether the partnership has 100 or fewer partners. Accordingly, the forthcoming proposed regulations will provide that, for purposes of determining whether a partnership has 100 or fewer partners for purposes of electing out under § 6221(b), the partnership must include (1) the statement (Schedule K-1) the partnership is required to furnish to the QSub partner under § 6031(b), and (2) each statement (Schedule K-1) the S corporation that holds 100 percent of the stock of the QSub partner is required to furnish to its shareholders under § 6037(b).

Effective Date. The notice provides that Treasury and the IRS intend to issue the proposed regulations within eighteen months of the enactment of [Consolidated Appropriations Act, 2018, Pub. L. No. 115-141](#), which was enacted on March 23, 2018. Pursuant to § 7805(b)(2), the effect of issuing the proposed regulations in this period will be that the regulations will apply to all partnership taxable years beginning after 2017. The notice also provides that, if the proposed regulations are not issued within this eighteen-month period, then the regulations will apply to partnership taxable years beginning after 2017 and ending after December 20, 2018, the date on which the notice was issued to the public.

G. Miscellaneous

1. *Nonowner contributions to the capital of partnerships and LLCs taxed as partnerships are not excludable, and the common law contribution to capital doctrine is on life support if not dead.* The [2017 Tax Cuts and Jobs Act](#), § 13312, amended Code § 118 effective after December 22, 2017, such that nonshareholder contributions to the capital of corporations made by governmental entities or civic groups no longer are excludable from the recipient corporation's gross income. Previously, such capital contributions were nontaxable, and they occasionally were made to incentivize corporations either to locate in particular communities or to acquire or redevelop distressed property in a community (or do both). In addition, the [Conference Report](#) accompanying the changes to § 118, along with the cases summarized below, probably leads to the conclusion that similarly-motivated capital contributions to *noncorporate entities* (i.e., partnerships and LLCs taxed as partnerships) no longer are excludable from gross income (if they ever were), even though such contributions are outside the purview of either old or amended § 118.

a. *No good deed goes unpunished.* [Ginsburg v. United States](#), 136 Fed. Cl. 1 (1/31/18). In this decision, the Court of Federal Claims held that the State of New York's payment of approximately \$1.8 million to an LLC (taxed as a partnership) to incentivize and reward redevelopment of brownfield property is includable in the taxpayer-member's gross income. The taxpayer owned 90% of an LLC taxed as a partnership for federal income tax purposes. The taxpayer's LLC participated in New York's Brownfield Development Tax Credit program in connection with acquiring an abandoned shoe factory in 2004 and eventually restoring it as a 134-unit residential building by 2011. New York's Brownfield Tax Credit program allows certain credits against state income taxes based upon investment in qualifying brownfield property. Further, if the credit is fully used by a taxpayer to offset applicable New York state income taxes, the excess of the credit over the amount used against state income taxes is paid to the taxpayer. Accordingly, after certifying that the taxpayer's LLC had complied with the terms of the Brownfield Development Tax Credit program, in 2013 New York paid the taxpayer's LLC approximately \$1.8 million in satisfaction of the taxpayer's excess credit amount. The taxpayer took the position on his 2013 federal income tax return that his 90% allocable share of the \$1.8 million payment was excludable from gross income as a nontaxable capital contribution to the LLC. (New York law allowed exclusion of the payment for New York income tax purposes.) Upon audit, the Service determined that the payment constituted gross income to the LLC and thus to the taxpayer as part of his allocable share of partnership income. This adjustment resulted in additional gross income to the taxpayer for 2013 and a corresponding underpayment of approximately \$602,000. The taxpayer paid the underpayment, filed a refund claim, and then brought this action in the Court of Federal Claims.

Analysis: Upon cross-motions for summary judgment, Court of Federal Claims (Judge Hodges) agreed with the government that the \$1.8 million constituted gross income to the taxpayer's LLC and thereby to the taxpayer. The government had argued, and the court agreed, that the payment was

includable by the broad terms of § 61(a) (gross income from whatever source derived) and that no statutory exclusions or exceptions applied. The taxpayer argued unsuccessfully that the \$1.8 million payment was (i) a nontaxable contribution to the LLC's capital, (ii) a nontaxable recovery of the LLC's investment in the Brownfield project owned by the LLC, or (iii) a nontaxable state "general-welfare" grant to the LLC. The taxpayer acknowledged that under any of the above theories the taxpayer's basis in the brownfield project would be adjusted downward by the amount excludable. Judge Hodges reasoned that, because the taxpayer could not point to an express provision of the Code to support his nontaxable contribution to capital theory, no such exclusion applied. Furthermore, Judge Hodges reasoned that the payment to the partnership could not be a recovery of the LLC's investment in the project because the payment came from a third party (the State of New York), not from the seller of the property. Judge Hodges expressed the view that the recovery of capital doctrine applies only in the context of buyers and sellers of "goods," and in that context, a payment can be nontaxable as a purchase price adjustment. (We believe the court was wrong about basis recovery being limited to sales of "goods." Regardless, the taxpayer's "recovery of investment" argument probably was not a winner anyway. For instance, see the court's analysis in *Uniquist Delaware*, discussed immediately below.) Finally, Judge Hodges determined that New York's payment to the taxpayer's LLC did not qualify for the "general-welfare" exclusion recognized in Rev. Rul. 2005-46, 2005-2 C.B. 120 (state disaster relief grants) because the tax credit in question was not conditioned on a showing of need.

- The holding of the Court of Federal Claims regarding the unavailability of the general welfare exclusion is consistent with the Tax Court's holding in *Maines v. Commissioner*, 144 T.C. 123 (2015). In *Maines*, the Tax Court held that the refundable portions of certain New York targeted economic development credits that remained after first reducing state tax liability were accessions to the taxpayers' wealth and were includable in gross income under § 61 for the year in which the taxpayers received payment or, under the constructive receipt doctrine, were entitled to receive payment, even if they elected to carry forward the credit. The Tax Court concluded that the taxpayers could not exclude the payments under the general welfare exclusion because the payments were not conditioned on a showing of need.

b. *Yet again, no good deed goes unpunished. But perhaps there could have been a workaround?* [Uniquist Delaware, LLC v. United States](#), 294 F. Supp. 3d 107 (W.D.N.Y. 3/27/18). In this decision, the U.S. District Court for the Western District of New York held that a grant paid by the New York State Empire State Development Corporation (which appears to have been a government-funded corporation) to an LLC taxed as a partnership was not excludable from the LLC's gross income as a contribution to capital. The taxpayer in this case was the LLC (unlike *Ginsburg v. United States*, 136 Fed. Cl. 1 (1/31/18), in which the taxpayer was a partner-member of the LLC). The LLC, a TEFRA partnership, had two equal members, each of which was a disregarded single-member LLC, that in turn were each wholly-owned by separate subchapter S corporations. The case arose in connection with a TEFRA partnership audit of the LLC, a fact which was important to the court's ultimate decision (as explained further below). In 2009, the LLC received an \$11 million grant from the New York State Empire State Development Corporation for the restoration of a building in Buffalo. The original grant proposal expressly stated that "[t]here is no element of compensation of specific, quantifiable or other services to the government agencies involved; the grants contemplated by this offer are being offered solely for the purpose of obtaining an advantage for the general community." The LLC did not include the \$11 million grant in its income on its partnership tax return for 2009. During the audit and at Service Appeals, the Service asserted that the \$11 million grant was included in the LLC's gross income in 2009 and ultimately issued an FPAA accordingly. The taxpayer-LLC then sought judicial review of the FPAA in the U.S. District Court for the Western District of New York.

Analysis: As in *Ginsburg*, the Service's argument in this case was simple: § 61(a) requires inclusion of the \$11 million grant in gross income, and no exception or exclusion in the Code provides otherwise. The taxpayer-LLC, similar to the taxpayer in *Ginsburg*, argued alternatively that the \$11 million grant was either (i) excludable under the "common law contribution to capital doctrine" or (ii) akin to a "rebate" that resulted in an adjustment to the taxpayer-LLC's basis in the building, but which was not includable in gross income. [As to this latter "rebate" argument, see Rev. Rul. 76-96, 1976-1 C.B. 23 (rebates paid by car manufacturers, but not the dealer who sold the car, are not income

but instead reduce the purchaser's basis in the car). Rev. Rul. 76-96 has been suspended in part on other grounds by Rev. Rul. 2005-28, 2005-1 C.B. 997.] Judge Wolford ruled against the taxpayer-LLC with respect to both arguments. Regarding the taxpayer-LLC's "common law contribution to capital doctrine" argument, the court reasoned that the cases supporting the doctrine involved corporate taxpayers only, and the holdings in these cases were codified by § 118 (the pre-TCJA version), which expressly does not apply to noncorporate entities. Regarding the taxpayer-LLC's "rebate" argument, Judge Wolford ruled that the \$11 million grant is distinguishable, stating "unlike a retail customer who purchases a car with the knowledge that a rebate is forthcoming, [the taxpayer] purchased the [Buffalo Building] and then subsequently sought and received the [\$11 million grant]. Therefore, the [\$11 million grant] cannot be considered a discount or reduction in the purchase price of the building."

Indirect §§ 118/702 Argument: The taxpayer-LLC argued that, even if § 118 applies only to corporations, the court should indirectly rule it applicable to resolve the dispute with the Service because the ultimate owners of the taxpayer-LLC were subchapter S corporations. The taxpayer further argued in this regard that § 118 (pre-TCJA) would have allowed the S corporation members of the taxpayer-LLC to exclude the grant from gross income. Therefore, the taxpayer-LLC argued, if the S corporation members could have excluded the grant under § 118, then the grant ultimately should be held nontaxable by virtue of § 702's distributive share approach to partner-level income. With respect to this final argument, Judge Wolford ruled that because TEFRA audit procedures treat the taxpayer-LLC as an entity separate from its owners, the partner-level treatment by the ultimate owners of the LLC was not within the court's subject-matter jurisdiction. See § 6226(f) and *American Boat Co., LLC v United States*, 583 F.3d 471, 478 (7th Cir. 2009) ("A court does not have jurisdiction to consider a partner-level defense in a partnership-level proceeding.")

Planning pointer: Had the subchapter S corporations first received the \$11 million grant from New York and then contributed the funds to the taxpayer-LLC as additional capital contributions, we believe the grant would not have been taxable pursuant to the pre-TCJA version of § 118 and § 721, respectively. On the other hand, perhaps the terms of the grant would not allow the funds to be paid to the S corporation members because the acquisition and development was performed by the taxpayer-LLC, not the S corporation members.

c. **The Federal Circuit has affirmed the Claims Court's decision that an LLC classified as a tax partnership could not exclude from gross income a cash payment received from the State of New York.** [Ginsburg v. United States](#), 922 F.3d 1320 (Fed. Cir. 4/25/19), *aff'g* 136 Fed. Cl. 1 (1/31/18). In an opinion by Judge Wallach, the U.S. Court of Appeals for the Federal Circuit has affirmed the decision of the U.S. Court of Federal Claims granting summary judgment to government and held that an LLC classified as a partnership had to include in gross income a cash payment received from the State of New York. As a result, the members of the LLC, including the taxpayers in this case, had to include their distributive shares of the payment in gross income. The taxpayer owned 90% of an LLC taxed as a partnership for federal income tax purposes. The taxpayers held 90 percent of the membership interests in an LLC that participated in New York's Brownfield Development Tax Credit program in connection with acquiring an abandoned shoe factory in 2004 and eventually restoring it as a 134-unit residential building by 2011. Under this program, if the credit is fully used by a taxpayer to offset applicable New York state income taxes, the excess of the credit over the amount used against state income taxes is paid to the taxpayer. After certifying that the taxpayers' LLC had complied with the terms of the Brownfield Development Tax Credit program, in 2013 New York paid the taxpayer's LLC approximately \$1.8 million in satisfaction of the taxpayer's excess credit amount. The taxpayers took the position on their 2013 federal income tax return that their 90% allocable share of the \$1.8 million payment was excludable from gross income as a nontaxable capital contribution to the LLC. Following an audit, the taxpayers paid the underpayment asserted by the IRS of approximately \$602,000, filed a refund claim, and then brought a refund action in the Court of Federal Claims, which held that the payment constituted gross income. On appeal, the Federal Circuit first concluded that the funds received were an economic gain over which the taxpayers had complete dominion and therefore constituted gross income under the taxpayers had gross income under *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). The court rejected all of the taxpayer's arguments that the payments were excludable from income, including the arguments that: (1) the payment for the excess amount was a nontaxable return of capital, and (2) the brownfield

redevelopment tax credit was “indistinguishable from . . . inducement payments, rebates, and reimbursements that’ have historically been treated as ‘not includable in gross income.’”

2. *Relief for not reporting negative tax capital accounts.* Notice 2019-20, 2019-14 I.R.B. 927 (3/7/19). The updated 2018 Instructions for Form 1065 and accompanying Schedule K-1 now require a partnership that does not report tax basis capital accounts to its partners to report, on line 20 of Schedule K-1 (Form 1065) using code AH, the amount of a partner’s tax basis capital both at the beginning of the year and at the end of the year if either amount is negative. Aware that some taxpayers and their advisors may not have been prepared to comply with this new requirement for 2018 returns, Notice 2019-20 provides limited relief. Specifically, the IRS will waive penalties (i) under § 6722 for failure to furnish a partner a Schedule K-1 (Form 1065) and under § 6698 for failure to file a Schedule K-1 (Form 1065) with a partnership return, (ii) under § 6038 for failure to furnish a Schedule K-1 (Form 8865), and (iii) under any other section of the Code for failure to file or furnish a Schedule K-1 or any other form or statement, for any penalty that arises solely as a result of failing to include negative tax basis capital account information provided the following conditions are met:

4. The Schedule K-1 or other applicable form or statement is timely filed, including extensions, with the IRS; is timely furnished to the appropriate partner, if applicable; and contains all other required information.
5. The person or partnership required to file the Schedule K-1 or other applicable form or statement files with the IRS, no later than one year after the original, unextended due date of the form to which the Schedule K-1 or other applicable form or statement must be attached, a schedule setting forth, for each partner for which negative tax basis capital account information is required: (a) the partnership’s name and Employee Identification Number, if any, and Reference ID Number, if any; (b) the partner’s name, address, and taxpayer identification number; and (c) the amount of the partner’s tax basis capital account at the beginning and end of the tax year at issue.

The above-described supplemental schedule should be captioned “Filed Under Notice 2019-20” in accordance with instructions and additional guidance posted by the IRS on www.irs.gov. The due date for this supplemental schedule is determined without consideration of any extensions, automatic or otherwise, that may apply to the due date for the form itself. Furthermore, the schedule should be sent to the address listed in the Notice, and the penalty relief applies only for taxable years beginning after December 31, 2017, but before January 1, 2019.

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. *The Ninth Circuit channels the economic substance doctrine to tell the Tax Court that it was too quick to dismiss transferee liability in a midco case.* [Slone v. Commissioner](#), 788 F.3d 1049 (9th Cir. 6/8/15), *amended*, 2015 WL 5061315 (8/28/15), *vacating and remanding*, T.C. Memo. 2012-57 (3/1/12). The taxpayer’s family-owned corporation sold all of its assets for cash, resulting in a gain of over \$38 million and an estimated combined federal and state income tax liability of over \$15 million. None of the proceeds had been distributed at the time Fortrend and MidCoast made an unsolicited offer to purchase the stock of the corporation, which ultimately was accepted, at a purchase price of \$35,753,000, plus assumption of the corporation’s liabilities for federal and state income taxes owed as of the closing date. Not unsurprisingly, the taxes were never paid and the Service asserted transferee liability against the shareholders. Because the asset sale and stock sale were independent of each other and the shareholders “had no reason to believe that Fortrend’s methods were illegal or inappropriate, . . . [n]either the substance over form doctrine nor any related doctrines appl[ie]d to recast the stock sale as a liquidating distribution.” Thus, because the Service’s transferee liability theory was grounded on recasting the stock sale as a liquidation, the Service lost in the Tax Court because under this view the taxpayer was not a “transferee.”

On appeal, the Tax Court’s decision was vacated and remanded in a decision written by Judge Ikuta. According to the Ninth Circuit, the Tax Court erred in respecting the form of the shareholders’ stock sale because it applied an erroneous standard. The Court of Appeals’ majority opinion first noted that that the “Supreme Court has long recognized ‘the importance of regarding matters of substance

and disregarding forms,’ *United States v. Phellis*, 257 U.S. 156, 168 because ‘[t]he incidence of taxation depends upon the substance of a transaction,’ *Comm’r v. Court Holding Co.*, 324 U.S. 331, 334 (1945).” The court then looked to its economic substance doctrine precedents to conclude that the same “approach is applicable for determining whether a taxpayer is a transferee for purposes of § 6901. Accordingly, when the Commissioner claims a taxpayer was ‘the shareholder of a dissolved corporation’ for purposes of 26 C.F.R. § 301.6901-1(b), but the taxpayer did not receive a liquidating distribution if the form of the transaction is respected, a court must consider the relevant subjective and objective factors to determine whether the formal transaction ‘had any practical economic effects other than the creation of income tax losses.’” However, the majority concluded that it could not determine on appeal whether the shareholder was a transferee because the Tax Court “did not address either the subjective or objective factors we apply in characterizing a transaction for tax purposes, as it failed to make any finding on whether the shareholders had a business purpose for entering into the stock purchase transaction other than tax avoidance, or whether the stock purchase transaction had economic substance other than shielding the ... shareholders from tax liability.” The Tax Court was directed on remand to make the findings necessary to correctly apply the transferee test as articulated by the Court of Appeals. “[T]he tax court should apply the relevant subjective and objective factors to determine whether the Commissioner erred in disregarding the form of the transaction in order to impose tax liability on the shareholders as ‘transferees’ under § 6901.”

- Judge Noonan concurred with the majority’s holding that the Tax Court erred by applying the wrong standard and that economic substance doctrine principles properly applied to determine whether to disregard the form of the transaction in order to determine whether the shareholders were transferees under § 6901. But he thought the record was sufficient to hold that the stock sale transaction had no economic substance and that the shareholders were transferees under § 6901. He would have remanded to the Tax Court only on the question of state law substantive liability.

a. *The Ninth Circuit has reversed the Tax Court yet again in this midco case. [Slone v. Commissioner](#), 896 F.3d 1083 (9th Cir. 7/24/18), vacating and remanding T.C. Memo. 2016-115 (6/13/16).* This case has considerable history, as recounted above, but in both instances the Tax Court held for the taxpayers only to have the Ninth Circuit reverse in favor of the Service. In this second round in the Ninth Circuit, the Service appealed the Tax Court’s decision (Judge Haines) that the form of the transaction (a stock sale) could not be ignored to impose transferee liability on the taxpayers unless the taxpayers knew that the “entire transactional scheme” was intended to avoid taxes. Judge Haines determined that the Service had not met its burden of proof on this issue. In an opinion by Judge Schroeder, however, the Ninth Circuit concluded that the “record contains ample evidence” the taxpayers were at the very least on “constructive notice that the entire scheme has no purpose other than tax avoidance.” The court stated as follows:

This record establishes that the Petitioners were, at the very least, on constructive notice of such a purpose. In reaching a contrary conclusion, the Tax Court confused actual and constructive notice, in effect allowing Petitioners to shield themselves through “the willful blindness the constructive knowledge test was designed to root out.” *Diebold*, 736 F.3d at 189–90; see *Salus Mundi*, 776 F.3d at 1020.

In the Ninth Circuit’s view, the transaction constituted a constructive liquidation (not a stock sale) resulting in transferee liability being imposed upon the taxpayers. The court reversed and remanded for entry of judgment in favor of the Service.

2. *The taxpayer came to regret his decision to organize his business as a C corporation, and a midco transaction failed to solve the problem. [Tricarichi v. Commissioner](#), T.C. Memo 2015-201 (10/14/15).* The taxpayer was the sole shareholder of a C corporation, West Side Cellular, Inc. After lengthy litigation regarding network access, West Side received a settlement of \$65 million and was required both to terminate its business as a retail provider of cell phone service and to end all service to its customers. To reduce the impact of corporate-level tax, the taxpayer engaged in a midco transaction in which a Cayman Islands affiliate of Fortrend International LLC purchased the stock of West Side for approximately \$11.2 million more than the corporation’s net asset value (the value of its assets less its estimated federal tax liabilities) and then used a distressed debt strategy to generate a bad debt deduction of \$42.4 million to eliminate West Side’s tax liabilities. In the notice of

deficiency issued to West Side, the Service determined a deficiency of \$15.2 million based on its disallowance of the corporation's bad debt deduction and asserted an accuracy-related penalty of roughly \$62,000 and a gross valuation misstatement penalty of \$5.9 million. The Tax Court (Judge Lauber) held the taxpayer liable as a transferee for West Side's federal tax liability, the accuracy-related penalty, and the gross valuation misstatement penalty. In order for a shareholder to have transferee liability for a corporation's tax liability, the court stated, two requirements must be satisfied: (1) the shareholder must be liable for the corporation's debts under some provision of state law, and (2) the shareholder must be a "transferee" within the meaning of § 6901. With respect to the first requirement, the court held that the taxpayer was liable as a transferee under Ohio law (the Uniform Fraudulent Transfer Act) for the corporation's tax deficiency as well as the penalties:

In sum, we find that petitioner had constructive knowledge of Fortrend's tax-avoidance scheme; that the multiple steps of the Midco transaction must be collapsed; and that collapsing these steps yields a partial or complete liquidation of West Side from which petitioner received in exchange for his stock a \$35.2 million liquidating distribution. Under [Ohio law], petitioner is thus a direct transferee of West Side's assets under respondent's "de facto liquidation" theory as well as under the "sham loan" theory discussed previously.

With respect to the second requirement, the court disregarded the form of the transaction and concluded that the taxpayer was a transferee within the meaning of § 6901 because the taxpayer had in substance directly received West Side's cash. Any appeal of the court's decision will be directed to the Ninth Circuit.

a. *How about a little salt in that wound? The taxpayer also is liable for pre-notice interest of \$13.9 million.* [Tricarichi v. Commissioner](#), T.C. Memo. 2016-132 (7/18/16). In a supplemental opinion, the Tax Court (Judge Lauber) upheld the government's calculation of pre-notice interest, i.e., interest that accrued on the corporation's unpaid federal income tax liability from the date on which payment was due from the corporation in March 2004 to the date on which the Service issued the notice of liability to the taxpayer in June 2012. The government asserted that the taxpayer's liability for pre-notice interest must be determined under federal law and computed in accordance with the rules for interest on underpayments in § 6601. According to the government, the pre-notice interest amounted to \$13.9 million. The taxpayer contended that his liability for pre-notice interest must be determined under state law, and that under state law his liability for pre-notice interest was zero. The court reviewed prior decisions addressing liability for pre-notice interest, including *Lowy v. Commissioner*, 35 T.C. 393 (1960) and *Estate of Stein*, 37 T.C. 945 (1962), and concluded that courts have applied state law to determine liability for pre-notice interest only when the transferee has received an amount less than the transferor's liability:

In short, the courts have consulted State law to ascertain whether the Government may recover from the transferee, in the form of pre-judgment interest, an amount larger than the value of the assets the transferee received. Petitioner has cited, and our own research has discovered, no case in which a court has invoked State law governing pre-judgment interest as a basis for reducing the Government's recovery to an amount smaller than the value of the assets the transferee received. That is what petitioner seeks to do here, and there is simply no precedent for it.

Because the taxpayer received from the corporation assets in the amount of \$35.2 million, more than the \$35.1 million total of the transferor corporation's liability for income tax, penalties, and pre-notice interest, the taxpayer's liability for pre-notice interest was properly determined under federal law. Accordingly, the court held the taxpayer liable as a transferee for \$13.9 million in pre-notice interest.

b. *The Ninth Circuit has affirmed the Tax Court's holding that the taxpayer was liable as a transferee.* [Tricarichi v. Commissioner](#), 752 Fed. Appx. 455 (9th Cir. 11/13/18), *aff'g* T.C. Memo. 2016-132 (7/18/16). In a brief, memorandum opinion, the U.S. Court of Appeals for the Ninth Circuit affirmed the Tax Court's decision that the taxpayer, who sold in a midco transaction the stock of West Side Cellular, Inc., a C corporation of which he was the sole shareholder, was liable as a transferee for the corporation's federal tax liability. The court cited its prior opinion in *Slone v. Commissioner*, 810 599 (9th Cir. 2015), for the two-prong test that must be satisfied for a shareholder

to have transferee liability for a corporation's tax liability: (1) the shareholder must be liable for the corporation's debts under some provision of state law, and (2) the shareholder must be a "transferee" within the meaning of § 6901. The court held that the Tax Court had properly concluded that the corporation's cash had been "transferred" to the taxpayer within the meaning of the Ohio Uniform Fraudulent Transfer Act (thus satisfying the first prong), and that the Tax Court had "properly determined, looking through the form of the stock sale to consider its substance, that it lacked a non-tax business purpose or any economic substance other than the creation of tax benefits," which satisfied the second prong of the test.

c. *The Ninth Circuit has affirmed the Tax Court's decision regarding the taxpayer's liability for pre-notice interest.* [Tricarichi v. Commissioner](#), 908 F.3d 588 (11/13/18). In an opinion by Judge Owens, the U.S. Court of Appeals for the Ninth Circuit has affirmed the Tax Court's decision that the taxpayer, who sold in a midco transaction the stock of West Side Cellular, Inc., a C corporation of which he was the sole shareholder, was liable as a transferee not only for the corporation's federal tax liability, but also for pre-notice interest. Pre-notice interest is interest that accrued on the corporation's unpaid federal income tax liability from the date on which payment was due from the corporation in March 2004 to the date on which the Service issued the notice of liability to the taxpayer in June 2012. In its prior decision in *Edelson v. Commissioner*, 829 F.2d 828, 834 (9th Cir. 1987), the court had held that "[w]here transferee liability is found to exist but the transferred assets are insufficient to satisfy the transferor's total tax liability, a transferee's liability for interest is controlled by state law." The Ninth Circuit had not previously addressed the situation in which the transferee had received assets worth *more* than the transferor's total tax liability. The court took note of the Tax Court's prior decisions in *Lowy v. Commissioner*, 35 T.C. 393 (1960) and *Estate of Stein*, 37 T.C. 945 (1962), in which the Tax Court had held that, when the assets transferred are more than the federal tax liability of the transferor (including interest), it is unnecessary to look to state law to determine whether the transferee is liable for pre-notice interest. The court also discussed the First Circuit's opinion in *Schussel v. Werfel*, 758 F.3d 82 (1st Cir. 2014), in which the First Circuit followed *Lowy* and *Estate of Stein*. The Ninth Circuit agreed with the First Circuit's reasoning and held

that because the value of assets transferred from West Side to Tricarichi is more than West Side's total federal tax liability, the federal Internal Revenue Code determines Tricarichi's pre-notice interest liability, and there is no need to consult state law regarding such interest.

Accordingly, in addition to being liable for the corporate transferor's federal tax liability, the taxpayer was liable for more than \$13 million of pre-notice interest.

3. *You only need to read the first two sentences of this S corporation ESOP case to know that it's a loser for the taxpayer.* [Pacific Management Group et al. v. Commissioner](#), 116 T.C.M. (CCH) 181, 2018 T.C.M. (RIA) ¶ 2018-131 (8/20/18). You know it's not going to go well for the taxpayers when the first two sentences of the Tax Court's opinion read as follows: "These consolidated cases involve a complex tax shelter scheme featuring four C corporations, five individual shareholder-employees of the C corporations, five employee stock ownership plans (ESOPs), five S corporations, and (inevitably) a partnership. This scheme was devised by [attorney], who serves as co-counsel for the petitioners in these cases." Essentially, the "scheme" (as Judge Lauber labeled it) enabled the taxpayers' C corporations to pay purportedly deductible "factoring fees" and "management fees" to the taxpayers' partnership over the years 2002 through 2005 in order to minimize or eliminate any corporate level tax. The partnership then allocated the income from those payments to S corporations, with one S corporation having been established for each of the five principals, with their allocable shares of partnership income being determined based upon their relative percentage ownership of stock in the C corporations. The principals received and paid taxes on their salaries from their respective S corporations, but the excess profits over their salaries accumulated tax free in the five separate S corporations that were owned by five separate ESOPs. Judge Lauber, after 80 pages of facts and analysis, held that the so-called "factoring fees" and "management fees" claimed by that the taxpayer C corporations were in fact either disguised dividends or improperly assigned income taxable to the five principals. Regarding the "factoring fees," Judge Lauber found that the arrangement lacked economic substance, and instead was merely a device to extract profits from the C corporations disguised as tax-deductible payments. Regarding the "management fees," which were compensation

and bonuses paid to the principals for their services, Judge Lauber applied the *Elliotts* factors to determine whether the payments constituted reasonable compensation. See *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1245-1247 (9th Cir. 1983), *rev'g and remanding* T.C. Memo. 1980-282. Applying those factors, Judge Lauber found that only a portion of the bonus payments constituted reasonable compensation. The balance of the bonuses constituted nondeductible dividends by the C corporations. Ultimately, the Tax Court agreed with the Service's proposed adjustment of approximately \$1.75 million of additional taxable income among the five principals. With respect to certain of the five principals, underpayment penalties also were imposed based upon their individual circumstances after taking into account other, unrelated income for the years in issue.

B. *Identified "tax avoidance transactions"*

C. *Disclosure and Settlement*

D. *Tax Shelter Penalties*

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. *Exempt Organizations*

1. *Congress shoots a probable NCAA "airball": After TCJA, it will cost 21 percent more to pay big-time, private school coaches like Coach K (Duke-\$7.2M); but Wildcat fans celebrate as Coach Calipari (Kentucky-\$6.5M) gets an "assist" from Congress.* Presumably believing that \$1 million salaries at tax-exempt organizations are per se unreasonable, Congress decided to take a "shot" (*pun intended*) at curtailing them under TCJA. Specifically, the [2017 Tax Cuts and Jobs Act](#), § 13602, adds Code § 4960 to impose a 21 percent excise tax on "applicable tax-exempt organizations" ("ATEOs") and broadly-defined "related organizations" paying over \$1 million annually to "covered employees." In addition to § 527 political organizations and § 521 farmers cooperatives, ATEOs include the following two additional types of organizations: (i) those exempt from tax under § 501(a) (most nonprofits, including churches, hospitals, and private schools); and (ii) those "with income excluded from taxation under § 115(l)" (income of certain public utilities and income derived from "any essential governmental function and accruing to a State or any political subdivision thereof"). A "covered employee" is defined as any one of the five highest compensated employees of an ATEO either (i) for the current taxable year or (ii) for any year beginning after December 31, 2016. Licensed medical or veterinarian professionals, however, are excluded from the definition of "covered employee." New § 4960 is permanent and effective for taxable years beginning after 2017. Given that many tax-exempt organizations have taxable years ending June 30 or October 31, many potentially affected organizations will have time to either comply or attempt to avoid new § 4960.

a. *The NCAA "airball."* Congress apparently thought that new § 4960 defined an ATEO so that both public and private colleges and universities would have to pay the 21 percent excise tax on compensation exceeding \$1 million. The legislative history accompanying § 4960 states: "An [ATEO] is an organization exempt from tax under section 501(a), an exempt farmers' cooperative, a Federal, State or local governmental entity with excludable income, or a political organization." See H.R. Conf. Rep. No. 115-466, at 492 (Dec. 15, 2017) (emphasis added). At least one well-respected exempt organization scholar, however, has pointed out that, at least according to the Service, "[i]ncome earned by a state, a political subdivision of a state, or an integral part of a state or political subdivision of a state" is not taxable regardless of § 115, citing Rev. Rul. 87-2, 1987-1 C.B. 18. Instead, it is the Service's position that public colleges and universities are not taxable under our federalist system unless and until Congress enacts a specific statutory provision subjecting such state-affiliated organizations to tax like § 511(a)(2)(B) (state colleges and universities are subject to unrelated business income tax). See the blog post by Professor Ellen P. Aprill [here](#), and her full law review article on the subject: Ellen P. Aprill, *The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Government Affiliates*, 23 J. Corp. Law 803 (1997). The Service admits to Congress's mistake in Notice 2019-9 (discussed below) by clarifying that state colleges and universities generally are not subject to new § 4960; however, the Notice also takes the somewhat dubious position that if such organizations exclude any income from taxation under § 115 or if they applied for and obtained exempt status under § 501(a), then they are subject § 4960 notwithstanding the fact that they integral

part of state and local government. The authors are not so sure the Service is on solid ground here, but we'll see

b. *And another thing* ... Churches are exempt from taxation under § 501(a) along with hospitals and private schools. But we wouldn't bet money that any church paying its pastor more than \$1 million annually is going to pay an excise tax under new § 4960 without a fight based on the First Amendment. Ultimately, the church may lose such a fight because it is clear that churches are subject to the unrelated business income tax of § 511, but if a church can pay its pastor \$1 million a year, it can pay a tax lawyer to litigate too.

c. *Interim guidance on the § 4960 21 percent excise tax on applicable tax-exempt organizations.* Notice 2019-9, 2019-4 I.R.B. 403 (12/31/18). In this notice, the Service announced that Treasury will issue proposed regulations under § 4960, the provision enacted by the [2017 Tax Cuts and Jobs Act](#) that imposes an excise tax at the highest rate in § 11 (currently 21 percent) on “applicable tax-exempt organizations” (“ATEOs”) and broadly-defined “related organizations” paying over \$1 million annually to “covered employees.” The notice provides, in Q&A format, extensive interim guidance on new § 4960. Until further guidance is issued, taxpayers may base their positions upon a good faith, reasonable interpretation of § 4960, including its legislative history, to comply with the requirements of the statute. The notice provides that the positions reflected in it constitute a good faith, reasonable interpretation of the statute. The preamble to the notice describes certain positions that will be regarded as not consistent with a good faith, reasonable interpretation of the statutory language. Among other guidance, the notice provides in Q&A 5 that public universities with Service determination letters recognizing their tax-exempt status under § 501(c)(3) are ATEOs and therefore subject to § 4960, but “a governmental unit (including a state college or university) that does not have a determination letter recognizing its exemption from taxation under section 501(a) and does not exclude income from gross income under section 115(1) is not an ATEO” and therefore is not subject to § 4960. Nevertheless, the notice provides that such a governmental unit may be liable for the excise tax imposed by § 4960 if it is a related organization under § 4960(c)(4)(B) with respect to an ATEO.

2. *Successful private colleges and universities really must be in the dog house because, in addition to taxing them for highly-paid coaches, Congress has decided to tax their endowments too! And, just to keep us on our toes, the legislative history says the statute turns on the number of an institution's “tuition paying” students, but § 4968 simply reads “students.”* The [2017 Tax Cuts and Jobs Act](#), § 13701, adds § 4968 which imposes a new 1.4 percent annual excise tax upon the net investment income of certain private colleges and universities and affiliated organizations with endowments worth \$500,000 or more per full-time student. The excise tax imposed by new § 4968 is similar in many respects to the annual excise tax imposed upon private foundations under § 4940. In particular, new § 4968 applies to an “applicable educational institution” which is defined as institution: (i) that is an “eligible educational institution” as described in § 25A(f)(2) (which in turn refers to 20 U.S.C. § 1088); (ii) that has at least 500 students during the preceding taxable year more than 50 percent of which are in the U.S.; (iii) that is not described in the first section of § 511(a)(2)(B) (state colleges and universities); and (iv) that has assets (other than assets used directly in carrying out the institution's exempt purpose) with an aggregate fair market value as of end of the preceding taxable year of at least \$500,000 per student. For this latter purpose, the number of students of an institution is based on the daily average number of full-time students attending the institution, with part-time students taken into account on a full-time student equivalent basis. Moreover, the legislative history of new § 4968 states that the \$500,000 per student figure should be calculated based upon “tuition paying” students; however, the Senate Parliamentarian struck that language from § 4968 immediately before it was passed by the House and Senate. Whether regulations can fill in the gap is anybody's guess. New § 4968 is permanent and effective for taxable years beginning after 2017, again giving fiscal-year private colleges and universities time to cope.

a. *Maybe students negotiating for scholarships at private colleges and universities now have a little more leverage.* As originally passed late in 2017, new § 4968 taxed private colleges and universities (and affiliates) with endowments worth \$500,000 or more per “student” (as defined in the statute to account for full and part-time students); however, the legislative history of new § 4968 stated that the \$500,000 per student figure should be calculated based upon “tuition-paying” students. The discrepancy between the statute and the legislative history was created

because the Senate Parliamentarian struck the “tuition-paying” language from § 4968 immediately before the 2017 Tax Cuts and Jobs Act ultimately was passed by Congress. Thanks to the [Bipartisan Budget Act of 2018](#), § 41109, though, § 4968 is amended to include the “tuition-paying” modifying language. Thus, only those private colleges and universities (and affiliates) with endowments worth \$500,000 or more per tuition-paying student will be subject to the new 1.4 percent annual excise tax.

b. *Then again . . . maybe not!* [Notice 2018-55](#), 2018-26 I.R.B. 773 (06/08/18). The Service has announced that proposed regulations under new § 4968 will determine “net investment income” gains and losses of an “applicable educational institution” by reference to an endowment asset’s fair market value as of December 31, 2017, not its historical adjusted basis (unless historical adjusted basis is greater than fair market value as of December 31, 2017). This special rule allowing an applicable educational institution to use the *greater of* (i) fair market value as of the end of the taxable year of enactment of the statute or (ii) historical adjusted basis for purposes of calculating net investment income is patterned after the approach taken in 1969 with respect to private foundations subject to § 4940. *See* § 4940(c)(1) (greater of adjusted basis or fair market value as of December 31, 1969). Therefore, net investment income of applicable educational institutions subject to new § 4968 should be minimal for the next year or so. Notice 2018-55 further announces that proposed regulations under new § 4968 (i) will take into account net investment losses only to the extent of net investment gains (with no allowance for capital loss carryovers or carrybacks) and (ii) will permit related organizations described in § 4968(d)(2) to consolidate gains and losses for purposes of calculating net investment income. Notice 2018-55 also invites comments by September 6, 2018, regarding the to-be-proposed regulations under new § 4968.

3. *The eleven-factor facts and circumstances test for political campaign activity by tax exempts set forth in Rev. Rul. 2004-6 is neither unconstitutionally vague nor overbroad, at least on its face.* [Freedom Path, Inc. v. Internal Revenue Service](#), 120 A.F.T.R. 2d 2017-5125 (N.D. Tex. 7/7/17). In this unreported decision from the U.S. District Court for the Northern District of Texas, Judge Fitzwater upheld Rev. Rul. 2004-6, 2004-1 C.B. 328, as being neither unconstitutionally vague nor overbroad on its face for purposes of determining impermissible political campaign activity by a § 501(c)(4) organization. Rev. Rul. 2004-6 sets forth an eleven-factor facts and circumstances test used by the Service to determine whether certain activity by tax-exempt § 501(c)(3) or (c)(4) organizations is impermissible political campaign activity. The Service preliminarily denied exempt § 501(c)(4) status to Freedom Path, Inc. on the basis that its proposed activities were primarily political in nature. Freedom Path then sued Lois Lerner and the Service before the Service even issued a final negative determination letter to Freedom Path. The opinion in this case is the fourth ruling issued by Judge Fitzwater in a series of claims made in this ongoing lawsuit against the Service and former Exempt Organizations Director Lois Lerner alleging that conservative § 501(c)(4) groups had been targeted for denial of tax-exempt status during the 2011-2012 election cycle. The specific issue in this case was whether Rev. Rul. 2004-6 was unconstitutional on its face under either the First Amendment (free speech) or Fifth Amendment (due process) for being vague or overbroad. Judge Fitzwater held that it was not. The next and fifth ruling in this case almost certainly will be whether the eleven-factor test in Rev. Rul. 2004-6 was applied in an unconstitutional manner by the Service to preliminarily deny § 501(c)(4) exempt status to Freedom Path, Inc. Stay tuned

a. *Meanwhile, prompted by the Service, the Fifth Circuit has another idea how to resolve the issue of the facial challenge to Rev. Rul. 2004-6.* [Freedom Path, Inc. v. Internal Revenue Service](#), 913 F.3d 503 (5th Cir. 1/16/19), *vacating and remanding* 120 A.F.T.R. 2d 2017-5125 (N.D. Tex. 7/7/17). On appeal of the narrow issue regarding whether Rev. Rul. 2004-6 is unconstitutional on its face, the Fifth Circuit, in an opinion written by Judge Southwick, decided Freedom Path lacked standing to sue. Freedom Path had made the same arguments before the Fifth Circuit as it had made before Judge Fitzwater. Cleverly, though, the Service argued before the Fifth Circuit that Rev. Rul. 2004-6 technically was not applied to deny Freedom Path’s application for exempt status under § 501(c)(4). (The Service had not made this argument before Judge Fitzwater.) Rather, the Service pointed out that the facts and circumstances test described in Rev. Rul. 2004-6 was considered by the Service, along with other authorities, as part of the decision to deny (c)(4) status to Freedom Path, but the actual application of Rev. Rul. 2004-6 by its terms relates to determining an exempt organization’s tax liability (if any) under § 527 (political organizations). Furthermore, argued the Service, Freedom

Path has no tax liability under § 527. Thus, the Service concluded, Rev. Rul. 2004-6 is not the source of the alleged injury to Freedom Path. The Fifth Circuit agreed with the Service's analysis and determined that Freedom Path did not have standing because its claim (i.e., denial of (c)(4) status) was not "fairly traceable" to the text of Rev. Rul. 2004-6. Therefore, the Fifth Circuit vacated Judge Fitzwater's opinion (which had considered but rejected Freedom Path's constitutional challenge to Rev. Rul. 2004-6) and remanded the case to be dismissed for lack of jurisdiction. As noted above, Freedom Path's claim that it was unconstitutionally denied (c)(4) status (as opposed to its claim that Rev. Rul. 2004-6 is unconstitutional on its face) remains subject to challenge by Freedom Path and likely will be the next chapter in this story.

4. *Oh goody! Changes to the UBTI rules too!* The [2017 Tax Cuts and Jobs Act](#), §§ 13702 and 13703, also made certain changes to the determination of unrelated business taxable income ("UBTI") with respect to tax-exempt organizations. Most tax-exempt organizations are subject to federal income tax at regular rates (corporate rates for exempt corporations and trust rates for exempt trusts) on net income (i.e., after permissible deductions) from a trade or business, regularly carried on, that is unrelated to the organization's exempt purpose (other than its need for revenue). Exceptions exist for most types of passive, investment income as well as for narrow categories of other types of income (e.g., thrift store sales). See §§ 511-514. The rationale behind the changes to the UBIT rules was to put tax-exempt organizations on par with taxable organizations with respect to certain types of compensation and fringe benefits. Because, however, disallowing deductions for fringe benefits such as parking and transportation expenses (which is what the [2017 Tax Cuts and Jobs Act](#), § 13304(c), did by adding § 274(a)(4)) does not work for exempt organizations which do not normally pay tax, Congress did something weird. Specifically, Congress decided to arbitrarily increase an exempt organization's unrelated business income (even if such income was otherwise zero) by the value of the fringe benefits the organization provides to employees. Sounds like a simple solution, right? *Wrong!* See below.

Stop using good UBI money to chase bad UBI money! Under pre-TCJA law, if an exempt organization had unrelated business income ("UBI") from one activity, but unrelated losses from another activity, then the income and losses could offset, meaning that the organization would report zero or even negative UBI. Congress apparently doesn't like this result, so under new § 512(a)(6) income and losses from separate unrelated businesses no longer may be aggregated. This new UBI provision is effective for taxable years beginning after 2017, thus giving fiscal year nonprofits some time to plan. Moreover, under a special transition rule, unrelated business income net operating losses arising in a taxable year beginning before January 1, 2018, that are carried forward to a taxable year beginning on or after such date, are not subject to § 512(a)(6).

Congress doesn't like using UBI to help fund fringe benefits, so when your organization's highly-compensated employees are pumping iron at the charity's free gym, you can pump up your UBI too. Under new § 512(a)(7), an organization's unrelated business taxable income is increased by the amount of any expenses paid or incurred by the organization that are not deductible because of the limitations of § 274 for (i) qualified transportation fringe benefits (as defined in § 132(f)); (ii) a parking facility used in connection with qualified parking (as defined in § 132(f)(5)(C)); or (iii) any on-premises athletic facility (as defined in § 132(j)(4)(B)). New § 512(a)(7) is effective for amounts paid or incurred after 2017, so affected tax-exempt organizations need to deal with this change immediately. The Service has granted some relief, though, in the form of [Notice 2018-100](#), 2018-52 I.R.B. 1074 (12/10/18), discussed further below. Moreover, Notice 2018-100 clarifies that with respect to on-premises athletic facilities UBI is increased under § 512(a)(7) only if the benefits provided discriminate in favor of highly-compensated employees.

Perhaps worth noting here: Because the TCJA reduced the top federal income tax rate on C corporations to 21 percent, it likewise reduced to 21 percent the top rate on UBI of tax-exempt organizations formed as nonprofit corporations, which are the vast majority. So, the news for tax-exempts is not all bad.

a. *A tax law oxymoron: nonprofit trades or businesses. Huh?* [Notice 2018-67](#), 2018-36 I.R.B. 409 (8/21/18). Organizations described in §§ 401(a) (pension and retirement plans) and 501(c) (charitable and certain other entities) generally are exempt from federal income taxation.

Nevertheless, §§ 511 through 514 impose federal income tax upon the “unrelated business taxable income” (“UBTI”) of such organizations including for this purpose state colleges and universities. The principal sources of UBTI are §§ 512 and 513 “unrelated trade or business” gross income (minus deductions properly attributable thereto) and § 514 “unrelated debt-financed income” (minus deductions), including a partner’s allocable share of income from a partnership generating UBTI. Prior to TCJA, exempt organizations could aggregate income and losses from unrelated trades or businesses before determining annual UBTI potentially subject to tax. Excess losses (if any) after aggregating all UBTI-related items of an exempt organization created a net operating loss subject to the rules of § 172. [See Reg. § 1.512(a)-1(a) prior to enactment of TCJA. After TCJA, § 172 permits only carryforwards.] Effective for taxable years beginning after 2017, however, TCJA added new § 512(a)(6) to disaggregate unrelated trades or businesses of exempt organizations for purposes of determining UBTI. Specifically, new § 512(a)(6) provides that for any exempt organization with more than one unrelated trade or business: (1) UBTI must be computed separately (including for purposes of determining any net operating loss deduction) for each such unrelated “trade or business;” and (2) total annual UBTI is equal to (i) the sum of positive UBTI from each such separate “trade or business” minus (ii) the specific \$1,000 deduction allowed by § 512(b)(12). Under a special transition rule, unrelated business income net operating losses arising in a taxable year beginning before January 1, 2018 and carried forward to a taxable year beginning on or after such date, are not subject to new § 512(a)(6).

Now we get to the crux of the matter. The logical result of new § 512(a)(6) is that every exempt organization must segregate its unrelated trade or business income and losses for purposes of determining its annual UBTI. Yet, Treasury and Service have never defined separate “trades or businesses” for this purpose or, frankly, for any other federal income tax purpose. Further complicating matters, TCJA also enacted a related subsection, new § 512(a)(7), that increases an exempt organization’s UBTI by expenses for which a deduction is disallowed under certain provisions of §§ 274 and 132 (specified transportation, parking, and athletic facility fringe benefits) *unless* the expense is “directly connected with an unrelated trade or business which is regularly carried on by the organization.” Thus, new § 512(a)(7) also requires identification of each unrelated “trade or business” of an exempt organization, but § 512(a)(7) has the further deleterious effect of potentially creating UBTI for an exempt organization that otherwise has no unrelated trade or business. In Notice 2018-67, Treasury and Service take the first step toward providing guidance with respect to both § 512(a)(6) and (7) and delineating separate trades or businesses for UBIT purposes.

What’s in the Notice? Aside from requesting comments, Notice 2018-67 is lengthy (36 pages) and contains thirteen different “SECTIONS,” ten of which address substantive, technical aspects of new § 512(a)(6) and (7). The high points are summarized below, but Notice 2018-67 is a must read for tax advisors to § 501(c) organizations, state colleges and universities, and § 401(a) pension and retirement plans, especially where those entities have UBTI from partnership interests they hold as investments. To summarize:

1. *General Rule.* Until proposed regulations are published, all exempt organizations affected by the changes to § 512(a)(6) and (7) may rely upon a “reasonable, good-faith interpretation” of §§ 511 through 514, considering all relevant facts and circumstances, for purposes of determining whether the organization has more than one unrelated trade or business. Because of the way § 512(a)(6) operates, exempt organizations will be inclined to conclude that they have only one unrelated trade or business, but that is not easy to do given the so-called “fragmentation” principle of § 513(c) and Reg. § 1.513-1(b). For example, advertising income earned by an exempt organization (e.g., National Geographic) from ads placed in the organization’s periodical is UBTI even if subscription income is not UBTI. For an exempt organization this general rule includes using a reasonable, good-faith interpretation when determining: (a) whether to separate debt-financed income described in §§ 512(b)(4) and 514; (b) whether to separate income from a controlled entity described in § 512(b)(13); and (c) whether to separate insurance income earned through a controlled foreign corporation as described in § 512(b)(17). The use of the 6-digit code North American Industry Classification System (“NAICS”) for segregating trades or businesses will be considered a reasonable, good-faith interpretation until regulations are proposed.

2. *Partnership Interests*. In general, partnership activities are attributable to partners such that holding a partnership interest can result in multiple lines of UBTI being considered allocable to an exempt organization partner. Until proposed regulations are issued, however, exempt organizations (other than § 501(c)(7) social clubs) may rely upon either of two rules for aggregating multiple lines of UBTI from a partnership, including UBTI attributable to lower-tier partnerships and unrelated debt-financed income:
 - The “interim rule” that permits the aggregation of multiple lines of UBTI from an exempt organization’s interest in a single partnership if the partnership meets either a “de minimis test” or a “control test.” The de minimis test generally is met if the exempt organization partner holds a 2 percent or less capital and profits interest in a partnership. The control test generally is met if the exempt organization partner holds a 20 percent or less capital interest in a partnership and does not have “control or influence” over the partnership. Control or influence over a partnership is determined based upon all relevant facts and circumstances. For purposes of determining an exempt organization’s percentage interest in a partnership under the interim rule, partnership interests held by disqualified persons (as defined in § 4958), supporting organizations (as defined in § 509(a)(3)), and controlled entities (as defined in § 512(b)(13)(D)) must be considered.
 - The “transition rule” that permits the aggregation of multiple lines of UBTI from an exempt organization’s interest in a single partnership if the interest was acquired prior to August 21, 2018. For example, if an organization has a 35 percent interest in a partnership [acquired] prior to August 21, 2018, it can treat the partnership as being in a single unrelated trade or business even if the partnership’s investments generated UBTI from various lower-tier partnerships that were engaged in multiple types of trades or businesses (or, presumably, from debt-financed income).
3. *IRC § 512(a)(7)*. Income under § 512(a)(7) [i.e., the UBIT increase for expenses not directly connected with an unrelated trade or business regularly carried on by the organization and for which a deduction is disallowed under certain provisions of §§ 274 and 132 (specified transportation, parking, and athletic facility fringe benefits)] is not income from a trade or business for purposes of § 512(a)(6). Thus, such UBIT appears to be entirely separate from § 512(a)(6) income and therefore not offset by any deductions or losses.
4. *GILTI*. An exempt organization’s inclusion of global intangible low-taxed income (“GILTI”) under § 951A is treated as a dividend which is not UBTI (pursuant to § 512(b)(1)) unless it is debt-financed (and thus included in UBIT under § 512(b)(4)).

b. *Guidance on determining the increase to UBTI for employer-provided parking*. Notice 2018-99, 2018-52 I.R.B. 1067 (12/10/18). In this notice, the Service announced that Treasury and the Service will issue proposed regulations under §§ 274 and 512 that will include guidance on determining the calculation of increased unrelated business taxable income (UBTI) of tax-exempt organizations that provide qualified transportation fringes (and also the nondeductible parking expenses and other expenses for qualified transportation fringes provided by non-tax-exempt employers). Until further guidance is issued, employers that own or lease parking facilities where their employees park can rely on interim guidance provided in the notice to determine the increase in the amount of UBTI under § 512(a)(7) attributable to nondeductible parking expenses. The guidance in the notice for determining the increase in UBTI mirrors the guidance for determining the nondeductible parking expenses of non-tax-exempt employers summarized earlier in this outline. The notice explains that an increase to UBTI is not required “to the extent the amount paid or incurred is directly connected with an unrelated trade or business that is regularly carried on by the organization” because, in such a case, the expenses for qualified transportation fringes are disallowed by § 274(a)(4) as a deduction in calculating the UBTI of the unrelated trade or business. The notice confirms that the effect of the increase in UBTI can be to require a tax-exempt organization to file Form 990-T, *Exempt Organization Business Income Tax Return*, if the organization’s gross income included in computing UBTI is \$1,000 or more. The rules for determining the increase in UBTI are illustrated by examples 9 and 10 in the notice.

c. *Never had UBTI or paid estimated taxes thereon? Not to worry, says the IRS.* Notice 2018-100, 2018-52 I.R.B. 1074 (12/10/18). Prior to the enactment of § 512(a)(7), many if not most § 501(c)(3) organizations had never reported UBTI or paid any unrelated business income tax (“UBIT”) thereon. Organizations that owe UBIT are required to pay estimated taxes or suffer penalties. See IRC § 6655(c) and (d)(1)(A). Furthermore, because these organizations have never paid UBIT, they would not be eligible for the safe harbor exclusion for estimated taxes under § 6655(d)(1) (estimated payments equal to prior year’s UBIT). Accordingly, with new § 512(a)(7) catching most tax-exempt organizations off guard, the Service has decided “in the interest of sound tax administration” (in other words, to prevent another Boston Tea Party) to waive the penalty for failure to make estimated UBIT payments for such exempt organizations. Note, however, the penalty waiver is limited to “tax-exempt organizations that provide qualified transportation fringes (as defined in § 132(f) and any parking facility used in connection with qualified parking (as defined in § 132(f)(5)(C)) to an employee to the extent that the underpayment of estimated income tax results from enactment of [§§ 13304(c) and 13703 of the 2017 Tax Cuts and Jobs Act].” Furthermore, the relief is available only to a tax-exempt organization that was not required to file a Form 990-T (the UBIT form) for the taxable year immediately preceding the organization’s first taxable year ending after December 31, 2017. Notice 2018-100 does not address the possibility of estimated UBIT payments attributable to discriminatory on-premises athletic facilities. To avail themselves of the relief granted by the Notice, exempt organizations must write “Notice 2018-100” on the top of the organization’s Form 990-T.

5. *Taxpayer’s healthcare consulting nonprofit diagnosed as terminal under IRC § 501(c)(3).* [Abovo Found., Inc. v. Commissioner](#), T.C. Memo 2018-57 (4/30/18). Based upon the facts set forth in its application for exempt status (IRS Form 1023) and the administrative record, the Tax Court (Judge Foley) holds that the taxpayer, a Texas nonprofit corporation, failed the operational test and thus cannot qualify as tax-exempt under § 501(c)(3). Although the taxpayer met the requirements of the organizational test under § 501(c)(3) (i.e., the taxpayer had the proper § 501(c)(3) restrictive language in its articles and bylaws), a § 501(c)(3) also must meet an operational test to be exempt. Part of the operational test requires that an organization operate primarily for exempt purposes, and that no part of the organization’s net earnings inure to the benefit of any private individual. The taxpayer disclosed in its Form 1023 that it planned to hire Dr. Okonkwo — a military veteran, medical doctor, and board-certified expert in patient safety and risk management — as President and taxpayer’s sole employee to deliver quality-management and patient-safety consulting services on behalf of the taxpayer. The taxpayer argued that its operations would “lessen the burdens of government” and thus should qualify as exempt. The taxpayer’s Form 1023 and the administrative record, however, disclosed that Dr. Okonkwo would be paid a market rate for his services (i.e., a \$217,000 salary plus an annual bonus of up to \$100,000). Furthermore, no facts in the record demonstrated that the taxpayer would act on behalf of or otherwise lessen the burdens of government. Instead, Judge Foley determined that the taxpayer would (i) serve as a “facade for Dr. Okonkwo’s consulting activities;” (ii) help him develop his “business relationships;” (iii) further his consulting career as a board-certified expert in patient safety and risk management; and (iv) potentially confer a private benefit on him of annual compensation in excess of \$300,000. As a result, Judge Foley denied the taxpayer exempt status under § 501(c)(3).

6. *Has so-called “dark money” become virtually invisible (except to the Service, of course)?* [Rev. Proc. 2018-38](#), 2018-31 I.R.B. 280 (07/16/18). Oversimplifying a bit for the sake of convenience, since 1969 § 6033(b)(5) has required § 501(c)(3) organizations to disclose on their annual information returns (Forms 990) certain contributions as well as “the names and addresses of [the organization’s] substantial contributors” for the year. Section 507(d)(2) defines a “substantial contributor” as any person contributing \$5,000 or more to an organization if such amount is greater than 2 percent of the total contributions to the organization during the taxable year. Section 1.6033-2 of the regulations extended this disclosure requirement to other types of organizations exempt under § 501(a), including § 501(c)(4) “social welfare” organizations and § 501(c)(6) “trade associations.” In particular, some § 501(c)(4) social welfare organizations have been created and funded to engage in lobbying and political campaign activity that is prohibited to § 501(c)(3) organizations. This use of § 501(c)(4) organizations has been termed “dark money” by some and is controversial. Although the names and addresses of “dark money” contributors were supposed to be redacted on the organization’s

Form 990 made publicly available by the Service pursuant to § 6104(b), some inadvertent disclosures have occurred. Reportedly, a few of the largest organizations impacted have been entities affiliated with the National Rifle Association, the U.S. Chamber of Commerce, and Americans for Prosperity, the latter being tied to billionaires Charles and David Koch. *See* R. Rubin, “U.S. Treasury Restricts Donor Disclosure Requirement for Some Nonprofit Groups,” *Wall St. J.* (July 16, 2018). After Rev. Proc. 2018-38, though, substantial contributors’ names and addresses are no longer required to be disclosed on a non-(c)(3) organization’s annual Form 990. As stated in the revenue procedure, “The Service does not need personally identifiable information of [such] donors to be reported . . . in order for it to carry out its responsibilities. The requirement to report such information increases compliance costs for some private parties, consumes Service resources in connection with the redaction of such information, and poses a risk of inadvertent disclosure of information that is not open to public inspection.” The reporting changes announced by Rev. Proc. 2018-38 are effective for taxable years ending on or after December 31 2018. Notwithstanding this relief from disclosure granted to § 501(a) organizations other than (c)(3)s, Rev. Proc. 2018-38 states that the affected organizations must maintain donor information in the organization’s books and records in case such information is requested by the Service.

B. Charitable Giving

1. *Used underwear is just not worth what it “used” to be!* T.D. 9836, *Substantiation and Reporting Requirements for Cash and Noncash Charitable Contribution Deductions*, 83 F.R. 36417 (7/30/18). The Treasury Department and the Service have finalized, with only minor changes, proposed regulations (which addressed the deductibility of “good condition” but used clothing and other household items, among other things) (REG-140029-07, *Substantiation and Reporting Requirements for Cash and Noncash Charitable Contribution Deductions*, 73 F.R. 45908 (8/7/8)) regarding substantiation and reporting requirements for cash and noncash charitable contributions. The proposed and now final regulations [principally, Reg. §§ 1.170A-15 through 1.170A-18] reflect the enactment of certain provisions of the American Jobs Creation Act of 2004 [§ 170(f)(11) and (12)] and the Pension Protection Act of 2006 [§ 170(f)(16) and (17)]. Section 170(f) contains numerous limitations on the charitable contribution deduction with respect to donations of certain items of property (e.g., remainder interests, partial interests, insurance policies, used vehicles, stuffed animals, used clothing and household goods, etc.). Complicating matters further, § 170 also contains three distinct subsections [§ 170(f)(8), (11), and (17)] pertaining to substantiation and recordkeeping requirements for both cash and “noncash” (i.e., property) contributions. The proposed and now final regulations attempt to clarify and reconcile several of the foregoing limitations in § 170 with the distinct substantiation and recordkeeping rules in § 170. The five major changes from the proposed regulations (REG-140029-07) are as follows. One, due to the Tax Court’s decision in *Crimi v. Commissioner*, T.C. Memo 2013-51 (reasonable-cause is inherently facts and circumstances specific), the final regulations do not provide a standard for a “reasonable-cause” excuse for failure to meet the substantiation requirements. Two, when substantiating noncash contributions that exceed \$500, a donor can treat similar items contributed during the tax year as one property. Three, the substantiation requirements apply to carryover years as well as the year of donation. Four, if a Form 8323 is required in connection with a donation, the appraiser’s taxpayer identification number (or EIN of the appraiser’s business) must be included. Lastly, the final regulations clarify that a completed Form 8323 does not substitute for any required contemporaneous written acknowledgment. Thankfully, no changes were made to the rules regarding donations of used clothing, so we can continue to take a deduction (albeit small) for donations of old underwear. The final regulations are effective for contributions made after July 30, 2018. For further details, read on.

Cash or Monetary Contributions. Reg. § 1.170A-15 provides that the substantiation requirements of § 170(f)(17) regarding *cash or monetary contributions of less than \$250* may be met if the taxpayer has one of two items: (i) a “bank record” (a monthly bank statement with a photocopy or image obtained from the bank of the front of the check indicating the name of the charity, or a credit card statement for contributions made via credit card), or (ii) a “written communication” (essentially, a receipt) from the charity showing the name of the charity, the date of the contribution, and the amount of the contribution. Separate contributions of less than \$250 made during a year are not aggregated for this purpose. *See* Reg. § 1.170a-13(F)(1). Notwithstanding the foregoing, a written communication is

not required to substantiate contributions of less than \$250 to certain charitable trusts (*see* Reg. § 1.170A-15(g)); however, if the contribution is \$250 or more, a “contemporaneous written acknowledgment” (see below) from the charitable trust apparently is required. Further, a written communication from a charity is not necessary to substantiate unreimbursed, out-of-pocket” expenses of less than \$250 incurred incident to the rendition of services to a charitable organization; however, taxpayers must maintain records of such expenses. For *cash or monetary contributions of \$250 or more*, pursuant to § 170(f)(8), the minimal “bank record” or “written communication” requirement must be met plus the donor must have a so-called “contemporaneous written acknowledgment” from the charity indicating the name of the donor, whether the charity provided goods or services in exchange for the contribution, and the amount of the contribution. The contemporaneous written acknowledgment may be electronic and, in general, is “contemporary” if it is delivered to the taxpayer before the taxpayer files a return for the year of the contribution. Further, the contemporaneous written acknowledgment may substitute for the minimal “written communication” requirement for cash or monetary contributions under \$250 (and, as a practical matter, almost always will be provided in lieu of a receipt) if it also shows the date of the contribution. For unreimbursed “out of pocket” expenses of \$250 or more, a donor may meet the substantiation requirement by having a written record of each such expense and a contemporaneous statement by the charity describing the services and indicating whether goods or services were provided to the taxpayer in return for the expense. A contribution made by payroll deduction may be substantiated by (i) a pay stub, Form W-2, or other document furnished by the employer that sets forth the amount withheld during the taxable year for payment to a charity, together with (ii) a pledge card or other document prepared by or at the direction of the charity that shows the name of the organization.

Noncash Contributions. Reg. § 1.170A-16 provides that for *noncash contributions of less than \$250*, a taxpayer must substantiate the deduction with a “written communication” (essentially, a receipt) from the charity showing the name and address of the charity, the date of the contribution, and an adequate description of the property (*see* Reg. § 1.170A-16(a)(iii) for what is considered “adequate,” especially for securities). If obtaining a written communication from the charity is impractical (such as for contributions made at unattended drop sites), then a taxpayer must substantiate the donation with “reliable written records” (generally, the same information as a charity-provided receipt, but see Reg. § 1.170A-16(a)(2) for details). For *noncash contributions of \$250 or more up to \$500*, the taxpayer must substantiate such contributions with a contemporary written acknowledgment from the charity. For *noncash contributions of more than \$500 but not more than \$5,000*, substantiation requires a contemporaneous written acknowledgment plus a properly completed Form 8283 (Section A) (which requires detailed information concerning the property contributed, including the taxpayer’s cost or other basis in the property). For *noncash contributions of more than \$5,000*, substantiation requires a contemporaneous written acknowledgment, a “qualified appraisal” prepared by a “qualified appraiser,” and a properly completed Form 8283 (Section B); however, a qualified appraisal is not required for publicly-traded securities and certain other readily-valuable property. *See* Reg. § 1.170A-16(d)(2). For *noncash contributions of more than \$500,000*, substantiation requires that all of the above requirements be met plus the qualified appraisal must be attached to the taxpayer’s return claiming the deduction.

Qualified appraisal and qualified appraiser. Reg. § 1.170A-17 sets forth the detailed requirements for a “qualified appraisal” and a “qualified appraiser.” These requirements did not change significantly from those set forth in the proposed regulations; however, in order to provide appraisers with a reasonable amount of time to meet new education and experience requirements, the final regulations under § 1.170A-17 apply only to contributions made after January 1, 2019.

2. *Want to take a charitable contribution deduction? Check this out first!* **Rev. Proc. 2018-32**, 2018-23 I.R.B. 739 (5/16/18). Rev. Proc. 2018-32 modifies and supersedes Rev. Proc. 81-6, 1981-1 C.B. 620; Rev. Proc. 81-7, 1981-1 C.B. 621; Rev. Proc. 89-23, 1989-1 C.B. 844; and Rev. Proc. 2011-33, 2011-25 I.R.B. 887, and combines them into one revenue procedure to provide more easily accessible guidance to grantors and contributors to tax-exempt organizations on deductibility and reliance issues. There is nothing drastically new in Rev. Proc. 2018-32. Rather, it consolidates prior guidance into one document relating to several subjects relevant to grantors and contributors to

tax-exempt organizations and provides non-substantive modifications and changes throughout for clarity and readability purposes. The subjects covered in Rev. Proc. 2018-32 include:

- The extent to which grantors and contributors may rely on the listing of an organization in the Service’s databases for purposes of determining whether the grants or contributions to such organizations may be deductible under § 170, and for certain other purposes.
- Safe harbors for determining that a grantor’s or contributor’s grant or contribution will not cause the grantor or contributor to be considered to be responsible for, or aware of, an act that results in an organization’s loss of public charity classification and for determining that a grant or contribution is considered an unusual grant.
- Modifications made in the transition from the use of Publication 78 to the use of the Service’s database.
- Changes to regulations eliminating the advance ruling process and changing the computation period for determining public support for organizations classified under §§ 170(b)(1)(A)(vi) and 509(a)(1) or under § 509(a)(2).

3. *Deduction for charitable contribution of façade easement denied to long-term lessee of building.* [Harbor Lofts Associates v. Commissioner](#), 151 T.C. No. 3 (8/27/18). The Tax Court has held that a taxpayer with a long-term lease of two historic buildings was not entitled to a charitable contribution deduction for donating façade easements over the buildings to a historical preservation organization. The taxpayer was a partnership that had leased the buildings for a 47-year term from the fee owner, the Economic Development & Industrial Corporation of Lynn (“EDIC”), a public corporation authorized under Massachusetts law. The 47-year lease between the taxpayer and EDIC made the taxpayer responsible for all insurance, utility, maintenance, and other costs associated with occupying the buildings and entitled the taxpayer to a portion of any proceeds if the land and buildings were taken under eminent domain. The taxpayer-lessee and EDIC jointly contributed the façade easement to the historical preservation organization in December of 2009. The taxpayer then claimed a charitable contribution deduction of almost \$4.5 million on its 2009 return. On audit, the Service challenged the claimed charitable contribution deduction arguing that, although the façade easement may have been “granted in perpetuity” by EDIC, the taxpayer’s contribution of a façade easement essentially was a waiver of the taxpayer’s “time-limited” contract rights. Thus, the taxpayer did not make a contribution of a “qualified real property interest” as required by § 170(h)(2)(C). In response, the taxpayer argued that by jointly contributing the façade easement with the fee owner, EDIC, the “granted in perpetuity” requirement was met and that the taxpayer’s long-term leasehold interest in the façade of the buildings coupled with EDIC’s fee interest equated with a “qualified real property interest.” Moreover, the taxpayer argued that it should be treated as the equitable and tax owner of the buildings due to the nature of the long-term lease. The Tax Court (Judge Buch) denied the taxpayer’s charitable contribution deduction. Judge Buch concluded that, under Massachusetts law, the taxpayer held only a leasehold interest, not a fee interest, and that Massachusetts law characterized the taxpayer’s leasehold interest as personal property. Judge Buch further reasoned that the taxpayer’s leasehold was a personal property right, not a “qualified real property interest” within the meaning of § 170(h)(2)(C). Judge Buch also determined that, in any event, the taxpayer was incapable of granting a perpetual restriction over the façade of the buildings because the taxpayer did not hold perpetual rights. Judge Buch distinguished the facts in this case from one in which tenants-in-common grant deductible conservation easements due to the fact that EDIC and the taxpayer were not tenants in common, but rather lessor and lessee under Massachusetts law. Finally, Judge Buch ruled that, even if the taxpayer were considered the equitable owner of the buildings for federal income tax purposes, the façade easement granted by the taxpayer was not a “grant in perpetuity” because it was limited by the 47-year term of the lease.

4. *This taxpayer took a swing at getting a charitable contribution deduction for a golf course conservation easement, but was distracted by a PLR and whiffed the “extinguishment regulation.”* [PBBM Rose Hill, Ltd. v. Commissioner](#), 900 F.3d 193 (5th Cir. 9/14/18). The taxpayer, a TEFRA partnership, had paid approximately \$2.4 million for 241.48 acres of golf course property in 2002. The property was deed-restricted for use as a golf course, but by 2007 it was clear that operating a golf course on the property was not economically viable. Therefore, in July of 2007, the taxpayer

entered into a judicially-approved settlement agreement with certain interested parties, including a neighboring property owner's association ("POA"), that removed the golf course deed restriction over the land. Then, in August of 2007, the taxpayer agreed to sell the land to the POA for \$2.3 million. Meanwhile, in December of 2007, the taxpayer granted a conservation easement over approximately 234 acres of the property to the North American Land Trust ("NALT"). Consistent with § 170(h)(4)(a)(i)-(iv), the conservation easement deed required the land to remain undeveloped (i) "for outdoor recreation by, or education of, the general public;" (ii) "as a relatively natural habitat of fish, wildlife, or plants;" (iii) "for open space which provides scenic enjoyment to the general public;" and (iv) "as open space which, if preserved, will advance [government conservation policy] and will yield a significant public benefit." On its 2007 partnership tax return, the taxpayer claimed a charitable contribution deduction for the easement of approximately \$15 million. Subsequently, in January of 2008, the taxpayer sold the property to the POA for \$2.3 million. The POA then operated the property as a golf course and a park, but limited public access to the property via a gatehouse and "residents only" signs. On audit, the Service disallowed the taxpayer's charitable contribution deduction on two grounds: (1) due to the POA's use of the land as a golf course and park primarily for nearby homeowners and very limited public benefit, the easement failed to meet the "conservation purposes" requirement of § 170(h)(4)(a)(i)-(iv) in execution even if the proper language was in the deed; and (2) the rights reserved to the taxpayer-grantor (and the POA as successor) in the easement deed did not comply with the "extinguishment regulation," thus failing the "protected in perpetuity" requirement of § 170(h)(5)(A). After a five-day trial, the Tax Court upheld the Service's position on both grounds. The Tax Court also held that the taxpayer overvalued the easement and thus was subject to overvaluation penalties. The taxpayer appealed to the Fifth Circuit which (in an opinion written by Judge King) determined that the conservation purposes as expressed in the easement deed were sufficient to meet the "conservation purposes" requirement of § 170(h)(4)(a)(i)-(iv) notwithstanding the actual private use of the property by the POA because the Service could not demonstrate that the taxpayer knew the POA would restrict public access and NALT would fail to object. Nevertheless, the Fifth Circuit agreed with the Tax Court that the "protected in perpetuity" requirement of § 170(h)(5)(A) was not met because the taxpayer's easement deed failed to meet the "extinguishment regulation" (Reg. § 1.170A-14(g)(6)). The extinguishment regulation ensures that conservation easement property is protected in perpetuity because, upon destruction or condemnation of the property and collection of any proceeds, the charitable donee must proportionately benefit. The charitable donee's proportionate benefit is determined by a fraction equal to the value of the easement at the time of the gift as compared to the total value of the property at the time of the gift. This extinguishment language must be in the conservation easement deed. The taxpayer's deed, however, followed Priv. Ltr. Rul. 200836014 (9/5/08) and allowed the taxpayer (or the taxpayer's successor, the POA) to recover the value of any improvements to the property before determining the charitable donee's proportionate benefit. The Fifth Circuit determined that this was not allowed under the plain language of Reg. § 1.170A-14(g)(6) notwithstanding the Service's prior determination to the contrary. The Fifth Circuit further agreed with the Tax Court that overvaluation penalties were appropriately imposed against the taxpayer.

5. *In a conservation easement case appealable to the Eleventh Circuit, the Tax Court says again to the Fifth Circuit that we think you got it wrong in BC Ranch II so we're not going to follow your decision, but we are going to follow our Belk decision which was affirmed by the Fourth Circuit. Pine Mountain Preserve, LLLP v. Commissioner, 151 T.C. No. 14 (12/27/18) and Pine Mountain Preserve, LLLP v. Commissioner, T.C. Memo. 2018-214 (12/27/18).* In a late-in-the-year development deserving more robust treatment when publication deadlines permit—and when we have the stamina to digest 150+ pages of opinion—the Tax Court disallowed a taxpayer's claimed charitable contribution deduction for a conservation easement. Despite the taxpayer's argument to the contrary, the Tax Court refused to follow the Fifth Circuit's opinion in *B.C. Ranch II, L.P. v. Commissioner*, 867 F.3d 547 (5th Cir. 2017), *vacat'g and remand'g* T.C. Memo. 2015-130, regarding the "protected in perpetuity" requirement for qualified conservation easements. *BC Ranch II* held that the "protected in perpetuity" requirement is not violated if the taxpayer-grantor reserves certain rights to reclaim property subject to a conservation easement while substituting other property therefor. On the other hand, the Tax Court and the Fourth Circuit in *Belk v. Commissioner*, 140 T.C. 1 (2013), *aff'd*, 774 F.3d 221 (4th Cir. 2014), determined that such substitution of property is not permissible under the "protected in perpetuity" requirement.

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. *Better be careful who you hire as CFO, and raise all your arguments against liability as a responsible person at the summary judgment stage, not afterward.* [McClendon v. United States](#), 119 A.F.T.R.2d 2017-1037 (S.D. Tex. 3/6/17). The government successfully established through a motion for summary judgment that the taxpayer, a physician, was liable under § 6672 for a \$4.3 million penalty equal to the amount of unpaid federal employment taxes owed by his medical practice. The CFO he had hired had embezzled funds and ultimately pleaded guilty to felony counts of theft. When the taxpayer learned of the unpaid taxes, he made a loan to the practice to allow it to make payroll, and these funds went to the employees rather than the government. The government used this preferential payment as the basis for establishing that the taxpayer had willfully violated his duty to pay the taxes due. The taxpayer moved for reconsideration and argued that his liability should be limited to the \$100,000 preferential payment that was the basis for his liability. The court rejected this argument for two reasons. First, the taxpayer had failed to raise it in response to the government's motion for summary judgment. Second, even if he had raised it in a timely manner, the taxpayer had failed to meet his burden to prove the absence of funds available to pay the taxes due:

At the summary judgment stage, as now, Dr. McClendon did not try to prove up the funds available to [the practice] or show that whatever funds existed were encumbered so that he had no obligation to pay them to the Service. Instead, he effectively argues that, at summary judgment, it was the government's burden to demonstrate his liability for each dollar of the penalty. Not so. Dr. McClendon was presumptively liable for the balance of the Service penalty assessed against him. The government moved for summary judgment and argued that the evidence did not create a genuine factual dispute material to deciding whether the Service penalty was properly assessed. That discharged the government's summary judgment burden. Dr. McClendon, who would bear the burden at trial, then had the burden to submit or identify record evidence showing that he was not liable.

a. *In this § 6672 trust fund recovery case, the Fifth Circuit has reversed and remanded for trial on the issue of the amount of available, unencumbered funds in the business's bank accounts after the responsible person became aware of the unpaid withholding taxes.* [McClendon v. United States](#), 892 F.3d 775 (5th Cir. 6/14/18). In the District Court, Dr. McClendon (now deceased) argued that his liability under § 6672 should be limited to \$100,000, the amount of the loan he made to the business to allow it to make payroll after he had learned of the unpaid employment taxes. The District Court rejected this argument as untimely because Dr. McClendon had not raised it in his response to the government's motion for summary judgment and instead had raised it for the first time in his motion for reconsideration after the District Court had granted summary judgment in the government's favor. Nevertheless, the District Court considered the merits of the argument and concluded that Dr. McClendon had failed to meet his burden of submitting or identifying evidence in the record to show the amount of the business's funds that were unencumbered and available to pay the unpaid taxes. In an opinion by Judge Davis, the U.S. Court of Appeals for the Fifth Circuit has vacated the District Court's grant of summary judgment and remanded for trial on the issue of the amount of available, unencumbered funds in the business's bank accounts after discovery of the unpaid withholding taxes. The court first noted that its review of the District Court's denial of Dr. McClendon's motion to reconsider its grant of summary judgment is de novo because the District Court reached the merits of the motion and considered materials submitted in connection with it. The court cited *Barnett v. I.R.S.*, 988 F.2d 1449 (5th Cir. 1993), for the proposition that, when the government asserts that a responsible person willfully failed to pay employment taxes by using the business's unencumbered funds to pay the business's creditors other than the Service, the responsible person's liability under § 6672 is limited to the amount of "available, unencumbered funds deposited into [the business's] bank accounts after [the responsible person] became aware that the accrued withholding taxes were due." Dr. McClendon, the court explained, had testified in his deposition and in his affidavit regarding the actions taken and the funds available once the unpaid withholding taxes came to light, including his \$100,000 loan and the amount of receivables and insurance proceeds paid to the Service, and had submitted copies of checks payable to the Service that he asserted represented the closing

balance in the business's accounts shortly after the unpaid taxes were discovered. To oppose the government's motion for summary judgment, the court stated, Dr. McClendon was not required to provide an accounting of the business's funds. The court cited the Eleventh Circuit's recent decision in *United States v. Stein*, 881 F.3d 853 (11th Cir. 2018), in which the court held that an affidavit can create an issue of material fact that precludes summary judgment even if the affidavit is self-serving and uncorroborated. Similarly, the Fifth Circuit reasoned, "[w]e can find no such corroboration requirement under § 6672." In the court's view, Dr. McClendon had come forward with sufficient evidence to establish an issue of material fact warranting trial regarding the amount of available, unencumbered funds.

Concurring Opinion. Judge Jones concurred in the court's opinion. She wrote separately to emphasize that, given Dr. McClendon and his partners had relied on their CFO for a decade before the CFO began embezzling, their reliance on his representations regarding the payment of employment taxes seemed plausible, and therefore she did not see how the District Court could rule as a matter of law on the government's argument that Dr. McClendon had willfully failed to pay employment taxes by acting with reckless disregard of a known or obvious risk that trust funds would not be remitted. She also stated that, in her view, the government had acted irresponsibly by introducing 285 pages of exhibits in support of its motion, including the business's records, and then arguing that Dr. McClendon had not met his burden at the summary judgment stage:

To challenge the legal consequences of McClendon's \$100,000 cash infusion is one thing; to claim, in the face of his sworn affidavit and documents, and their own access to corroborative financial records, that this isn't enough to raise a fact issue is irresponsible at best.

Dissenting Opinion. Judge Higginson dissented and argued that the court should affirm the District Court's grant of summary judgment in favor of the government.

2. *What is the meaning of "same taxpayer" under § 6621(d) when corporations merge (Part Deux)? Or, see what happens when different interest rates apply to overpayments and underpayments (which has never made any sense since 1986 anyway)! [Ford Motor Co. v. United States](#), 119 A.F.T.R.2d 2017-1998 (Fed. Cl. 5/30/17).* Enacted in 1998, § 6621(d) states simply: "To the extent that, for any period, interest is payable under subchapter A [underpayments] and allowable under subchapter B [overpayments] on equivalent underpayments and overpayments by the same taxpayer of tax imposed by this title, the net rate of interest under this section on such amounts shall be zero for such period." In theory, § 6621(d) accounts for and corrects the disparity between the higher interest rate imposed on underpayments and the lower interest rate applied to overpayments as long as the "same taxpayer" has made the payments. (Note: The IRS always has allowed interest netting for the same taxpayer for the same tax year.) Nevertheless, this straightforward concept and the simple language of § 6621(d) belie the difficult questions that arise regarding determinations of the "same taxpayer" in the merger and acquisition context. It seems to us that the controversy and confusion in this area are the result of two extreme views: The IRS interprets § 6621(d) very narrowly so that the term "same taxpayer" requires the same taxpayer identification number. Corporate taxpayers, however, interpret the term more broadly so that virtually any consolidation of corporate entities where one corporation has an overpayment and another has an underpayment meets the "same taxpayer" requirement. A reasoned approach would allow "same taxpayer" treatment if the corporate entities combine via a § 368(a)(1)(A) merger (regardless of the surviving corporation's taxpayer identification number), but not for other types of consolidations where corporate entities remain separately responsible for pre- and post-acquisition liabilities. *Read on only if you wish to risk incurring brain damage.*

Ford and its FSC. Ford Motor Company ("Ford") made an overpayment for 1992 while its former Netherlands foreign sales corporation, Ford Export Services B.V. ("Export"), made underpayments for 1992 through 1998 (excepting 1994). As a foreign sales corporation ("FSC") and a tax "Dodge" (pun intended) sanctioned under prior law, Export did not engage in substantial business activities. Export did perform enough activity to qualify under the FSC rules, but no physical transfers of money between Export and Ford occurred. Instead, transactions between Ford and Export were "reflected as entries on [Ford's and Export's] books of account or accounting and tax records." Between 1999 and 2005, Ford paid the IRS any underpayments owed by Export, plus interest accruing

at the standard underpayment interest rate, while in 2008 the government credited the 1992 overpayment due to Ford, plus interest accruing at the standard overpayment interest rate.

Ford's 2008 claim for refund. Meanwhile, in 2003 after the favorable rules for FSCs were repealed, Export elected to be treated as a disregarded entity owned entirely by Ford. This election of disregarded entity status had the tax effect of liquidating all of Export's assets and liabilities into Ford pursuant to Reg. § 301.7701-3(g)(1)(iii). Then, in August 2008 after the IRS had credited Ford's 1992 overpayment plus interest at the overpayment rate, Ford filed a claim for refund to recover \$11,740,528 from the IRS. Ford's position was that the "net interest rate of zero under [Subsection] 6621(d) [should] be applied to the underpayments and overpayments" of Export and Ford as the "same taxpayer." The IRS disallowed Ford's 2008 refund claim noting that Export and Ford filed separate returns under different taxpayer identification numbers; therefore, the "same taxpayer" requirement was not met.

Ford's 2010 claim for refund. Undaunted, after a series of transactions in 2010 that resulted in the assets and liabilities of Export becoming part of Ford, in November 2010 Ford filed a second claim for refund but this time for \$20,410,788. Ford argued that Export's eventual consolidation into Ford satisfied the "same taxpayer" requirement of § 6621(d). The IRS, though, again disallowed Ford's claim on the basis that Export and Ford still were not the "same taxpayer" because the 2010 transactions "did not result in [Ford] being both liable ... for the tax that [Export] underpaid and entitled to a credit or refund of the tax that [Export] overpaid." Thus, according to the IRS, there had not been a "merger" of Export and Ford. Now exasperated, Ford filed a refund suit in the U.S. Court of Federal Claims on May 28, 2014, seeking to recover \$20,410,788 under § 6621(d). The dispute came before Judge Lettow on cross-motions for summary judgment.

The landscape of interest netting. This is not an entirely new issue. According to Judge Lettow's opinion, two cases, *Energy E. Corp. v. United States*, 645 F.3d 1358 (Fed. Cir. 2011) and *Wells Fargo & Co v. United States*, 827 F.3d 1026 (Fed. Cir. 2016), *rev'g in part and aff'g in part*, 119 Fed. Cl. 27 (2014), establish how the interest netting rules of § 6621(d) should work.

6. If the surviving corporation in a merger or mergers has overpayments and underpayments across open tax years, interest netting is permitted. Wells Fargo supports this rule, and the IRS agrees because the overpayments and underpayments are made by a taxpayer with the same taxpayer identification number across the open years. (OK. This makes perfect sense to us. These were the facts of "Situation Two" in Wells Fargo.)
7. Oddly, though, if across open years one corporation has made an overpayment and another has made an underpayment, interest netting under § 6621(d) does not apply (according to the Federal Circuit) even if the two corporations subsequently merge under § 368(a)(1)(A). Wells Fargo supports this rule as well (contrary to the opinion of the lower court), and the IRS agrees because the taxpayer identification numbers of the overpaying and underpaying corporations are different at the time of the payments. (Our take: This makes no sense if the assets and liabilities of the two merging corporations become one. These are, though, the facts of "Situation One" in Wells Fargo where the IRS won.)
8. If a surviving corporation with an underpayment acquires the stock of another corporation with an overpayment (even if it subsequently files a consolidated return with the acquired subsidiary), interest netting is not permitted because the two corporations were not the "same taxpayer" at the time of the separate payments. In other words, a corporation apparently cannot "acquire" another corporation's overpayment via a stock purchase for purposes of § 6621(d) even if consolidated returns are subsequently filed. *Energy E. Corp.* supports this rule. (Our take: Although Judge Lettow's opinion does not elaborate, this rule makes sense too because after a stock purchase, even if the parent files a consolidated return with the acquired subsidiary, the parent is liable only for the subsidiary's post-acquisition taxes. See Reg. § 1.1502-6. The IRS presumably agrees with this approach because the taxpayer identification numbers of the underpaying and overpaying corporations remain different in this type of consolidation.)
9. On the other hand, if a corporation has an overpayment for an open tax year and merges into a surviving corporation that subsequently makes an underpayment, § 6621(d) interest netting is allowed. Wells Fargo "Situation Three" supports this rule. (Our take: This rule makes perfect sense because, in a merger, the assets and liabilities of the acquired corporation become the

assets and liabilities of the acquiring corporation. Nonetheless, it seems completely inconsistent with the court's holding for "Situation One" in *Wells Fargo*, and it seems the IRS would disagree as well because the corporation's taxpayer identification number at the time of the overpayment is different from the corporation's taxpayer identification number at the time of the underpayment.)

The Claims Court's ruling. As if matters could get any more confusing, in Ford's § 6621(d) refund claim, Ford was the surviving entity throughout a series of consolidations and had an overpayment while Ford's FSC subsidiary had an underpayment. Naturally, Ford (having made the overpayment and being owed interest by the IRS) contended that it was the "same taxpayer" as Export (having made the underpayment and therefore owing a greater amount of interest to the IRS). Strategically, though, Ford did not dispute the courts' holdings in either *Energy E. Corp.* or *Wells Fargo*. Instead, Ford made the novel argument that because Export was not really an active corporation since it was just a FSC set up to avoid taxes (legitimately, of course), Export's separate corporate existence should be ignored, and Export should be considered the "same taxpayer" as Ford for purposes of § 6621(d). After hearing cross-motions for summary judgment, Judge Lettow decided (not surprisingly) that under basic principles of tax law—specifically, *Moline Properties*—Ford and Export are separate and therefore not the "same taxpayer" for purposes of § 6621(d). Ford's \$20,410,788 refund claim thus was denied.

What does all this mean for corporate taxpayers with overpayments and underpayments? The rules applicable to corporate taxpayers under § 6621(d) are a mess under current case law (i.e., *Ford*, *Wells Fargo*, and *Energy E. Corp.*). In our view, "same taxpayer" treatment under § 6621(d) should apply across open years if the overpaying and underpaying corporations combine pursuant to a § 368(a)(1)(A) straight merger but probably not otherwise. Guidance from Congress or Treasury would be helpful, but don't hold your breath there.

a. *And the Federal Circuit affirms.* [Ford Motor Company v. United States](#), 908 F3d 805 (Fed. Cir. (11/9/18)). The Court of Appeals for the Federal District affirmed the IRS's position and the holding of the Claims Court based upon its analysis and decision in *Wells Fargo*, discussed above.

3. *Congress has directed Treasury to issue preparer due diligence requirements with respect to head-of-household filing status.* The [2017 Tax Cuts and Jobs Act](#), § 11001(b), amended Code § 6695(g) to extend the preparer due diligence requirements to returns or claims for refund that claim eligibility for head-of-household filing status. This change is effective for taxable years beginning after 2017.

a. *Return preparers need to be extra careful with not only the earned income tax credit, but also with the child tax credit, additional child tax credit, the American Opportunity Tax Credit, and head-of-household filing status.* [T.D. 9842, Tax Return Preparer Due Diligence Penalty Under Section 6695\(g\)](#), 83 F.R. 55632 (11/7/18). The Treasury Department and the Service have finalized amendments to Reg. § 1.6695-2 to implement changes made by the Protecting Americans from Tax Hikes Act of 2015 (2015 PATH Act) and the 2017 Tax Cuts and Jobs Act. The 2015 PATH Act extended the § 6695(g) preparer due diligence requirements for taxable years beginning after 2015 to returns or claims for refund including claims of the child tax credit (CTC), additional child tax credit (ACTC), and American Opportunity Tax Credit (AOTC), in addition to the earned income credit (EIC). The 2017 Tax Cuts and Jobs Act amended Code § 6695(g) to extend the preparer due diligence requirements to returns or claims for refund that claim eligibility for head-of-household filing status effective for taxable years beginning after 2017. Previously, Treasury and the Service issued proposed and temporary regulations in 2016 addressing the changes made by the 2015 PATH Act (see T.D. 9799, [Tax Return Preparer Due Diligence Penalty Under Section 6695\(g\)](#), 81 F.R. 87444 (12/5/16)) and issued proposed regulations in 2018 addressing the changes made by the 2017 Tax Cuts and Jobs Act and revising the 2016 proposed regulations (see REG-103474-18, [Tax Return Preparer Due Diligence Penalty Under Section 6695\(g\)](#), 83 F.R. 33875 (7/18/18)). These final regulations adopt the 2016 and 2018 proposed regulations without substantive change. As a result of the legislative changes, one return or claim for refund may contain claims for more than one credit or claim head-of-household filing status, all of which are subject to the due diligence requirements. Each failure to comply with the due diligence requirements set forth in the regulations results in a penalty, and therefore more than

one penalty could apply to a single return or claim for refund. Examples in the regulations illustrate how multiple penalties could apply when one return or claim for refund is filed and illustrate the types of situations in which return preparers must make inquiries and document the inquiries and responses. The final regulations are effective November 7, 2018, but they generally apply to tax returns and claims for refund prepared on or after December 5, 2016, for tax years beginning after December 31, 2015, except for the rules relating to the determination of a taxpayer's eligibility for head-of-household filing status, which apply to tax returns and claims for refund prepared on or after November 7, 2018, for tax years beginning after December 31, 2017.

4. *In determining whether the § 6751(b)(1) supervisory approval requirement has been met, an IRS settlement officer need not read the mind of the supervisor; a signature is sufficient.* [Blackburn v. Commissioner](#), 150 T.C. No. 9 (4/5/18). A corporation, which apparently was the taxpayer's employer, failed to pay its employment tax liabilities and failed to file certain Forms 941, Employer's Quarterly Federal Tax Return. The Service assessed trust fund recovery penalties against the taxpayer under § 6672. In a collection due process hearing, the Service settlement officer determined to uphold the Service's proposed collection of the penalty. The taxpayer sought review of the Service's determination in the Tax Court and argued that the settlement officer had failed to comply with § 6330(c)(1), which provides:

The appeals officer shall at the hearing obtain verification from the Secretary that the requirements of any applicable law or administrative procedure have been met.

The taxpayer argued that the settlement officer had not verified the Service's compliance with the supervisory approval requirement of § 6751(b)(1). The Service's evidence of supervisory approval was Form 4183, Recommendation re: Trust Fund Recovery Penalty, which was dated prior to assessment of the trust fund recovery penalty. The Form 4183, which was generated by the Service's computer system, did not contain the supervisor's signature but showed the supervisor's name in the signature block for the supervisor. The taxpayer argued that the signature of the supervisor, by itself, was inadequate to comply with § 6751(b)(1), and that § 6330(c)(1) requires a settlement officer to verify compliance by engaging in "a factual analysis of the thought process of the supervisor" and to make "a determination that the thought process was 'meaningful.'" The Service argued that (1) the supervisory approval requirement of § 6751(b)(1) does not apply to the § 6672 trust fund recovery penalty, and (2) even if it does apply, it was not an abuse of discretion for the settlement officer to find compliance because there was sufficient evidence of supervisory approval. The Tax Court (Judge Goeke) declined to address the legal question whether the supervisory approval requirement of § 6751(b)(1) applies to the § 6672 trust fund recovery penalty. The court held that, even if supervisory approval was required, a record of compliance existed in this case. The court reasoned that its prior decisions "have consistently upheld a settlement officer's verification of assessments when the administrative record reflects compliance with administrative procedures" and have permitted "reliance upon standard administrative records" to verify assessments. In *Davis v. Commissioner*, 115 T.C. 35 (2000), the court held in connection with a CDP hearing that it was not an abuse of discretion for the Service to rely on Form 4340, Certificate of Assessment and Payments, to verify assessment of a tax where the taxpayer had not shown any irregularity in the assessment procedure that would raise a question. Form 4340, like the Form 4183 in this case, does not require a signature. Accordingly, the court held that it was not an abuse of discretion for the settlement officer to find that the Service had met the requirements of applicable law and administrative procedure. The court therefore granted the Service's motion for summary judgment.

5. *Updated instructions on how to rat yourself out.* [Rev. Proc. 2019-9](#), 2019-2 I.R.B. 292 (12/20/18). This revenue procedure updates [Rev. Proc. 2018-11](#), 2018-5 I.R.B. 335 (1/26/18), and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d), relating to the substantial understatement aspect of the accuracy-related penalty, and for the purpose of avoiding the tax return preparer penalty under § 6694(a), relating to understatements due to unreasonable positions. There have been no substantive changes. The revenue procedure does not apply with respect to any other penalty provisions, including § 6662(b)(1) accuracy-related penalties. If this revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275-R, as appropriate, attached to the return for the

year or to a qualified amended return. A corporation's complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP, Uncertain Tax Position Statement, is treated as if the corporation had filed a Form 8275 or Form 8275-R regarding the tax position. The revenue procedure applies to any income tax return filed on a 2018 tax form for a taxable year beginning in 2018 and to any income tax return filed on a 2018 tax form in 2019 for a short taxable year beginning in 2019.

6. *The Service does not bear the burden of proof with respect to penalties in a partnership-level proceeding, says the Tax Court.* [Dynamo Holdings, Limited Partnership v. Commissioner](#), 150 T.C. No. 10 (5/7/18). The Service issued a notice of final partnership administrative adjustment with respect to three taxable years of Dynamo Holdings, Limited Partnership. In addition to adjustments to partnership items, the Service determined that accuracy-related penalties applied under § 6662(a) and (b)(1)-(2) for negligence and substantial understatements of income tax. In [Graev v. Commissioner](#), 149 T.C. No. 23 (12/20/17), the court had held that the Service's burden of production includes evidence of written supervisory approval of penalties as required by § 6751(b)(1). In this case, the Service had introduced some evidence of written supervisory approval, but the evidence, according to the court, was inconclusive and it was not clear whether the Service had met the burden of production. Accordingly, among other issues, the court considered whether the Service bears the burden of production with respect to penalties determined in a TEFRA partnership-level proceeding. Section 7491(c) provides:

Notwithstanding any other provision of this title, the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.

In a unanimous, reviewed opinion by Judge Buch (with Judge Vasquez not participating), the Tax Court held that the Service does not bear the burden of production with respect to penalties in a partnership-level proceeding. To the extent that the court's prior decisions have suggested to the contrary (such as [RERI Holdings I, LLC v. Commissioner](#), 149 T.C. 1 (7/3/17), and [Curtis Inv. Co. v. Commissioner](#), T.C. Memo. 2017-150), the court will not follow them. In reaching this conclusion, the court relied in part on the plain language of the statute, which requires a "proceeding with respect to the liability of any individual." Partnership-level proceedings, the court reasoned, do not determine liability and are not with respect to individuals. The court also expressed concern about the practical effect of applying § 7491(c) in a partnership-level proceeding. Doing so would require the court (contrary to the purpose of the TEFRA audit procedures) to devote time and resources to identifying the ultimate taxpaying partners. As an example, if one partner were a corporation and another were an individual, the Service would bear the burden of production as to penalties with respect to one partner but not the other, which might require the court to render separate holdings. The partnership had not raised the lack of supervisory approval of the penalties in its petition, at trial, or in its post-trial briefing and therefore had waived asserting the lack of supervisory approval as a defense to penalties. Because the Service, according to the court's holding, does not bear the burden of production with respect to penalties in a partnership-level proceeding, the court denied the partnership's motion to dismiss as to penalties.

7. *Is the Pope Catholic? The Tax Court does not need the written approval of a supervisor before imposing penalties for delay or frivolous arguments under § 6673(a)(1).* [Williams v. Commissioner](#), 151 T.C. No. 1 (7/3/18). Section 6673(a)(1) authorizes the Tax Court to impose a penalty of up to \$25,000 when a taxpayer has initiated or maintained proceedings primarily for delay, advanced a position that is frivolous or groundless, or has unreasonably failed to pursue available administrative remedies. In this case, the Tax Court (Judge Ruwe) held, not surprisingly, that § 6751(b), which provides that no penalty under Title 26 can be assessed "unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination," does not apply to the Tax Court when it imposes penalties under § 6673(a)(1).

8. *The Service can assess restitution a person has been ordered to pay upon conviction of violating section 7201 when the wrongdoing consisted of aiding and abetting the evasion of payment of a third party's tax liability.* [Bontrager v. Commissioner](#), 151 T.C. No. 12 (12/12/18). The taxpayer pleaded guilty to violating § 7201, which criminalizes any willful attempt to evade and

defeat tax. The basis for the taxpayer’s conviction was that he had aided and abetted his father’s evasion of tax. In connection with the criminal proceeding, the U.S. District Court sentenced the taxpayer to one year in prison and three years of supervised release and ordered him to pay criminal restitution in the amount of \$72,710. The Service subsequently assessed the restitution pursuant to § 6201(a)(4)(A), which provides—for criminal restitution paid after August 16, 2010—that the Service

“shall assess and collect the amount of restitution under an order pursuant to section 3556 of title 18, United States Code, for failure to pay any tax imposed under this title in the same manner as if such amount were such tax.

The Service subsequently filed a notice of federal tax lien, in response to which the taxpayer requested a collection due process hearing. Among other issues raised by the taxpayer, the settlement officer who conducted the CDP hearing rejected the taxpayer’s argument that the Service had no legal authority to assess the restitution. Specifically, the taxpayer argued that assessment of the restitution was not authorized by § 6201(a)(4)(A)—which authorizes assessment of restitution “for failure to pay any tax imposed under this title”—because the restitution was not for *his* failure to pay tax, but rather for his father’s failure to pay tax. In reviewing the notice of determination issued following the CDP hearing, the Tax Court (Judge Lauber) held that § 6201(a)(4)(A) authorized assessment of the restitution. The court reasoned that neither § 7201 nor § 6201(a)(4) requires that the tax imposed be a tax imposed on the person ordered to pay the restitution.

Section 7201 criminalizes any willful attempt to evade payment of “any tax imposed by this title.” Section 6201(a)(4) authorizes the assessment of restitution “for failure to pay any tax imposed under this title.” Petitioner was ordered to pay restitution for aiding and abetting Winston’s failure to pay Federal income tax. That tax was clearly “[a] tax imposed under this title.”

The court also rejected the taxpayer’s argument that his restitution obligation had been discharged in bankruptcy.

9. *All hardship exemptions, including a general hardship exemption, from the requirement to maintain minimum essential coverage can be claimed on an individual’s tax return for 2018.* Notice 2019-5, 2019-2 I.R.B. 283 (12/21/18). Under § 5000A, for months beginning after December 31, 2014, an individual must maintain minimum essential coverage and must pay a penalty (the individual shared responsibility payment) for failure to do so unless the person qualifies for an exemption. Some exemptions can be claimed only if an individual has obtained a hardship exemption certification from the Health Insurance Marketplace. Others can be claimed on the individual’s federal income tax return. This notice supplements Notice 2014-76, 2014-50 I.R.B. 946, as supplemented by Notice 2017-14, 2017-6 I.R.B. 783, both of which provided that certain hardship exemptions could be claimed on an individual’s tax return. Specifically, this notice reflects guidance issued by the Department of Health and Human Services on September 12, 2018, which provides that all hardship exemptions available under 45 C.F.R. § 155.605(d)(1), including a general hardship exemption, can be claimed on an individual’s federal income tax return. These hardship exemptions are:

1. “He or she experienced financial or domestic circumstances, including an unexpected natural or human-caused event, such that he or she had a significant, unexpected increase in essential expenses that prevented him or her from obtaining coverage under a qualified health plan;”
2. “The expense of purchasing a qualified health plan would have caused him or her to experience serious deprivation of food, shelter, clothing, or other necessities; or”
3. “He or she has experienced other circumstances that prevented him or her from obtaining coverage under a qualified health plan.”

• The 2017 Tax Cuts and Jobs Act, § 11081, amended Code § 5000A(c) to reduce to zero the penalty enacted as part of the Affordable Care Act for failing to maintain minimum essential coverage. This change applies to months beginning after 2018.

10. *Accuracy-related penalties determined by the IRS’s Automated Correspondence Exam system are penalties “automatically calculated through electronic means” and therefore are not subject to the requirement of § 6751(b) that they be approved in writing by a supervisor.* [Walquist v.](#)

[Commissioner](#), 152 T.C. No. 3 (2/25/19). The 2014 federal income tax return filed by the taxpayers, a married couple, reflected wages and other income of \$94,114 and a purported offset or deduction of \$87,648, labeled as a “Remand for Lawful Money Reduction.” They failed to report \$1,215 of unemployment compensation reported on Form 1099-G by the State of Minnesota. After taking into account the standard deduction, the taxpayers reported negative taxable income of (\$5,731). The IRS’s computer document matching system identified the return for examination, which was processed by the IRS’s Automated Correspondence Exam (ACE) system. The ACE system employed the IRS’s Correspondence Examination Automated Support (CEAS) software, which generated and issued to the taxpayers a Letter 525, General 30-Day Letter. The 30-day letter calculated a proposed deficiency \$13,832 and automatically calculated a 20 percent (\$2,766.40) accuracy-related penalty pursuant to § 6662(a), (b)(2), and (d)(1)(A) for a substantial understatement of income tax. Following the taxpayers’ failure to respond to the 30-day letter, the CEAS program generated a notice of deficiency, in response to which the taxpayers filed what purported to be a petition in the Tax Court. They filed a copy of the notice of deficiency, on each page of which they had written “REFUSAL FOR CAUSE,” and attached various documents that set forth arguments commonly made by tax protestors as well as a demand that the Tax Court garnish the wages of the Secretary of the Treasury. Among other issues in the case, the Tax Court (Judge Lauber) addressed whether the accuracy-related penalty calculated by the IRS’s CEAS program was subject to the requirement of § 6751(b) that the initial determination of the assessment of a penalty be “personally approved (in writing) by the immediate supervisor of the individual making such determination.” The court held that it was not. In *Graev v. Commissioner*, 149 T.C. No. 23 (2017), the Tax Court held that compliance with § 6751(b)(1) is properly a part of the IRS’s burden of production under I.R.C. § 7491(c). Further, in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), the U.S. Court of Appeals for the Second Circuit held that “the written approval requirement of § 6751(b)(1) is appropriately viewed as an element of a penalty claim, and therefore part of the IRS’s *prima facie* case.” Section 6751(b)(2), however, provides that supervisory approval is not required for “any addition to tax under section 6651, 6654, or 6655, or” for “any other penalty automatically calculated through electronic means.” The penalty in this case, the court concluded, “was determined automatically by a computer software program without the involvement of a human IRS examiner,” and therefore was a penalty “automatically calculated through electronic means” within the meaning of § 6751(b)(2)(B). The court noted that its decision is consistent with the IRS’s Internal Revenue Manual, which states that substantial understatement penalties determined by the CEAS program (as well as those calculated through the Automated Underreporter program) are exempt from the supervisory approval requirement. The court also noted that its conclusion is consistent with the policy underlying the supervisory approval requirement of § 6751(b), which was enacted as a means of preventing IRS employees from threatening unjustified penalties to encourage settlement. Because the supervisory approval requirement did not apply, the IRS had no burden of production with respect to the penalty. The court also imposed a penalty of \$12,500 on the taxpayers pursuant to § 6673(a)(1) for advancing frivolous positions in their petition and in subsequent proceedings.

- The Tax Court previously had held in *Williams v. Commissioner*, 151 T.C. No. 1 (7/3/18), that the supervisory approval requirement of § 6751(b) does not apply to the Tax Court when it imposes penalties under § 6673(a)(1).

11. *The supervisory approval requirement of § 6751(b) “includes no requirement that all potential penalties be initially determined by the same individual nor at the same time,” says the Tax Court.* [Palmolive Building Investors, LLC v. Commissioner](#), 152 T.C. No. 4 (2/28/19). The taxpayer, a TEFRA partnership, granted in 2004 a conservation easement valued at \$257 million on the façade of the Palmolive Building on North Michigan Avenue in Chicago. In a prior opinion, the Tax Court upheld the IRS’s disallowance of the taxpayer’s charitable contribution deduction on the ground that mortgages on the building were not fully subordinated to the conservation easement and therefore the charitable organization in whose favor the easement was granted was not, as required by relevant regulations, guaranteed the requisite share of proceeds in the event the easement was extinguished. See *Palmolive Building Investors LLC et al. v. Commissioner*, 149 T.C. No. 18 (10/13/17). The remaining issue was whether, in asserting certain penalties, the IRS had complied with the requirement of § 6751(b) that the initial determination of the assessment of a penalty be “personally approved (in writing) by the immediate supervisor of the individual making such determination.” During the examination of the partnership return for the year in question, the IRS’s examining agent

prepared Form 5701 (Notice of Proposed Adjustment) that had two Forms 886A (Explanation of Items) attached to it. One of the Forms 886A proposed and justified a penalty for gross valuation misstatement under § 6662(h)(1) and the other proposed and justified, in the alternative, a 20 percent negligence penalty under § 6662(b)(1). The agent's supervisor signed the Form 5701. The IRS issued a 30-day letter (Letter 1807) inviting the taxpayer to a closing conference to discuss the adjustments. The 30-day letter referenced only the gross valuation misstatement penalty. Subsequently, the IRS issued a 60-day letter (Letter 1827) proposing adjustments and giving the taxpayer 60 days within which to file a protest with IRS Appeals. The 60-day letter had attached to it the Form 5701 and both Forms 886-A, i.e., it referenced both penalties. In IRS Appeals, the Appeals Officer assigned to the case prepared a Form 5402-c (Appeals Transmittal and Case Memo) that had attached to it a proposed Notice of Final Partnership Administrative Adjustment, (FPAA) the last page of which was a Form 886A that asserted both the original penalties and, in the alternative, two additional penalties: a 20 percent penalty for substantial understatement of income tax under § 6662(b)(2) and a 20 percent penalty for substantial valuation misstatement under § 6662(b)(3). The immediate supervisor of the Appeals Officer signed both the Form 5402-c and the proposed FPAA. The Tax Court (Judge Gustafson) held that the IRS had complied with the supervisory approval requirement of § 6751(b). In reaching this conclusion, the court rejected the taxpayer's argument that the requirement had not been met with respect to the additional two penalties asserted by the Appeals Officer. "Section 6751(b)(1) includes no requirement that all potential penalties be initially determined by the same individual nor at the same time." The court also rejected the taxpayer's argument that the supervisory approval requirement had not been met because the IRS had failed to comply with certain provisions of the Internal Revenue Manual regarding documentation of penalty approval in workpapers. The court emphasized that § 6751(b)(1) "does not require written supervisory approval on any particular form" and does not require the signature or written name of the person making the initial determination of the penalty. The taxpayer also argued that the supervisory approval requirement had not been met because the IRS had failed to establish when the initial determinations of the penalties had been made and because the initial 30-day letter received by the taxpayer referred only to the gross valuation misstatement penalty and not to the negligence penalty. The court rejected these arguments as well. The court reasoned that the examining agent and the Appeals Officer each made their initial determinations at the time they solicited their respective supervisors' approval, and their supervisors had given the requested approval in writing.

12. *Don't think you can escape the penalty for filing an S corporation return late, even if you are the only shareholder, by requesting an extension of time to file your individual federal income tax return.* [ATL & Sons Holdings, Inc. v. Commissioner](#), 152 T.C. No. 8 (3/13/19). The petitioner in this case was a subchapter S corporation that filed its 2012 return on Form 1120S late. The S corporation failed to request an extension of time to file its return by filing Form 7004. The sole shareholders of the S corporation were Ralph and Cassandra Allen, a married couple, who timely requested an extension of time to file their 2012 federal income tax return and who timely filed the return by the extended due date. The IRS assessed a \$2,340 penalty against the S corporation pursuant to § 6699 for the late filing of its return. The assessment appeared on the S corporation's account transcript with transaction code 166, which indicated that it was a computer-generated assessment of a delinquency penalty. The S corporation had made an unspecified overpayment for 2013, which the IRS credited against the 2012 penalty. The IRS issued a final notice of intent to levy for the balance of the 2012 penalty, in response to which the S corporation requested a collection due process hearing. Following the CDP hearing, which the Allens missed but for which they submitted some additional information, the IRS settlement officer upheld the proposed collection action and the S corporation brought this challenge in the Tax Court. The Tax Court (Judge Gustafson) held that the settlement officer had not abused her discretion in upholding the proposed collection action and granted the IRS's motion for summary judgment. The court noted that an S corporation is an entity separate from its shareholders and is required to file its own return and to request its own extension of time to file the return. The court rejected the S corporation's argument that the penalty should be abated because the IRS had agreed to excuse the penalty under similar circumstances in a different year. The court also disagreed with the S corporation's position that it had a good faith, reasonable cause defense to the penalty because it had only two shareholders who were aware of the S corporation's loss for the year and that no harm had resulted from the late filing. "Section 6999 does not include a condition of harm before the penalty is imposed; it simply imposes a penalty when the filing is late (without reasonable

cause).” The court also held that the late-filing penalty of § 6699 was not subject to the requirement of § 6751(b) that the initial determination of the assessment of a penalty be “personally approved (in writing) by the immediate supervisor of the individual making such determination.” Section 6751(b)(2) provides that supervisory approval is not required for “any addition to tax under section 6651, 6654, or 6655, or” for “any other penalty automatically calculated through electronic means.” The court held that the § 6699 penalty is a “penalty automatically calculated through electronic means” and therefore is not subject to the § 6751(b) supervisory approval requirement. The court rejected the taxpayers’ argument that, because the penalty in question is subject to a good faith, reasonable cause defense, it is not a penalty that is “automatically calculated.” “The possibility of such a defense does not change the fact that the penalty itself is ‘automatically calculated.’” Regarding the IRS’s crediting of the S corporation’s 2013 overpayment against the 2012 § 6699 penalty, the court held that the IRS’s action had not violated § 6330(e)(1), which prohibits a levy before the conclusion of a CDP hearing. Although that provision prohibits collection by levy, “[n]othing in section 6330 prohibits the IRS from engaging in other nonlevy collection actions, including offsetting payments from other periods, as the IRS did in this instance.”

13. *No addition to tax under § 6654 will be made for farmers and fisherman for failure to make estimated income tax payments for 2018 if they file their 2018 returns and pay the total tax due by April 15, 2019 (April 17 for those in Maine and Massachusetts).* Notice 2019-17, I.R.B. 907 (2/28/19). Under § 6654, individuals are required to make advance payments of their estimated income tax liability. Normally, individuals are required to make these payments in equal quarterly installments. Section 6654(a) imposes an addition to tax for failure to pay a sufficient amount of estimated income tax. Those who qualify as farmers or fishermen (generally, those for whom two-thirds of gross income is from farming or fishing) are subject to special rules under which they make only one payment, due on January 15, 2019, for the 2018 tax year, but no addition to tax is imposed for 2018 if a farmer or fisherman files a 2018 return and pays the tax shown due on the return by March 1, 2019. Because of the magnitude of the changes enacted as part of the 2017 Tax Cuts and Jobs Act and the resulting difficulty farmers and fishermen encountered in estimating their income tax liability for 2018, the IRS has waived the addition to tax of § 6654 for a qualifying farmer or fisherman who files his or her 2018 income tax return and pays in full any tax due by April 15, 2019 (or by April 17, 2019, for those taxpayers who live in Maine or Massachusetts). To request this waiver, farmers and fishermen must attach Form 2210-F, Underpayment of Estimated Tax by Farmers and Fishermen, to their 2018 tax return, which the taxpayer can do whether the return is filed electronically or on paper. The notice provides that a taxpayer should enter his or her name and identifying number at the top of the form, and should check the waiver box (Part I, Box A). The rest of the form should be left blank.

14. *No addition to tax under § 6654 will be made for failure to make estimated income tax payments if total withholding and estimated tax payments exceed 80 percent of tax shown due on the 2018 return.* Notice 2019-25, 2019-15 I.R.B. (3/22/19). Under § 6654, individuals are required to make advance payments of their income tax liability either through withholding or quarterly estimated tax payments. Section 6654(a) imposes an addition to tax for failure to pay a sufficient amount of estimated income tax. No addition to tax is imposed if an individual makes payments equal to the lesser of (1) 90 percent of the tax shown on the return for the taxable year, or (2) 100 percent of the tax shown on the taxpayer’s return for the preceding taxable year (110 percent if the individual’s adjusted gross income on the previous year’s return exceeded \$150,000), as long as the preceding taxable year was a full twelve months. Because of the magnitude of the changes enacted as part of the 2017 Tax Cuts and Jobs Act and the resulting difficulty taxpayers encountered in estimating their income tax liability for 2018, the IRS previously issued Notice 2019-11, 2019-5 I.R.B. 430 (1/16/19), which waived any addition to tax under § 6654 for an individual whose total withholding and estimated tax payments made on or before January 15, 2019, equal or exceed 85 percent of the tax shown on that individual’s 2018 return. In this notice, the IRS has reduced this percentage to 80 percent. Accordingly, no addition to tax under § 6654 will be made with respect to an individual whose total withholding and estimated tax payments made on or before January 15, 2019, equal or exceed 80 percent of the tax shown on that individual’s 2018 return. To request this waiver, an individual must file Form 2210, Underpayment of Estimated Tax by Individuals, Estates, and Trusts, with his or her 2018 income tax return. The form can be filed with a return filed electronically or on paper. The notice provides further instructions regarding completion of Form 2210. Taxpayers who are eligible for a waiver and who already have

paid the addition to tax can seek a refund by filing Form 843, Claim for Refund and Request for Abatement and including the statement “80% Waiver of estimated tax penalty” on line 7. This notice supersedes Notice 2019-11.

B. *Discovery: Summonses and FOIA*

1. *Non-government attorneys KEEP OUT! REG-132434-17, Proposed Regulations on Certain Non-Government Attorneys Not Authorized to Participate in Examinations of Books and Witnesses as a Section 6103(n) Contractor*, 83 F.R. 13206 (3/28/18). Treasury and the Service have issued a notice of proposed rulemaking that would significantly narrow final regulations issued in 2016 that permit service providers with whom the Service contracts to receive books and records provided in response to a summons and participate in a summons interview. Section 6103(n) and Reg. § 301.6103(n)-1(a) permit the disclosure of returns and return information to any person for purposes of tax administration to the extent necessary in connection with the acquisition of property or certain services (such as processing, storage and reproduction) related to returns or return information. The final regulations issued in 2016 clarified that such persons with whom the Service or Chief Counsel contracts for services could not only receive and review books, papers, and records produced in compliance with a summons issued by the Service, but also in the presence and under the guidance of an IRS officer or employee, participate fully in the interview of a witness summoned by the Service to provide testimony under oath. *See T.D. 9778, Participation of a Person Described in Section 6103(n) in a Summons Interview Under Section 7602(a)(2) of the Internal Revenue Code*, 81 F.R. 45409 (7/14/16). Commentators, including the State Bar of Texas Tax Section, had recommended removing the provisions permitting contractors to participate in a summons interview because, among other reasons, doing so would “avoid the unsettled question of whether a private contractor has the legal authority to examine a witness.” 2014 TNT 180-24 (9/16/14). After publishing *Notice 2017-38*, 2017-30 I.R.B. 147 (7/7/17) [which related to the subsequently issued *Second Report to the President on Identifying and Reducing Tax Regulatory Burdens*, Dep’t of Treasury, Press Release (10/2/17), and *Department of the Treasury, 2017-2018 Priority Guidance Plan* (10/20/17)], the Service identified eight sets of regulations that “impose an undue financial burden,” “add undue complexity,” or “exceed [the Service’s] statutory authority.” The above-mentioned final regulations under § 7602 were one of the eight targeted for revision. Accordingly, Prop. Reg. § 301.7602-1(b)(3) provides new rules that significantly narrow the scope of the current regulations under § 7602 by excluding non-government attorneys from receiving summoned books, papers, records, or other data or from participating in the interview of a witness summoned by the Service to provide testimony under oath. The proposed regulations contain a limited exception for an attorney hired by the Service as a specialist in foreign, state, or local law, including tax law, or in non-tax substantive law that is relevant to an issue in the examination, such as patent law, property law, or environmental law, or is hired for knowledge, skills, or abilities other than providing legal services as an attorney. The preamble to the proposed regulations explains the change as follows:

The Summons Interview Regulations require the Service to retain authority over important decisions when section 6103(n) contractors question witnesses, but there is a perceived risk that the Service may not be able to maintain full control over the actions of a non-government attorney hired by the Service when such an attorney, with the limited exception described below, questions witnesses. The actions of the non-governmental attorney while questioning witnesses could foreclose IRS officials from independently exercising their judgment. Managing an examination or summons interview is therefore best exercised solely by government employees, including government attorneys, whose only duty is to serve the public interest. These concerns outweigh the countervailing need for the Service to use non-government attorneys, except in the limited circumstances set forth in proposed paragraph (b)(3)(ii). Treasury and the Service remain confident that the core functions of questioning witnesses and conducting examinations are well within the expertise and ability of government attorneys and examination agents.

The proposed regulations apply to examinations begun or administrative summonses served by the Service on or after March 27, 2018.

- The Service’s position in the proposed regulations represents a change in policy. The Service made a controversial decision to engage the law firm Quinn Emanuel Urquhart & Sullivan, LLP, as a private contractor to assist in the Service’s examination of Microsoft’s 2004 to 2006 tax years. A federal district court expressed concern about this practice, but upheld enforcement of the summonses issued by the Service to Microsoft. *See United States v. Microsoft Corp.*, 154 F. Supp. 3d (W.D. Wash. 2015).

2. *Citing § 7611, purported church exorcizes devilish summons. The lesson for the Service? For God’s sake, get the “John Hancock” of at least the TE/GE Commissioner before sending a church tax inquiry or examination notice under § 7611!* [United States v. Bible Study Time, Inc.](#), 295 F.Supp.3d 606 (3/13/18). The District Court of South Carolina stayed a summons enforcement action because the Service failed to substantially comply with the notice requirements of § 7611(a) (church tax inquiries and examinations). The taxpayer, Bible Study Time, Inc., purported to be a church. The Service issued a summons to the taxpayer in connection with an inquiry and examination of the taxpayer’s tax-exempt status as a church. [Previously, the taxpayer had failed in its efforts to quash several Service third-party summonses issued to the taxpayer’s banks. *See Bible Study Time, Inc. v. United States*, 240 F.Supp.3d 409 (D.S.C. 2017).] Under § 7611, the Service must navigate certain procedural and notice rules prior to conducting a church tax inquiry or examination. One such rule requires an “appropriate high-level Treasury official” to sign off before a church tax inquiry or examination can begin. *See* § 7611(a). Furthermore, § 7611(e) provides that “any proceeding to compel compliance with respect to any church tax inquiry or examination shall be stayed until the court finds that all practicable steps to correct the noncompliance have been taken.” Due largely to the Service’s reorganization begun in 1998 and Congress’s failure to update § 7611 thereafter (as well as Treasury’s failure to update interpreting regulations), the law is unclear as to who is an “appropriate high-level Treasury official” within the meaning of § 7611. *See generally United States v. Living Word Christian Center*, 102 A.F.T.R.2d 2008-7220 (D. Minn. 2008) (IRS Director of Exempt Organizations, Examinations, is not an “appropriate high-level Treasury official). In this case, the IRS Tax-Exempt/Governmental Entities (“TE/GE”) Commissioner and the Director, Exempt Organizations (“DEO”), who reports to the TE/GE Commissioner, had signed off on an “Approval Cover Sheet” for the § 7611 notice, but for reasons that are unclear, only the DEO signed the actual § 7611 notice itself. The Service compounded this error by failing to communicate to the taxpayer that the TE/GE Commissioner had signed the “Approval Cover Sheet,” a fact which the taxpayer discovered only after contesting the summons. In response to the Service’s summons enforcement action, the taxpayer argued that the DEO was not of sufficiently high rank to comply with § 7611 and that even if the TE/GE Commissioner was of high enough rank, the Service’s failure to communicate that fact violated § 7611. The Service argued that the DEO was of sufficient rank, but regardless the TE/GE Commissioner’s signature on the § 7611 Approval Cover Sheet “substantially complied” (see § 7611(e)(1)) with § 7611, making the summons enforceable. Ultimately, after noting the Service’s reorganization during and after 1998 and the resulting ambiguity created under § 7611, the District Court of South Carolina (Judge Currie) ruled as follows: (i) pursuant to Delegation Order 193 (Nov. 8, 2000), the TE/GE Commissioner is of sufficiently high rank to sign a § 7611 notice; (ii) the DEO is not of sufficiently high rank; and (iii) the Service’s failure to communicate the TE/GE Commissioner’s authorization under § 7611 to the taxpayer requires a stay of the summons enforcement proceeding until the TE/GE Commissioner signs and delivers the actual § 7611 notice to the taxpayer.

C. Litigation Costs

1. *After the monks lose their patience, a good deed by the Service gets punished; however, the monks and their blood-sucking attorneys get no award of administrative or litigation costs under § 7430 due to the Service’s concession.* [Friends of the Benedictines in the Holy Land, Inc. v. Commissioner](#), 150 T.C. No. 5 (2/21/18). As required by § 508, the taxpayer applied for tax-exempt status under § 501(c)(3) by filing a Form 1023 (Application for Recognition of Exemption) on July 2, 2012. After receiving no response from the Service (other than a perfunctory acknowledgment letter) for over a year, the taxpayer filed a declaratory judgment action in Tax Court on September 20, 2013, as allowed by § 7428. Generally, § 7428 allows such declaratory judgment actions if the Service does not issue a determination letter within 270 days from the date the organization files a properly-completed Form 1023. On September 22, 2013, two days after the taxpayer filed the § 7428 declaratory

judgment action, the Service issued a determination letter granting § 501(c)(3) status to the taxpayer retroactive to March 14, 2012. Next, on October 1, 2013, IRS counsel contacted the taxpayer's counsel about filing a motion to dismiss the pending declaratory judgment action in Tax Court; however, the taxpayer's counsel preferred to resolve the litigation by preparing a joint decision and stipulation to which the Service would agree and the Tax Court would adopt. (*Perhaps taxpayer's counsel was laying a trap?*) Over the next month and one-half, IRS counsel and the taxpayer's counsel crafted a joint decision and stipulation stating that the taxpayer was indeed tax-exempt under § 501(c)(3). The Tax Court adopted and entered the joint decision and stipulation on December 31, 2013. Then (*perhaps closing the trap?*) on January 30, 2014, the taxpayer filed a motion for an award of reasonable administrative and litigation costs under § 7430. Generally, § 7430 permits taxpayers to recover reasonable administrative and litigation costs incurred in any administrative or court proceeding brought by or against the United States with respect to the "determination, collection, or refund of any tax, interest, or penalty" under the Code, including declaratory judgment actions filed under § 7428. To recover under § 7430, the taxpayer must establish that (1) it is the prevailing party, (2) it did not unreasonably protract the proceedings, (3) the amount of the costs requested is reasonable, and (4) it exhausted the administrative remedies available. Regardless, if the position of the United States in the administrative or court proceeding is "substantially justified," the taxpayer is not entitled to an award of costs under § 7430.

The taxpayer's and the Service's arguments. Taxpayer's counsel originally had agreed to assist the taxpayer with the filing of the Form 1023 on a pro bono basis. Nevertheless, citing the determination letter as well as the joint decision and stipulation, the taxpayer's counsel argued (1) that it was the "prevailing party" in both the administrative proceedings and the § 7428 declaratory judgment action and (2) that it thus should be awarded administrative and litigation costs totaling \$69,000. (*Assuming the best, perhaps taxpayer's counsel was going to donate the \$69,000 to the taxpayer?*) The Service countered that, although the taxpayer did not unreasonably protract the proceedings or fail to exhaust administrative remedies, the taxpayer was not the "prevailing party" and the asserted costs were unreasonable.

The Tax Court's analysis. The Tax Court (Judge Wells) initially noted with respect to the taxpayer's arguments and the Service's response that § 7430 requires a bifurcated analysis whereby an award of administrative costs is determined separately from an award of litigation costs. The taxpayer had asserted that its administrative costs were roughly \$8,500 and that its litigation costs were roughly \$60,500. The Service first argued that no administrative costs should be awarded under § 7430 because a request for a § 501(c)(3) determination letter is tantamount to a request for a private letter ruling, and the regulations under § 7430 provide an exception to the recovery of administrative costs in connection with a request for a private letter ruling or "similar determination." See Reg. § 301.7430-3(a). Judge Wells ruled with respect to this initial argument by the Service that because an organization is required by § 508 to seek a determination letter in order to be classified as exempt under § 501(c)(3), the exception in the regulations for private letter rulings or "similar determinations" did not apply. Next, with respect to the Service's argument that the taxpayer was not the "prevailing party" for administrative purposes under § 7430, the Service asserted that its issuance of the determination letter on September 22, 2013, granting the taxpayer's exempt status under § 501(c)(3) meant the taxpayer did not "prevail" over any contrary position asserted by the Service. Judge Wells ruled that the Tax Court did not need to decide whether the issuance of a determination letter meant the taxpayer "prevailed" administratively because the taxpayer had not adequately proven its *administrative* costs, but rather only *litigation* costs. Finally, with respect to litigation costs, the Service argued that no award should be granted under § 7430 because the Service's position in the declaratory judgment action, albeit a complete concession, was substantially justified. With respect to this argument by the Service, Judge Wells determined that a complete concession by the Service was reasonable under the circumstances and therefore the Service's position was substantially justified. Accordingly, Judge Wells held that the taxpayer was not a prevailing party within the meaning of § 7430 and was not entitled to an award of litigation costs either.

Although Judge Wells awarded neither administrative nor litigation costs, his opinion notes that the Tax Court was sympathetic to the taxpayer's plight, stating:

Petitioner waited well over 14 months after it applied, and even then the IRS declined to give petitioner any assurance that a ruling would be forthcoming. We cannot criticize petitioner for then filing a petition; and the IRS' almost immediate issuance of a determination and concession indicates that petitioner should not have been put to the trouble and expense of doing so.

D. Statutory Notice of Deficiency

1. 🎵🎵*If you want my love, leave your name and address ...* 🎵🎵 A notice of deficiency mailed to the address on the taxpayers' tax return was mailed to the taxpayers' last known address despite their filing of a power of attorney and a request for an extension using their new address. [Gregory v. Commissioner](#), 152 T.C. No. 7 (3/13/19). Section 6212(b)(1) provides that a notice of deficiency in respect of a tax imposed by subtitle A shall be sufficient if "mailed to the taxpayer at his last known address." For this purpose, a taxpayer's last known address is "the address that appears on the taxpayer's most recently filed and properly processed Federal tax return, unless the Internal Revenue Service (IRS) is given clear and concise notification of a different address". Reg. § 301.6212-2(a). The taxpayers in this case, a married couple, moved from Jersey City, New Jersey to Rutherford, New Jersey, on June 30, 2015. They filed their 2014 federal income tax return on October 15, 2015. The return incorrectly reflected their old, Jersey City address. In November 2015, a power of attorney on Form 2848 was submitted to the IRS that had their new, Rutherford address. In April 2016, they filed a request for an automatic extension of time to file their 2015 federal income tax return on Form 4868 that also had their new, Rutherford address. The IRS sent a notice of deficiency with respect to tax year 2014 by certified mail to the taxpayers' old, Jersey City address on October 13, 2016. The U.S. Postal Service returned the notice of deficiency to the IRS as unclaimed; the taxpayers never received it. They first became aware of the notice of deficiency on January 17, 2017, and, in response, filed a petition in the Tax Court that same day. The IRS moved to dismiss for lack of jurisdiction because the taxpayers had filed their petition late (outside the 90-day time period of § 6213(a)), and the taxpayers moved to dismiss for lack of jurisdiction on the ground that the petition had not been mailed to their last known address and therefore was invalid. The Tax Court (Judge Buch) held that the notice of deficiency had been mailed to the taxpayers' last known address and granted the government's motion to dismiss. The court first reasoned that neither the Form 2848 nor the Form 4868 submitted by the taxpayers was a "return" within the meaning of the last known address rule of Reg. § 301.6212-2(a). These forms, the court reasoned, are not returns under the four-part test of *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986). Further, the court explained, Reg. § 301.6212-2(a) provides that additional information on what constitutes a return for purposes of the last known address rule can be found in procedures published by the IRS, and Rev. Proc. 2010-16, 2010-19 I.R.B. 664, specifically provides that Forms 2848 and 4868 are not returns for this purpose. The court next concluded that the Forms 2848 and 4868 submitted by the taxpayers had not provided the IRS with clear and concise notification of their new address. The instructions to both forms, the court reasoned, explicitly provide that the forms will not update a taxpayer's address of record with the IRS. That these forms do not constitute clear and concise notification of a new address, the court explained, is implicit in Rev. Proc. 2010-16, which provides that Forms 2848 and 4868 are not returns and that they "will not be used by the Service to update the taxpayer's address of record." Finally, the court distinguished earlier decisions holding that a Form 2848 filed with the IRS does give clear and concise notification of a new address. *See Hunter v. Commissioner*, T.C. Memo. 2004-81; *Expanding Envelope & Folder Corp. v. Shotz*, 385 F.2d 402 (3d Cir. 1997). The court reasoned that these decisions were based on prior versions of Form 2848 and that "[s]ince 2004 the Commissioner has issued clear guidance informing taxpayers of what actions will and will not change their last known address with the Commissioner."

- If the taxpayers appeal this decision, the appeal will be heard by the U.S. Court of Appeals for the Third Circuit, the same court that held in *Expanding Envelope & Folder Corp.* that a prior version of Form 2848 did provide clear and concise notification of a taxpayer's new address. Stay tuned.

E. *Statute of Limitations*

1. *Shouldn't the limitations periods on seeking tax refunds be simpler? Another case in which a taxpayer loses the ability to obtain a refund because of a limit on the amount of tax recoverable.* [Borenstein v. Commissioner](#), 149 T.C. No. 10 (8/30/17). The taxpayer filed a timely extension request for her 2012 federal income tax return and paid a total of \$112,000 towards her 2012 federal tax liability. All of her payments, which she made through estimated tax payments and a payment with her extension request, were deemed to be made on April 15, 2013. She did not file her 2012 return until August 29, 2015, after she had received a notice of deficiency for 2012. Her return reflected a tax liability of \$79,559, which the IRS agreed was correct. Thus, she had overpaid her 2012 federal tax liability by \$38,447. In response to the notice of deficiency, the taxpayer filed a petition in the Tax Court. The issue before the court was whether the taxpayer was entitled to a credit or refund of the overpayment. The Tax Court (Judge Lauber) held that she was not. Under § 6512(b)(1), the Tax Court has jurisdiction to determine an overpayment if it has jurisdiction by virtue of a notice of deficiency. In this case, the court had deficiency jurisdiction because the IRS had issued a notice of deficiency and the taxpayer had filed a timely petition. Section 6512(b)(3), however, imposes a limit on the amount of tax that can be refunded. This provision states that only the portion of the tax paid within one of three specific time periods is allowed as a credit or refund. The parties agreed that the relevant period was that set forth in § 6512(b)(3)(B), which refers to tax paid

within the period which would be applicable under section 6511(b)(2), (c), or (d), if on the date of the mailing of the notice of deficiency a claim had been filed (whether or not filed) stating the grounds upon which the Tax Court finds that there is an overpayment.

In other words, the court must treat the taxpayer as having filed a hypothetical claim for refund on the date the notice of deficiency was mailed. The question is what amount of tax the taxpayer could have recovered through this hypothetical refund claim taking into account the limits of § 6511(b)(2), (c), or (d). Of these, only § 6511(b)(2) was relevant. This provision states that a taxpayer can recover tax paid within either a two-year or a three-year period ending on the date the taxpayer filed the claim for refund. The three-year look-back period applies when the taxpayer files the refund claim “within 3 years from the time the return was filed.” The two-year look-back period applies in all other cases. In this case, the court reasoned, § 6512(b)(3)(B) treats the hypothetical refund claim as having been filed on June 19, 2015, the date on which the notice of deficiency was mailed. This was *before* the taxpayer had filed her return for the year. Accordingly, the court held, the hypothetical refund claim could not be regarded as having been filed “within 3 years from the time the return was filed,” and therefore the amount of tax recoverable was limited to the portion paid within the two-year period preceding June 19, 2015. All of the tax in question was deemed paid on April 15, 2013, and therefore the taxpayer was not entitled to a refund of any of the tax paid.

In reaching this conclusion, the court rejected arguments made by the taxpayer and by the Philip C. Cook Low-Income Taxpayer Clinic at the Georgia State University College of Law and the Harvard Federal Tax Clinic as amici curiae. They argued that a three-year look-back period applied by virtue of the final sentence of § 6512(b)(3), which states:

[W]here the date of the mailing of the notice of deficiency is during the third year after the due date (with extensions) for filing the return of tax and no return was filed before such date, the applicable period under subsections (a) and (b)(2) of section 6511 shall be 3 years.

Congress added this flush language to the statute to overturn legislatively the U.S. Supreme Court's decision in *Commissioner v. Lundy*, 516 U.S. 235 (1996), in which the Court had held that, when a taxpayer has not filed a return, only a two-year look back period (not a two- or three-year, whichever is later, look back period) applies. The Tax Court agreed with the IRS that the parenthetical expression “(with extensions)” in the flush language of § 6512(b)(3) modifies the term “due date.” The extended due date was October 15, 2013. The court reasoned that “the third year” referred to in § 6512(b)(3)(B) began on October 15, 2015. The IRS mailed the notice of deficiency on June 19, 2015, which was, the court concluded, during the second year after the extended due date, not the third year. Accordingly, the flush language of § 6512(b)(3), in the Tax Court's view, did not trigger a three-year look-back

period. In reaching this conclusion, the court rejected the argument of the amici curiae that the IRS's interpretation of the statute created a six-month jurisdictional "black hole" into which the taxpayer's refund claim disappeared. That turn of phrase apparently resonated with the Second Circuit on appeal, as explained below.

a. *The Second Circuit has reversed the Tax Court's decision.* [Borenstein v. Commissioner](#), 919 F.3d 746 (2nd Cir. 4/2/19) *rev'g* 149 T.C. No. 10 (8/30/17). The Second Circuit (Judge Jacobs) has reversed the Tax Court's decision and held that the parenthetical expression "(with extensions)" in the flush language of § 6512(b)(3) does not create a six-month "black hole" for jurisdiction regarding refund claims asserted in the Tax Court. Instead, according to the court, the "(with extensions)" language modifies the phrase "third year after the due date." This interpretation has the effect of adding six months to the three-year look-back period that ended on June 19, 2015, the date on which the IRS mailed the notice of deficiency. A look-back period of three years and six months that ends on June 19, 2015, extends back to December 19, 2012. All of the tax in question was deemed paid on April 15, 2013, which was well within the look-back period. Accordingly, the Tax Court could order a refund of the taxpayer's overpayment with respect to 2012. Judge Jacobs reasoned that such an interpretation of the statutory language was consistent with Congressional intent in overturning *Lundy* and also was supported by the longstanding canon of statutory construction that ambiguities must be resolved in favor of taxpayers and against the government.

- On appeal, the Philip C. Cook Low-Income Taxpayer Clinic at the Georgia State University College of Law and the Harvard Federal Tax Clinic filed briefs in support of the taxpayer's position as amici curiae.

2. *Gains from the sale of PFIC stock allocated to years other than the year of disposition are not counted as gross income for purposes of the six-year limitations provision of § 6501(e)(1)(A)(i).* [Toso v. Commissioner](#), 151 T.C. No. 4 (9/4/18). Under § 6501(a), the Service generally can assess tax within three years from the time the return for the year is filed. This period is extended to six years by § 6501(e)(1)(A)(i) if a taxpayer omits from gross income an amount properly includible in gross income that exceeds 25 percent of the amount of gross income stated in the return. The taxpayer in this case failed to report for 2006 through 2008 gains from the sale of stock in passive foreign investment companies (PFICs). The Service issued a notice of deficiency on January 6, 2015. The taxpayer asserted that the Service was precluded from assessing tax for the years in question by the three-year limitations period of § 6501(a). The parties stipulated that, if the six-year limitations period of § 6501(e)(1)(A)(i) applied, then the Service was not precluded from assessing tax. The issue before the court was whether gains from the sale of PFIC stock are counted as gross income for purposes of § 6501(e)(1)(A)(i). The Tax Court (Judge Thornton) held that only gains from the sale of PFIC stock allocated to the year of disposition (current-year PFIC gain) is included in gross income for purposes of § 6501(e)(1)(A)(i), and that gain allocated to years other than the year of disposition (non-current-year PFIC gain) is not so included. There are three regimes that potentially apply to PFIC stock: (1) the default regime in § 1291(a)(1)-(2); (2) the elective treatment as a qualified electing fund authorized by § 1295 and set forth in § 1293; and (3) the elective mark-to-market treatment authorized by § 1296. The taxpayer had not made either of the latter two elections and therefore the default regime applied. Under the default regime, a United States person who owns stock in a PFIC is permitted to defer U.S. tax on the PFIC's earning, but upon a disposition of the PFIC stock (or receipt of an excess distribution) the United States person must pay both U.S. tax and interest on the deferred U.S. tax liability. This is accomplished by (1) allocating the gain from the disposition of the PFIC stock over the post-1986 years the shareholder held the stock; (2) applying the highest rate of tax on ordinary income in each year (other than the current year) to the amount of gain allocated to that year; (3) computing interest on the tax liability for each year as if the shareholder had failed to pay the tax liability when it was due; and (4) taking the sum of the amounts in steps 2 and 3. This sum is the "deferred tax amount." The court reasoned that, under this default regime, § 1291(a)(1)(B) provides that gross income includes only current-year PFIC gain. In contrast, non-current-year PFIC gain is not included in gross income. Instead, the taxpayer's tax liability for the current year is increased by the "deferred tax amount." Under this approach, the amounts the taxpayer had excluded from gross income for 2006 (not including non-current-year PFIC gains) exceeded 25 percent of the amount of gross income stated in the return, and therefore the Service was not precluded from assessing tax, but the

limitations periods for assessing tax for 2007 and 2008 had expired. The court rejected the taxpayer's argument with respect to 2006 that the taxpayer could net losses from the sale of PFIC stock against gains from such sales and that only net gain is allocated to the taxpayer's holding period for the stock.

3. *The common-law mailbox rule has been displaced by regulations, says the Ninth Circuit.* [Baldwin v. United States](#), 921 F.3d 836 (9th Cir. 4/16/19). The taxpayers, a married couple, filed a return for 2007 that reflected a net operating loss. They wished to carry this loss back to 2005 and, under the relevant statutory provisions (§ 6511(b)(1), (d)(2)(A)), in order to obtain a refund of taxes paid with respect to 2005, were required to file a claim for refund by October 5, 2011. The taxpayers asserted that they had filed an amended return seeking a refund for 2005 in June 2011. The IRS, however, never received that amended return. The IRS did receive an amended return for 2005 from the taxpayers in 2013, after the limitations period for seeking a refund had expired, and the IRS therefore denied their refund claim. The taxpayers brought this action for a refund in the U.S. District Court. Under § 7422(a), the jurisdiction of both U.S. District Courts and the U.S. Court of Federal Claims to hear tax refund actions is limited to those cases in which the taxpayer has "duly filed" a claim for refund with the Service. The issue in this case was how the taxpayers could prove that they had filed the necessary timely refund claim. Under the common-law mailbox rule developed and applied by some courts,

proof of proper mailing—including by testimonial or circumstantial evidence—gives rise to a rebuttable presumption that the document was physically delivered to the addressee in the time such a mailing would ordinarily take to arrive.

At trial, the taxpayers introduced the testimony of two of their employees, who testified that they had deposited the amended 2005 return in the mail at the post office in Hartford, Connecticut, on June 21, 2011. The District Court credited the testimony of the two employees, applied the common-law mailbox rule, and held that the taxpayers were entitled to a refund of approximately \$167,000 plus litigation costs of \$25,000. In an opinion by Judge Watford, the U.S. Court of Appeals for the Ninth Circuit reversed. The common-law mailbox rule, the court held, has been displaced by § 7502. Under § 7502(a), the postmark stamped on the cover in which a return or claim is mailed is deemed to be the date of delivery if the return or claim (1) is deposited in the mail in the United States within the time prescribed for filing in a properly addressed, postage prepaid envelope or other appropriate wrapper and bears a postmark date that falls within the time prescribed for filing, and (2) is delivered by United States mail after the prescribed time for filing to the agency with which it is required to be filed. The statute also provides that, if the return or claim is mailed by United States registered mail, the date of registration is treated as the postmark date and the registration is prima facie evidence that the return or claim was delivered to the agency to which it was addressed. Section 7502(c)(2) authorizes the Secretary of the Treasury to issue regulations providing the same treatment of returns or claims sent by certified mail, which Treasury and the IRS have done. *See* Reg. § 301.7502-1(c)(2). Section 301.7502-1(e)(2)(i) of the regulations further provides that, except for direct proof of actual delivery, proof of proper use of registered or certified mail (or a designated private delivery service) is the *exclusive means* to establish prima facie evidence of delivery and that "[n]o other evidence of a postmark or of mailing will be prima facie evidence of delivery or raise a presumption that the document was delivered." The Ninth Circuit assessed the validity of the regulation by applying the two-step analysis of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The court concluded in *Chevron* step one that the statute, § 7502, is silent as to whether it displaces the common-law mailbox rule with respect to items sent by regular mail, and in step two that Reg. § 301.7502-1(e)(2)(i) is a permissible interpretation of the statute. Accordingly, the court deferred to the regulatory interpretation of the statute and held that, because § 7502 displaces the common-law mailbox rule, the taxpayers could not rely on the testimony of their employees to raise a presumption that their refund claim was delivered.

- The Ninth Circuit previously had held in *Anderson v. United States*, 966 F.2d 487 (9th Cir. 1992), that § 7502 did not displace the common-law mailbox rule. Despite that prior decision, the court upheld the validity of the regulation by applying the rule of *National Cable & Telecomm. Association v. Brand X Internet Services*, 545 U.S. 967 (2005), which held that a court's prior judicial construction of a statute trumps an agency construction that is entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and

leaves no room for agency discretion. The Ninth Circuit's decision in *Anderson* did not express such a holding. Prior to Treasury's issuance of Reg. § 301.7502-1(e)(2)(i), other federal courts of appeal had split on the issue whether § 7502 displaced the common-law mailbox rule. It seems likely that, if the issue arises in these courts with respect to a year subject to the regulation, they will follow the Ninth Circuit in giving *Chevron* deference to the regulation.

F. *Liens and Collections*

1. *Does the date on the notice or the date on the envelope control when the period for responding begins to run?* [Weiss v. Commissioner](#), 147 T.C. 179 (8/17/16). In this collection due process case the taxpayer sought review of the Service's determination to uphold a notice of intent to levy. Before the Service may levy against a taxpayer's property, it must provide written notice of the proposed levy and inform the taxpayer of his right to a CDP hearing. Section 6330(a)(2) requires that a levy notice must be sent or delivered to the taxpayer "not less than 30 days before the day of the first levy," and § 6330(a)(3)(B) requires the notice to inform the taxpayer in simple and nontechnical terms of his right "to request a hearing during the 30-day period" specified in § 6330(a)(2). An IRS Revenue Officer attempted to deliver to the taxpayer in person a Final Notice of Intent to Levy, but was deterred by a dog blocking the driveway. The Revenue Officer chose instead to mail the notice by certified mail two days later without generating a new notice. The taxpayer argued that the period of limitations on collection of these liabilities expired in July 2009 based on the contention that he intentionally filed his request for a CDP hearing one day late, and thus was entitled only to an "equivalent hearing" rather than to the CDP hearing that the Service afforded him. If the taxpayer's contentions were correct, the period of limitations on collection would not have been suspended during the CDP process, and his tax liabilities would appear to have been uncollectible. The Tax Court (Judge Lauber) held that when the date appearing on a levy notice is earlier than the date of mailing, the 30-day period prescribed by § 6330(a)(2) and (3)(B) is calculated by reference to the date of mailing. The statutory directive that levy and lien notices should be drafted "in simple and nontechnical terms" does not require invalidation of a levy notice when there is a mismatch between the letter date and the mailing date. On the facts of the case, the taxpayer's request for a CDP hearing was timely because he mailed his Form 12153 to the Service, and under §§ 7502 and 7503 it was deemed received by the Service, within 30 days of the Service's mailing of the levy notice, even though it was mailed more than 30 days after the date on the notice itself. Accordingly, the period of limitations on collection was suspended pursuant to § 6330(e)(1) when the taxpayer timely requested a CDP hearing.

a. *The D.C. Circuit agrees. The takeaway: keep the envelope in which the final notice of intent to levy is mailed!* [Weiss v. Commissioner](#), 121 A.F.T.R.2d ¶ 2018-1853 (D.C. Cir. 5/22/18). In a per curiam, unpublished opinion, the U.S. Court of Appeals for the D.C. Circuit has affirmed the Tax Court's decision. According to the court, when the date appearing on a levy notice is earlier than the date of mailing, the 30-day period prescribed by § 6330(a)(2) and (3)(B) for requesting a collection due process hearing is calculated by reference to the date of mailing. Although the taxpayer mailed his request for a CDP hearing more than 30 days after the date of the notice of levy, he mailed it within 30 days of the date on which the Service mailed the notice. (The court's opinion notes that the taxpayer's wife opened the Service notice and discarded the envelope, so that the taxpayer apparently was not aware of the later date of mailing.) Because his request for a CDP hearing was timely, it had the effect of suspending the running of the ten-year limitations period on collection, and therefore the Service could exercise its collection powers. The court expressed its dissatisfaction with its ruling as follows:

Nonetheless, in spite of the unappealing proposition that we must side either with a taxpayer deliberately attempting to manipulate the Code to prevent paying his own taxes or a government agency that seems not to care whether it provides the citizenry with notice of their rights and liabilities, we must decide whether the date on the notice or the date of mailing governs. The taxpayer's position has the advantage of common sense. But the government's position has the insurmountable advantage of compliance with the language of the statute.

2. *A meeting with an IRS collections officer is not a prior administrative proceeding that precludes a collection issue from being raised in a subsequent CDP hearing.* [Loveland v.](#)

[Commissioner](#), 151 T.C. No. 7 (9/25/18). The taxpayers in this case, a married couple, were a retired boilermaker who left the workforce for health reasons and a retired teacher who survived breast cancer. They had outstanding federal tax liabilities of over \$60,000. In response to a final notice of intent to levy, the taxpayers did not request a collection due process hearing, but instead entered into negotiations with a Service collections officer. They submitted an offer-in-compromise on Form 433A (OIC) together with accompanying financial information. They also argued that their health issues combined with the loss of their home to foreclosure constituted special circumstances that limited their ability to pay. The collections officer rejected their offer and concluded that they could pay the full amount of the liability. They initially appealed the decision but withdrew the appeal when they were informed that they could not negotiate an installment agreement if the appeal was pending. While negotiations over the installment agreement were pending, the taxpayers made voluntary payments of \$800 per month and sought a mortgage loan on property they owned in order to pay the tax liability. On the same day they submitted their loan application, the Service filed a notice of federal tax lien, which had the effect of precluding the taxpayers from obtaining the mortgage loan. In response to the notice of federal tax lien, they requested a CDP hearing. They requested that the lien be released and asserted that the lien was causing economic hardship. The Appeals Officer assigned to their matter requested financial information on Form 433-A and supporting documents. In response, the taxpayers sent a letter asking the Appeals Officer to consider their previously rejected offer-in-compromise and attached to the letter their earlier Form 433A (OIC) and accompanying financial information, the letter by which they had initially appealed the earlier decision, and Form 433-D, Installment Agreement, in which they requested payments of \$800 per month. The Appeals Officer determined that the taxpayers qualified for an 84-month installment agreement of \$853, which would fully pay the liability. However, the Appeals Officer declined to review either the taxpayers' offer-in-compromise (because they had not properly appealed it) or their requested partial-pay installment agreement (because they had not submitted the necessary financial information). In response to an adverse notice of determination, the taxpayers filed a petition in the Tax Court. The Tax Court (Judge Buch) held that the taxpayers were not precluded from requesting an offer-in-compromise in the CDP hearing. Section 6330(c)(4)(A)(i) precludes an issue from being raised in a CDP hearing if "the issue was raised and considered at a previous hearing under section 6320 or in any other previous administrative or judicial proceeding." The court held, however, that prior negotiations with a collections officer outside of a CDP hearing are not a prior administrative hearing for purposes of § 6330(c)(4)(A)(i). Therefore, the taxpayers were able to request an offer-in-compromise in their CDP hearing. The Service's failure to consider it, the court held, was an abuse of discretion. The court also held that it was an abuse of discretion for the Service to decline to review the taxpayers' request for an installment agreement. The stated reason for failing to review the taxpayers' requested installment agreement was not that the financial information they had submitted was out of date, but rather that they had not submitted financial information, which they had. Finally, the court held that it was an abuse of discretion for the Service to consider the taxpayers' claim that full payment of the liability would cause economic hardship. The court remanded to the Appeals Office for further consideration.

3. *The taxpayers' attempt to pay their federal tax liability went awry when the Service levied on the bank account on which their check was drawn and applied the proceeds to other tax years. Following a CDP hearing, the appropriate standard of review is for abuse of discretion, says the Tax Court.* [Melasky v. Commissioner](#), 151 T.C. No. 8 (10/10/18). The taxpayers hand-delivered to the Service at the Service's office in Houston a check for \$18,000 and requested that the check be applied against their 2009 federal income tax liability. The Service accepted the check and initially applied it as the taxpayers had requested. A few days later, however, the Service levied against the bank account on which the check had been drawn and applied the proceeds of the levy to an earlier tax year. The effect of the levy was that the taxpayers' check bounced. The Service therefore reversed the payment against the 2009 liability and charged a \$360 penalty for writing a bad check. On the same day as the levy, the Service issued to the taxpayers a final notice of intent to levy with respect to certain years, including 2009. In response, the taxpayers requested a CDP hearing. The Service's settlement officer issued a notice of determination concluding that the proceeds of the levy constituted an involuntary payment, rather than a voluntary payment, and that the Service therefore was free to apply the payment as it wished. In response to the notice of determination, the taxpayers filed a petition in the Tax Court. The Tax Court (Judge Holmes) held that the appropriate standard of review in the Tax

Court was for abuse of discretion. In its earlier decision in *Goza v. Commissioner*, 114 T.C. 176 (2000), the court had established that the standard of review in a CDP case is normally for abuse of discretion, but that the standard of review is *de novo* when the underlying tax liability is appropriately before the court. The parties agreed that the standard of review for the 2009 tax year was *de novo* because the taxpayers contended that they had no tax liability for that year. Nevertheless, the court held that the standard of review was for abuse of discretion because the taxpayers were not challenging the underlying tax liability, but rather were challenging whether the Service properly applied a payment:

The question for the Melaskys' 2009 tax year is about whether the IRS properly applied a check. A question about whether the IRS properly credited a payment is not a challenge to a tax liability; i.e., the amount of tax *imposed* by the Code for a particular year. It is instead a question of whether the liability remains *unpaid*. Section 6330(c)(2)(A) allows a taxpayer to raise at a CDP hearing "any relevant issue relating to the unpaid tax," whereas section 6330(c)(2)(B) says a taxpayer may challenge "the existence or amount of the *underlying tax liability*" (emphasis added) only if he didn't receive a notice of deficiency or otherwise have an opportunity to do so. See *Kovacevich v. Commissioner*, T.C. Memo. 2009-160, 2009 WL 1916351, at *6. We therefore hold here that the Melaskys aren't challenging their underlying liability for 2009. See also Chief Counsel Notice CC-2014-002 (May 5, 2014) (announcing similar IRS position).

a. *A dishonored check is not a voluntary payment of tax and therefore the Service need not apply the tendered check as directed by the taxpayer, even when the check is dishonored because an IRS levy depleted the funds in the bank account.* [Melasky v. Commissioner](#), 151 T.C. No. 9 (10/10/18). In this separate, reviewed opinion (9-2-2) by Judge Thornton involving the same facts as *Melasky v. Commissioner*, 151 T.C. No. 8 (10/10/18), the Tax Court considered whether it was an abuse of discretion for the Service to decide: (1) not to apply against the taxpayers' 2009 income tax liability the proceeds of the levy on their bank account, and (2) to reject the taxpayers' proposed installment agreement. With respect to application of the levy proceeds, the court noted that the Service's policy is to apply voluntary payments as directed by the taxpayer, but that involuntary payments generally may be applied against whatever unpaid tax liabilities the Service chooses. The court rejected the taxpayers' argument that the check for \$18,000 they hand-delivered to the Service's office in Houston should be treated as a voluntary payment and therefore applied to 2009 as the taxpayers had directed. A payment by check, the court reasoned, is a conditional payment and is subject to the condition subsequent that the check be paid when presented to the drawee (the bank). If the condition subsequent is fulfilled, the court explained, "the payment generally becomes absolute and is deemed to relate back to the time when the check was provided." According to the court, acceptance of a check is not an absolute payment in the absence of an agreement that the check will be treated as an absolute payment. In this case, because the check was not honored, and there was no agreement that acceptance of the check would be treated as an absolute payment, the check was not a voluntary payment. The court rejected the taxpayers' argument that, because the Service's levy on the bank account led to the check being dishonored, a different result was warranted. It was not unreasonable or inappropriate, the court stated, for the Service to levy after approximately fifteen years of collection activity. The proceeds of the levy were an involuntary payment that the Service could apply as it chose. With respect to the second issue, the court held that it was not an abuse of discretion for the Service to reject the taxpayers' proposed partial-pay installment agreement.

- A concurring opinion by Judge Lauber (joined by Judges Thornton, Marvel, Gustafson, Kerrigan, Buch, Nega, Pugh, and Ashford) is highly critical of and responds to certain arguments in the dissenting opinion by Judge Holmes. Generally, the concurring opinion takes the position that the taxpayers did not raise in the CDP hearing the argument that the \$18,000 check, although dishonored, should be treated as a voluntary payment, and therefore "[t]he SO did not commit legal error by failing to address an argument petitioners did not make."

- A concurring opinion by Judges Buch and Pugh (joined by Judges Gustafson and Paris) notes that Rev. Proc. 2002-26 requires the Service to apply a voluntary payment as directed by the taxpayer, and that the court's opinion does not "foreclose finding an abuse of discretion if evidence were to show that, through negligence or malfeasance, the Commissioner circumvented his own revenue

procedure for designating payments.”

- Judge Holmes wrote a lengthy dissenting opinion that was joined by Judge Morrison. Judge Holmes agreed that the settlement officer did not abuse his discretion in rejecting the taxpayers’ proposed installment agreement, although for different reasons than those set forth in the court’s opinion. Judge Holmes dissented with respect to the treatment of the \$18,000 dishonored check. According to the dissenting opinion, the check was a voluntary payment that the Service should have applied as directed by the taxpayers.

4. 🎵 You say \$19.5 million, I say \$12,603. Let’s call the whole thing off. 🎵 We don’t see many taxpayer victories in the Tax Court following a collection due process hearing, but this case is one of them. [Campbell v. Commissioner](#), T.C. Memo. 2019-4 (2/4/19). In response to a notice of federal tax lien and a final notice of intent to levy with respect to \$1.2 million of unpaid tax liability and an accuracy-related penalty for 2001, the taxpayer requested a collection due process hearing. Following the CDP hearing, the IRS issued a notice of determination upholding the proposed collection action. The taxpayer sought review of the notice of determination by filing a petition in the Tax Court. In response to motions for summary judgment by the IRS, the Tax Court twice remanded the case to the IRS Appeals Office for supplemental CDP hearings. In the first supplemental CDP hearing, the taxpayer submitted an offer-in-compromise offering to compromise all liabilities for \$12,603. The IRS calculated the taxpayer’s reasonable collection potential (RCP) as \$1.5 million and issued a notice of determination rejecting the proposed offer-in-compromise. The taxpayer asserted that, in the first supplemental CDP hearing, the IRS had failed to address state law issues that could affect nominee and alter ego theories. In the second supplemental CDP hearing, the Appeals Officer increased the taxpayer’s RCP to \$19.5 million and issued a second supplemental notice of determination rejecting the taxpayer’s offer-in-compromise and sustaining the proposed collection action. The Tax Court (Judge Kerrigan) held that the IRS Appeals Officer abused her discretion in upholding the proposed collection action and declined to sustain the notice of determination. Specifically, the court held that the Appeals Officer abused her discretion in determining the taxpayer’s RCP in three respects. **First**, according to the Internal Revenue Manual, dissipated assets can be taken into account in determining a taxpayer’s RCP if the transfer of assets took place within a three-year period immediately preceding the taxpayer’s submission of an offer-in-compromise. (Generally, dissipated assets are those disposed of in an attempt to avoid payment of a tax liability, or disposed of after the tax is assessed for items other than the production of income or for the health and welfare of the taxpayer and family members.) Assets transferred outside the three-year look-back period can be taken into account if they were transferred within six months before or after the tax was assessed. The taxpayer had submitted the offer-in-compromise in March 2014. The tax had been assessed on April 19, 2010, which meant that the Appeals Officer could look back to assets transferred within six months of that date. The Appeals Officer, however, took into account \$5 million that the taxpayer had contributed in 2004 to an irrevocable grantor trust established in the West Indies. The court found that, even after making this contribution, the taxpayer’s net worth exceeded any potential tax liability and that the Appeals Officer had abused her discretion in treating trust assets as dissipated assets. The court also found that the Appeals Officer abused her discretion by treating as dissipated assets investments the taxpayer had made in residential and commercial real estate on the Gulf Coast region under Go Zone legislation from 2006 through 2010 that were lost due to issues such as Chinese drywall in some of the homes and the 2008 subprime mortgage crisis. “There is no indication in the record, and none was demonstrated at trial, that petitioner invested in the Go Zone in an attempt to avoid paying his 2001 tax liability.” **Second**, the Appeals Officer determined that the West Indies trust was a nominee or alter ego of the taxpayer, and therefore the trust’s assets could be taken into account in determining RCP as amounts collectible from third parties. According to *Drye v. United States*, 528 U.S. 49 (1999), this conclusion requires an inquiry whether the taxpayer has rights in property under state law and, if so, whether the taxpayer’s rights qualify as property rights under federal tax law. The taxpayer, as beneficiary of the trust and with limited rights to request distributions or to request replacement of the trustee, argued that he had no property interest in the trust’s assets. The court found that the Appeals Officer had abused her discretion in determining that the trust was the taxpayer’s nominee or alter ego because the IRS had produced no evidence that petitioner had a property right in the trust under state law. **Third**, the court held that the Appeals Officer had abused her discretion in determining that the taxpayer had control over the trust’s assets and that the assets therefore could be taken into account in determining

RCP as assets available to the taxpayer but beyond the reach of the government. The court found that the taxpayer did not have control over the trustee and specifically did not control the trustee's decision to invest in some of the Gulf Coast real estate projects of the taxpayer.

G. *Innocent Spouse*

1. *Never, ever, never rely upon Service correspondence concerning the law, and school your students and junior colleagues about the harsh reality that there is no equitable relief in tax from jurisdictional requirements.* [Rubel v. Commissioner](#), 856 F.3d 301 (3d Cir. 5/9/17), *aff'g* [Rubel v. Commissioner](#), No. 9183-16 (U.S. Tax Court 7/11/16). In a case that went all the way to the U.S. Court of Appeals for the Third Circuit, the taxpayer, admirably represented by the Federal Tax Clinic at the Harvard Legal Services Center, claimed innocent spouse relief under § 6015 for the years 2005 through 2008. The Service had denied the taxpayer's requests for each year via four separate notices of determination issued in January 2016. Section 6015(e)(1)(A) provides that a taxpayer who seeks innocent spouse relief may petition the Tax Court and that the Tax Court "shall have jurisdiction" if the petition is filed within specified time limits and no later than 90 days after the date the Service mails the notice of determination. For the years 2006 through 2008, the taxpayer's petition in Tax Court was due by April 4, 2016. For 2005, the taxpayer's petition was due by April 12, 2016. Meanwhile, after receiving the notices, the taxpayer submitted additional information to the Service concerning her claim for innocent spouse relief. The Service again denied the taxpayer's claim via letter dated March 3, 2016; however, the letter misrepresented the due date for filing a petition in the Tax Court stating: "Please be advised this correspondence doesn't extend the time to file a petition with the U.S. Tax Court. Your time to petition the U.S. Tax Court began to run when we issued you our final determination [in January] and will end on Apr. 19, 2016. However, you may continue to work with us to resolve your tax matter." The taxpayer subsequently filed a petition in the Tax Court on April 19, 2016, and the Service moved the Tax Court to dismiss the taxpayer's claim for lack of jurisdiction (because the petition was outside the 90-day period). The Tax Court agreed with the Service and dismissed the petition. The taxpayer appealed to the Third Circuit arguing for equitable relief and estoppel against the Service due to the misrepresentation in the March 3, 2016, Service letter. The Third Circuit affirmed the Tax Court's dismissal of the case stating: "[T]he ninety-day deadline is jurisdictional and cannot be altered 'regardless of the equities' of the case."

a. *Another case confirming that you cannot rely on what the Service tells you about the filing deadline! The 90-day period for filing a Tax Court petition seeking review of an IRS determination denying innocent spouse relief is jurisdictional and not subject to equitable tolling.* [Matuszak v. Commissioner](#), 862 F.3d 192 (2d Cir. 7/5/17), *aff'g* [Matuzak v. Commissioner](#), No. 471-15 (U.S. Tax Court 12/29/15). The Service issued a notice of determination denying the taxpayer's request for innocent spouse relief. Under § 6015(e)(1)(A), the taxpayer then had 90 days from the date of mailing of the notice of determination to file a petition in the Tax Court. The taxpayer filed her petition in the Tax Court one day late. The Tax Court (Judge Marvel) granted the government's motion to dismiss the petition. The Tax Court subsequently denied the taxpayer's motion to vacate. See [Matuszak v. Commissioner](#), No. 471-15 (7/29/16). In doing so, the Tax Court rejected the taxpayer's argument that the 90-day period for filing the petition could and should be equitably tolled because she had relied on erroneous verbal advice from IRS agents concerning the deadline for filing the petition. The taxpayer argued that recent developments in jurisdictional jurisprudence warranted overruling [Pollock v. Commissioner](#), 132 T.C. 21 (2009), in which the court had concluded that the 90-day period of § 6015(e)(1)(A) is jurisdictional and not subject to equitable tolling. The Tax Court, however, declined to do so. The Tax Court noted that, in [Guralnik v. Commissioner](#), 146 T.C. 230 (6/2/16), it had recently rejected a similar argument for changing its view on the jurisdictional nature of the 30-day period in § 6330(d)(1) for seeking review in the Tax Court of an IRS notice of determination following a CDP hearing. In a per curiam opinion, the U.S. Court of Appeals for the Second Circuit affirmed the Tax Court's decision. The Second Circuit acknowledged that recent decisions from the U.S. Supreme Court have distinguished between jurisdictional rules, which are not subject to equitable tolling, and non-jurisdictional claim-processing rules, which are. Nevertheless, the Second Circuit concluded that the 90-day period specified in § 6015(e)(1)(A) is jurisdictional. The court emphasized that the language of the statute provides that "the Tax Court shall have jurisdiction" if the petition is filed within the 90-day period. The court also noted that, in [Maier v. Commissioner](#), 360 F.3d 61 (2d

Cir. 2004), it had previously recognized the jurisdictional nature of § 6015 by concluding that the statute did not confer jurisdiction on the Tax Court over petitions seeking review of innocent spouse determinations filed by the non-electing spouse.

- The taxpayer was represented on the appeal by the Federal Tax Clinic at the Harvard Legal Services Center.

b. *Things really are not looking good for those seeking to toll the 90-day period for filing a Tax Court petition to seek review of an IRS determination denying innocent spouse relief. The Fourth Circuit has agreed with the Second and Third Circuits. [Naufflett v. Commissioner](#), 892 F.3d 649 (4th Cir. 6/14/18), *aff'g* [Naufflett v. Commissioner](#), No. 24427-15 (U.S. Tax Court 8/9/16).* The taxpayer in this case sought innocent spouse protection with respect to four years for which she had filed joint returns with her husband. The Service denied the taxpayer's requested relief in multiple notices of determination dated July 17, 2015. The notices of determination informed the taxpayer of the rule set forth in § 6015(e)(1)(A), which provides that a taxpayer has 90 days from the date of mailing of the notice of determination to file a petition in the Tax Court. The taxpayer asserted that she had contacted both the IRS contact person listed on the notices and an employee at the IRS Taxpayer Advocate Service for assistance, and that they both incorrectly had informed her that she had until September 22, 2015, to file her petition. The taxpayer's petition to the Tax Court was postmarked September 22. However, the last day of the 90-day period specified by § 6015(e)(1)(A) was September 15, 2015. The Tax Court (Judge Marvel) granted the Service's motion to dismiss the petition. The Tax Court subsequently denied the taxpayer's motion to vacate or revise. *See [Naufflett v. Commissioner](#), No. 24427-15 (U.S. Tax Court 5/25/17).* In an opinion by Judge Agee, the U.S. Court of Appeals for the Fourth Circuit affirmed the Tax Court's decision. The court emphasized that the language of § 6015(e)(1)(A) provides that "the Tax Court shall have jurisdiction" if the petition is filed within the 90-day period. "We need not look beyond that mandate because Congress has, in fact, uttered 'magic words,' expressly conditioning the Tax Court's power on the timely filing of a petition." The court also relied on the "broader context of subsection (e)(1)(A) within § 6015." Because § 6015(e)(1)(A) is jurisdictional, the court concluded, courts do not have discretion to waive compliance based on equitable considerations.

2. *Even a Johnny Cash song couldn't have told a story like this. A taxpayer prevails in her quest for innocent spouse relief. [Contreras v. Commissioner](#), T.C. Memo. 2019-12 (2/26/19).* The taxpayer sought innocent spouse relief under § 6015(f) with respect to the years 2006 through 2009. The taxpayer married her husband in August of 2000. He had his own home construction business and she stayed home to care for their two children and her husband's two children from a prior relationship. They lived in a mobile home on property in Liberty County, Texas (Lot 12) and planned to build a home on the lot next door, Lot 13. When they applied for financing to assist with construction, the taxpayer learned that Lot 13 was owned by her husband and the woman with whom he had previously been in a relationship. She and her husband were advised by an attorney that her husband was still in a common law marriage with the other woman and that, to remove the other woman's name from the title to Lot 13, her husband would have to go through a divorce proceeding, which he did. This necessarily meant that, when the taxpayer had married her husband, he was already married and therefore the taxpayer had never been legally married to him. Ultimately, her husband built the house on Lot 13, largely using materials left over from various jobs of his home construction business, and the family moved into the home. During the course of their relationship, the taxpayer's husband was abusive and routinely came home in a drunken state. The police were called to their home on several occasions. When the taxpayer's husband came home in a drunken state, she and her husband argued and on various occasions her husband kicked in a bedroom door, damaged property, threw the taxpayer's possessions outside the home, and committed other aggressive acts. On these occasions, the taxpayer often left the home with her children to go to the home of her grandmother. The taxpayer's husband had at least one affair with another woman during their marriage. Her husband handled the filing of their federal income tax returns. No returns were filed for the year 2006 through 2009. She was divorced from her husband in 2011. The decree of divorce awarded each spouse as separate property a one-half interest in Lots 12 and 13. In addition, the divorce decree awarded the taxpayer \$127,050 and authorized the taxpayer to foreclose on her ex-husband's interest in Lots 12 and 13 if he did not pay this amount by a specified date. Her ex-husband failed to pay this amount and voluntarily

transferred to the taxpayer his interests in Lots 12 and 13. The deed transferring title was prepared with the assistance of an attorney and recorded in the public land records. Just prior to their divorce, the IRS filed a notice of lien against her husband and, just after the divorce, the U.S. Department of Justice brought an action in the U.S. District Court seeking to reduce tax liabilities to judgment and to foreclose on the home on Lot 13 in which the taxpayer lived with her two children. Following their divorce, the taxpayer's ex-husband filed returns for 2008 and 2009 with the incorrect filing status of head-of-household. In 2013, in connection with an IRS audit of the years 2006 through 2009, the taxpayer signed joint returns for 2006 and 2007 as well as amended returns for 2008 and 2009 that were joint returns. She placed the words "as to form" next to her signature on the 2006 and 2007 returns. She repeatedly expressed that she did not understand the returns and did not understand why she had to sign a joint return with her ex-husband. She was represented in the course of the audit by an attorney whose fees were paid by her ex-husband. The IRS sought to hold the taxpayer liable for nearly \$300,000 in taxes, penalties and interest for the years 2006 through 2009. The taxpayer filed an administrative request for innocent spouse relief, which the IRS denied. The taxpayer then filed a petition in the Tax Court. The Tax Court (Judge Paris) held that the taxpayer was entitled to innocent spouse relief under § 6515(f) (equitable relief) with respect to all of the years at issue. The taxpayer and the IRS agreed that the taxpayer met all threshold requirements for equitable relief under Rev. Proc. 2013-34, 2013-43 I.R.B. 397, except for one. The IRS asserted that assets (Lots 12 and 13) had been transferred between the spouses as part of a fraudulent scheme. The court rejected this argument largely on the basis that the transfer was made pursuant to rights granted to the taxpayer in the divorce decree and that the taxpayer and her husband had not attempted to conceal the transfer; they had recorded the transfer in the public land records. The court also rejected the IRS's arguments that the taxpayer was not entitled to streamlined relief under Rev. Proc. 2013-34. The IRS argued that the taxpayer would not suffer economic hardship if relief was not granted, which the court rejected on the basis that the taxpayer's only sources of income were child support payments, which were not reliable, and government assistance. The IRS also argued that streamlined relief was unavailable because the taxpayer had knowledge that her ex-husband would not or could not pay the liabilities in question. The court rejected this argument based on the taxpayer's credible testimony (as well as that of her daughter) regarding her ex-husband's abusive and controlling behavior.

- The taxpayer was represented by the Low Income Taxpayer Clinic at South Texas College of Law Houston.

H. Miscellaneous

1. *The D.C. Circuit found that registered (?) tax return preparers were entitled to be unqualified.* The IRS had de gall to require character, competence, and continuing education for "independent" tax return preparers who only needed PTINs to continue preparing error-laden tax returns for their unsophisticated clientele. [Loving v. IRS](#), 742 F.3d 1013 (D.C. Cir. 2/11/14), *aff'g* 920 F. Supp. 2d 108 (D. D.C. 2/1/13). The D.C. Circuit (Judge Kavanaugh) held that regulations issued in 2011 under 31 U.S.C. § 330 that imposed new character, competence, and continuing education requirements on tax return preparers were "foreclose[d] and render[ed] unreasonable" by the statute, and thus failed at the *Chevron* step 1 standard. They would have also failed at the *Chevron* step 2 standard because they were "unreasonable in light of the statute's text, history, structure, and context."

- Judge Kavanaugh's opinion found six problems with the 2011 regulations: (1) tax return preparers were not "representatives" because they are not "agents" and, thus, lack "legal authority to act on the taxpayer's behalf"; (2) the preparation and filing of a tax return did not constitute "practice ... before the Department of the Treasury" because that term implies "an investigation, adversarial hearing, or other adjudicative proceeding"; (3) the history of the statutory language originally enacted in 1884 "indicated that the statute contemplated representation in a contested proceeding"; (4) the regulation was inconsistent with the "broader statutory framework," (!) in which Congress had enacted a number of statutes specifically directed at tax-return preparers and imposing civil penalties, which would not have been necessary if the Service had authority to regulate tax-return preparers; (5) the statute would have been clearer had it granted power "for the first time to regulate hundreds of thousands of individuals in the multi-billion dollar tax-preparation industry" ["the enacting Congress did not intend to grow such a large elephant in such a small mousehole"]; and (6) the Service's past approach showed that until 2011 it never maintained that it had authority to regulate tax return preparers.

- Judge Kavanaugh concluded: “The IRS may not unilaterally expand its authority through such an expansive, atextual, and ahistorical reading of Section 330.”

a. *In light of the Service’s loss in Loving v. IRS, a new, voluntary Annual Filing Season Program to give tax return preparers the ability to claim they hold “a valid Annual Filing Season Program Record of Completion” and that they have “complied with the IRS requirements for receiving the Record of Completion.”* [Rev. Proc. 2014-42](#), 2014-29 I.R.B. 192 (6/30/14). In order to encourage unenrolled tax return preparers, i.e., those who are not attorneys, CPAs or EAs, to complete continuing education courses in order to get a better understanding of federal tax law, the carrot of being able to claim superiority to the ordinary run-of-the-mill slob tax return preparers is offered. The requirements for this voluntary program include a six-hour refresher course, with a 100-question test at the end, plus other continuing education of two hours of ethics and ten hours of federal tax law topics. Holders of the Record of Completion may not use the terms “certified,” “enrolled,” or “licensed” to describe the designation.

b. *The AICPA’s challenge to the Annual Filing Season Program fails, but the court signals that others might successfully challenge it.* [American Institute of Certified Public Accountants vs. Internal Revenue Service](#), 199 F. Supp. 3d 55 (D.D.C. 8/3/16). The AICPA challenged as unlawful the voluntary Annual Filing Season Program established by the Service in [Rev. Proc. 2014-42](#), 2014-29 I.R.B. 192 (6/30/14), and the U.S. Court of Appeals for the District of Columbia ruled that the AICPA had standing to bring the challenge. [American Institute of Certified Public Accountants vs. Internal Revenue Service](#), 804 F.3d 1193 (D.C. Cir. 10/30/15). In that opinion, the D.C. Circuit declined to address an issue raised by the Service for the first time on appeal: that the AICPA’s grievance does not “fall within the zone of interests protected or regulated by the statutory provision it invokes.” On remand, the District Court (Judge Boasberg) held that the AICPA failed the zone of interests test because its grievance (which the court characterized as the grievance of the AICPA’s members) is neither regulated nor protected by the relevant statute. Accordingly, the court granted the Service’s motion to dismiss. The court characterized the grievance of the AICPA and its members as competitive injury from brand dilution, i.e., that the AFS Program would dilute the credentials of the AICPA’s members by introducing a government-backed credential and government-sponsored public listing. The relevant statute, the court concluded, is 31 U.S.C. § 330(a), which authorizes the Secretary of the Treasury to regulate the practice of representatives of persons before the Treasury Department and to require that certain conditions be satisfied, such as good character, before admitting a person to practice. The AICPA is not a representative of persons within the zone of interests regulated by the statute, the court concluded, because to satisfy this requirement the party must be regulated by the particular regulatory action being challenged. To demonstrate that it is in the zone of interests protected by the statute, the AICPA would have to demonstrate either that it is an intended beneficiary of the statute or that it is a “suitable challenger” to enforce the statute. The AICPA did not contend that it was an intended beneficiary of the statute, and the court concluded that the AICPA was not a suitable challenger. The court reasoned that the purpose of 31 U.S.C. § 330(a) is consumer protection, and that the AICPA’s interest in avoiding intensified competition as a result of the AFS Program was not congruent with that purpose. “On the contrary, AICPA members’ competitive interests are on a collision course with Congress’s interest in safeguarding consumers.”

- Although it dismissed the AICPA’s challenge, the court added:

A final word. While AICPA does not have a cause of action under the APA to bring this suit, the Court has little reason to doubt that there may be other challengers who could satisfy the rather undemanding strictures of the zone-of-interests test.

c. *The D.C. Circuit had good news and bad news for the AICPA. The good news: the AICPA had standing to challenge the Service’s Annual Filing Season Program. The bad news: on the merits, the Service had authority to adopt the program and the program does not violate the Administrative Procedure Act.* [American Institute of Certified Public Accountants v. Internal Revenue Service](#), 122 A.F.T.R.2d ¶2018-5507 (D.C. Cir. 8/14/18). The AICPA appealed the decision of the U.S. District Court for the District of Columbia that the AICPA lacked standing to challenge the Service’s Annual Filing Season (AFS) Program and the court’s dismissal of the AICPA’s challenge. In an opinion by Judge Ginsburg (with Judge Griffith concurring in part and dissenting in part), the

U.S. Court of Appeals for the District of Columbia Circuit reversed the District Court on the issue of standing and, reaching the merits of the AICPA's challenge, held that the Service had statutory authority to create the AFS Program and had not violated the Administrative Procedure Act in doing so. The court addressed three issues: (1) whether the AICPA had standing to challenge the AFS Program, (2) whether the Service had statutory authority to adopt the AFS Program, and (3) whether the Service followed the requisite procedures in creating the AFS Program.

Standing. With respect to standing, the court concluded that the AICPA had both constitutional and statutory standing to bring the challenge. The AICPA had constitutional standing, the court held, because its members who employ unenrolled return preparers are injured by the AFS Program, which applies Circular 230 to a new class of employees (the unenrolled preparers) and therefore imposes new supervisory responsibility requirements on those who employ them. On the issue of statutory standing, the court agreed with the District Court that the relevant statute is 31 U.S.C. § 330(a), which authorizes the Secretary of the Treasury to regulate the practice of representatives of persons before the Treasury Department and to require that certain conditions—such as good character—be satisfied before admitting a person to practice. In contrast to the District Court, however, the court held that the AICPA is a representative of persons within the zone of interests *regulated* by the statute. The relevant zone of interests regulated or protected by the statute, the court reasoned, is consumer protection and regulation of those who practice before the Service. According to the court, the AICPA's injury fell within this zone of interests because its members who employ unenrolled agents are injured by the AFS Program, which imposes new supervisory responsibility requirements on them. In other words, the additional supervisory responsibilities of which the AICPA complained established both constitutional and statutory standing.

Statutory Authority for the AFS Program. The court recognized that, when it reverses a District Court's dismissal of a case for lack of standing, its normal practice is to remand to allow the District Court to address the merits. Nevertheless, the court chose to reach the merits of the AICPA's challenge because it presented purely legal issues that the parties had fully briefed. The court considered whether two statutes provided the Service with authority to implement the AFS Program. First, the court considered 31 U.S.C. § 330(a), which authorizes the Secretary of the Treasury to regulate the practice of representatives of persons before the Treasury Department. The court rejected the AICPA's argument that the AFS Program relies on this statute to regulate the business of tax return preparation, contrary to the court's decision in *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014). To the contrary, the court reasoned, unenrolled preparers who participate in the AFS Program do not consent to be subject to Circular 230 in connection with their preparation of tax returns, but rather in connection with their limited right to represent clients before the Service. The court held that the AFS Program is thus within the Service's statutory authority to regulate those who practice before the Service. Second, the court analyzed Code § 7803(a)(2)(A), which authorizes the Service to “administer ... the execution and application of the internal revenue laws or related statutes.” This provision, the court concluded, does not provide any additional substantive authority for the AFS Program, but does authorize the Service to publish the public directory of those who hold a “Record of Completion” of the AFS Program. “In sum, § 330(a) authorizes the Service to establish and operate the Program, and § 7803(a)(2)(A) authorizes the agency to publish the results of the Program.”

Procedural Requirements. The court also considered the AICPA's argument that the Service had violated the Administrative Procedure Act by issuing [Rev. Proc. 2014-42](#), 2014-29 I.R.B. 192 (6/30/14), to create the AFS Program. The revenue procedure, the AICPA argued, was a legislative rule that could be adopted only by following a notice-and-comment process, which the Service had failed to do. The court rejected this argument for two reasons. First, the court explained, agency action constitutes a legislative rule only if it binds private parties or the agency with the force of law, which the AFS Program does not do because it “merely provides an opportunity for those unenrolled preparers who choose to participate and satisfy its requirements.” Second, the court reasoned, [Revenue Procedure 2014-42](#) did not withdraw a benefit that had been created through a notice-and-comment process and therefore could not be regarded as a legislative rule on that basis. Prior to 2011, when the Service issued the regulations that ultimately were held invalid in *Loving*, all unenrolled tax return preparers had the ability to represent a taxpayer during an examination if the preparer had prepared and signed the return under examination. [Revenue Procedure 2014-42](#) limits this right to unenrolled preparers who

have a Record of Completion under the AFS Program. Nevertheless, the court held, the pre-2011 right of unenrolled preparers to represent taxpayers “was the product of Revenue Procedure 81-38, which—like [Revenue Procedure 2014-42](#)—was issued without notice and comment.”

Dissenting Opinion. Judge Griffith concurred with the majority on the first two issues (standing of the AICPA and statutory authority for the AFS Program). In a lengthy dissenting opinion, however, he dissented on the issue whether [Revenue Procedure 2014-42](#) was a legislative rule that could be issued only following a notice-and-comment process. In Judge Griffith’s view, the revenue procedure is a legislative rule because it binds private parties with the force of law. Specifically, he emphasized, although it is voluntary for those unenrolled preparers who participate, it (1) imposes new supervisory responsibility requirements on enrolled practitioners who employ unenrolled preparers with a Record of Completion, and (2) precludes unenrolled preparers who do not hold a Record of Completion from representing taxpayers before the Service as they formerly could. In addition, Judge Griffith reasoned, the revenue procedure is a legislative rule because it modifies a rule that had been created following a notice-and-comment process. Contrary to the majority, Judge Griffith expressed the view that the limited practice right of unenrolled preparers had been created not by Rev. Proc. 81-38, but rather by a 1959 regulation, which was subject to notice and comment. *See Appearance of Unenrolled Preparers of Returns*, 24 Fed. Reg. 1157 (2/14/59). Because Judge Griffith viewed [Revenue Procedure 2014-42](#) as a legislative rule that had not been issued following a notice-and-comment process, the AFS Program, he concluded, is unlawful and should be vacated.

2. *The Service has provided extensions of filing and payment due dates for those affected by California wildfires, flooding, mudflows and debris flows.* In news release [CA-2018-1](#) (1/17/18), the Service has extended to April 30, 2018, several filing and payment due dates for those affected by the wildfires, flooding, mudflows and debris flows that took place beginning on December 4, 2017, in parts of California. The relief is available to individuals and businesses in the counties of Los Angeles, San Diego, Santa Barbara, and Ventura. The due dates extended include the January 16, 2018, due date for quarterly estimated tax payments and the April 17, 2018, due date for 2017 individual returns. More generally, taxpayers have until April 30, 2018, to file most tax returns (including individual, corporate, and estate and trust income tax returns; partnership returns, S corporation returns, and trust returns; estate, gift, and generation-skipping transfer tax returns; and employment and certain excise tax returns; annual information returns of tax-exempt organizations; and employment and certain excise tax returns), that have either an original or extended due date occurring on or after December 4, 2017, and before April 30, 2018. The Service will automatically provide filing and penalty relief to any taxpayer with an address of record in one of these disaster areas. Taxpayers in one of these areas who receive a notice from the Service regarding a late-filing or late-payment penalty should contact the Service at the number listed on the notice to have the penalty abated. Affected taxpayers who reside or have a business located outside the covered disaster area must call the Service’s disaster hotline at 866-562-5227 to request this tax relief.

a. *The Service has extended several filing and payment deadlines for those affected by wildfires and high winds that began July 23, 2018, in parts of California.* In news release [CA-2018-11](#) (8/6/18), the Service has extended to November 30, 2018, several filing and payment due dates that occurred beginning on July 23, 2018, for those in areas affected by wildfires and high winds that began July 23, 2018 in parts of California. The relief is available to individuals and businesses in Lake and Shasta Counties, to relief workers who live elsewhere who are affiliated with a recognized government or philanthropic organization assisting in relief efforts in the covered areas, and to those visiting the areas who are killed or injured as a result of the disaster. The due dates extended include (1) the September 17, 2018, due date for quarterly estimated tax payments; (2) the September 17, 2018, due date for certain returns, such as those for calendar-year partnerships that filed timely extension requests for 2017; (3) the October 15, 2018, due date for 2017 individual returns for individuals who filed timely extension requests; (4) the October 31, 2018, due date for quarterly payroll and excise tax returns; (5) the November 15, 2018, due date for 2017 returns of calendar-year tax-exempt organizations that filed timely extension requests, and (6) due dates on or after after July 23, 2018, and before November 30, 2018 for the filing of Form 5500 series returns. The Service will automatically provide filing and penalty relief to any taxpayer with an address of record in one of these disaster areas. Taxpayers in one of these areas who receive a notice from the Service regarding a late-filing or late-

payment penalty should contact the Service at the number listed on the notice to have the penalty abated.

b. *The Service has provided extensions of filing and payment due dates for those in areas affected by Hurricane Florence.* In news releases [IR-2018-187](#) (9/15/18) and [SC-2018-01](#) (9/24/18), the Service has provided relief from several filing and payment deadlines to those in areas affected by Hurricane Florence. The relief is available to individuals and businesses in parts of North Carolina and South Carolina, to relief workers affiliated with a recognized government or philanthropic organization assisting in relief efforts in the covered areas, and to those visiting the areas who are killed or injured as a result of the disaster.

Deadlines extended to January 31, 2019. For those in affected areas, the following due dates have been extended to January 31, 2019: (1) the September 17, 2018, and January 15, 2019, due dates for quarterly estimated tax payments; (2) the September 17, 2018, due date for certain returns, such as those for calendar-year partnerships that filed timely extension requests for 2017; (3) the October 15, 2018, due date for 2017 individual returns for individuals who filed timely extension requests; (4) the October 31, 2018, due date for quarterly payroll and excise tax returns; (5) the November 15, 2018, due date for 2017 returns of calendar-year tax-exempt organizations that filed timely extension requests, and (6) due dates after September 7, 2018, and before January 31, 2019 for the filing of Form 5500 series returns. *Note:* individuals who filed a timely request for an extension of time to file their 2017 returns do not obtain any relief for tax payments related to the 2017 return because those payments were due on April 18, 2018.

Waiver of late-deposit penalties for federal payroll and excise taxes. For those in affected areas, the Service has waived late-deposit penalties for federal payroll and excise taxes due on or after September 7, 2018, and before September 24, 2018, as long as the deposits are made by September 24, 2018.

Relief provided automatically. The Service will automatically provide filing and penalty relief to any taxpayer with an address of record in one of the designated disaster areas. Taxpayers in one of these areas who receive a notice from the Service regarding a late-filing or late-payment penalty should contact the Service at the number listed on the notice to have the penalty abated. In contrast, affected taxpayers who reside or have a business outside the covered disaster area must call the Service to request relief.

3. *“All explanations tend to be self-serving.” And that’s okay, says the Eleventh Circuit. An affidavit that satisfies FRCP 56 can create an issue of material fact and preclude summary judgment even if it is self-serving and uncorroborated.* [United States v. Stein](#), 881 F.3d 853 (11th Cir. 1/31/18) (en banc). The government brought this action against the taxpayer to collect assessed but unpaid taxes, penalties, and interest with respect to several years. In the District Court, the government moved for summary judgment and submitted copies of the taxpayer’s returns, transcripts of her accounts, and an affidavit from an IRS officer. The taxpayer responded by submitting an affidavit in which she stated that, after her husband’s death, she had retained an accounting firm to prepare and file joint returns for the relevant years and that, “to the best of [her] recollection,” she had paid the amounts in question. Her affidavit specified, for each year, when she had filed the return, the amount she had paid, and whether the Service had a record of that payment. Her affidavit also stated that she no longer had bank records for the years in question and could not obtain them. The District Court granted the government’s motion for summary judgment on the ground that the taxpayer had the burden to overcome the presumption of correctness that is attributed to the government’s documentation, that the taxpayer had failed to meet that burden, and therefore there was no genuine issue of material fact and the government was entitled to judgment as a matter of law. On appeal, a panel of the United States Court of Appeals for the Eleventh Circuit affirmed and cited its previous opinion in *May v. United States*, 763 F.2d 1295 (11th Cir. 1985), for the proposition that “general and self-serving assertions that [the taxpayer] paid the taxes owed and related late penalties for [the relevant] tax years failed to rebut the presumption established by the [Service’s] assessments. The Eleventh Circuit subsequently vacated the panel’s opinion and granted rehearing en banc. In a unanimous opinion by Judge Jordan, the Eleventh Circuit held that, if an affidavit satisfies Rule 56 of the Federal Rules of Civil Procedure, it can create an issue of material fact and preclude summary judgment even if the affidavit is self-serving and uncorroborated. The court overruled *May v. United States*, 763 F.2d 1295 (11th Cir. 1985),

“to the extent it holds or suggests that self-serving and uncorroborated statements in a taxpayer’s affidavit cannot create an issue of material fact with respect to the correctness of the government’s assessments.” The court reasoned that, if an affidavit is otherwise admissible, nothing in Rule 56 prohibits it from being self-serving or imposes a corroboration requirement. An affidavit cannot be conclusory, the court emphasized, but most of its prior decisions had concluded that a litigant’s self-serving statements based on personal knowledge or observation can defeat summary judgment. Tax cases, the court explained, are no different. The court also explained that it was not holding that a self-serving or uncorroborated affidavit always is sufficient to defeat a motion for summary judgment; rather, the court held only that the self-serving and/or uncorroborated nature of an affidavit cannot prevent it from creating an issue of material fact. The court remanded to the panel to determine the impact of the taxpayer’s affidavit.

a. *The Eleventh Circuit panel remanded to the District Court.* [United States v. Stein](#), 889 F.3d 1200 (11th Cir. 5/9/18). After remand to the original Eleventh Circuit panel, the court, in a per curiam opinion, vacated the summary judgment entered by the District Court and remanded for further consideration. In doing so, the Eleventh Circuit panel declined to address arguments that the parties had not presented to the District Court, such as the government’s argument that, to defeat summary judgment, the taxpayer had to “show that funds were actually delivered to the [Internal Revenue Service].”

4. *Successive motions to vacate or revise a Tax Court decision that raise substantially the same grounds as prior motions do not affect the 90-day period for filing a notice of appeal.* [Annamalai v. Commissioner](#), 884 F.3d 530 (5th Cir. 3/8/18). Addressing an issue of first impression, the U.S. Court of Appeals for the Fifth Circuit has held that successive motions to vacate or revise a Tax Court decision that raise substantially the same grounds as a prior motion do not affect the time period in which a party may appeal the Tax Court’s decision. Under Federal Rule of Appellate Procedure 13(a), a party who wishes to appeal a decision of the Tax Court must file a notice of appeal within ninety days. The 90-day period runs from either (1) the entry of the Tax Court’s decision, or (2) if a party moves to vacate or revise the Tax Court’s decision, from the entry of the Tax Court’s ruling on that motion. In this case, the Tax Court entered its decision on June 23, 2016. On July 13, 2016, the taxpayers filed motions to vacate the Tax Court’s decision. The Tax Court denied those motions on November 18, 2016. On December 12, 2016, the taxpayers jointly filed a motion to vacate that did not raise any substantially new grounds or arguments. The Tax Court denied this second motion on December 22, 2016. On March 15, 2017, the taxpayers filed a notice of appeal with the clerk of the Tax Court. In a per curiam opinion, the Fifth Circuit held that the taxpayers’ second motion to vacate, which raised substantially the same grounds as their first, had no effect on the period within which they could appeal the Tax Court’s decision. The court found support for its conclusion in its prior decisions concluding that a successive motion for reconsideration based on substantially the same grounds as a prior motion does not toll the running of the thirty-day period provided by Federal Rule of Appellate Procedure 4(a) for appealing decisions in civil cases. The court also noted that its conclusion was consistent with that of the Tenth Circuit, which similarly had held that a taxpayer’s “renewed” motion to vacate a decision of the Tax Court did not affect the running of the 90-day period for appeal. *See Okon v. Commissioner*, 26 F.3d 1025 (10th Cir. 1994); *see also Dean v. Commissioner*, 2017 WL 4232520 (D.C. Cir. 9/13/17) (unpublished opinion); *Robertson v. Commissioner*, 22 Fed. Appx. 215 (4th Cir. 2001). Because the taxpayers had filed their notice of appeal more than ninety days after November 18, 2016, the date on which the Tax Court denied their initial motions to vacate, the Fifth Circuit dismissed their appeal as untimely.

5. *The Tenth Circuit, the Tax Court, the Service, and Code § 280E continue to be buzz killers for the marijuana industry.* Section 280E disallows any deduction or credit otherwise allowable if such amount is paid or incurred in connection with a trade or business consisting of trafficking in controlled substances. Marijuana remains a controlled substance under federal law (the “Controlled Substances Act”) even though it has been legalized for medical or recreational use (or both) in a majority of states. Unlike some other federal agencies under the prior administration, the Service has not turned a blind eye to taxpayers engaging in the domestic production and sale of marijuana, even where such activities are permitted under state law. Instead, relying upon § 280E, the Service has

audited such taxpayers, disallowed deductions, and asserted corresponding deficiencies and penalties. In general, the courts have upheld the Service's position in these cases, as summarized below.

a. *The taxpayer may have the “green solution,” but the Service gets the “green light” to continue its audit of this Colorado marijuana dispensary.* [The Green Solution Retail, Inc. v. United States](#), 855 F.3d 1111 (10th Cir. 5/2/17). The United States Court of Appeals for the Tenth Circuit, in an opinion by Judge McHugh, held that the Anti-Injunction Act (“AIA”) and the Declaratory Judgment Act (“DJA”) bar a marijuana dispensary's suit to enjoin the Service from auditing its business records. The Service's examination of the taxpayer, a Colorado-based marijuana dispensary, sought to determine if § 280E applies to disallow certain of the taxpayer's claimed deductions and credits. The taxpayer argued that the AIA and DJA do not apply and the Service thus should be prohibited from examining the taxpayer's business records on three grounds. One, the taxpayer argued that the Tenth Circuit's prior decision in *Lowrie v. United States*, 824 F.2d 827, 830 (10th Cir. 1987), which held that the AIA bars actions seeking to enjoin “activities leading up to, and culminating in, ... assessment” (such as an IRS audit) was implicitly overruled by the Supreme Court of the United States in *Direct Marketing Ass'n v. Brohl*, ___ U.S. ___, 135 S.Ct. 1124 (2015). *Direct Marketing* involved a suit by taxpayers seeking to enjoin Colorado taxing authorities from obtaining information from online retailers about the retailers' customers. The Supreme Court held in *Direct Marketing* that the Tax Injunction Act (“TIA”), which generally prohibits federal injunctions against state tax assessment and collection actions, did not bar a federal suit seeking to enjoin Colorado from demanding information about customers from the online retailers. After a detailed examination of the language of the AIA as compared to the TIA, the Tenth Circuit determined that its decision in *Lowrie* was not implicitly overruled by *Direct Marketing*. Further, the Tenth Circuit determined that if the AIA bars the taxpayer's suit, then the DJA — which bars declaratory judgments in certain federal tax cases — similarly bars the taxpayer's suit because the acts are “coterminous.” Therefore, at least in the Tenth Circuit, the AIA and DJA continue to bar taxpayer suits seeking to enjoin the Service from “activities leading up to, and culminating in, ... assessment” (such as an IRS audit). Two, the taxpayer argued that, by seeking to determine in an audit whether the taxpayer was engaged in a federal crime under the Controlled Substances Act, the Service was acting outside of its administrative authority. The Tenth Circuit was unconvinced. Three, the taxpayer argued that § 280E imposes a “penalty,” not a “tax,” and that the AIA and DJA prohibit only actions seeking to enjoin the assessment or collection of a federal “tax.” The Tenth Circuit dispensed of this latter argument by the taxpayer as well and upheld the District Court's dismissal of the taxpayer's suit to enjoin the Service's audit.

b. *The Tenth Circuit snuffs out this marijuana business's refund claim.* [Alpenglow Botanicals, LLC v. United States](#), 894 F.3d 1187 (10th Cir. 7/3/18). In this case before the U.S. Court of Appeals for the Tenth Circuit, the taxpayers (who were the member-partners of Alpenglow Botanicals, LLC) sought a refund from the Service arguing that, by disallowing Alpenglow's deductions under § 280E and assessing a deficiency against the taxpayers, the Service exceeded its administrative authority. Specifically, the taxpayers argued that the Service lacked authority to investigate and deny tax deductions under § 280E without a criminal conviction having been established first and that, even if it had such authority, the Service had insufficient evidence of “trafficking” to apply § 280E to the taxpayers LLC. The taxpayers further argued that Congress has not expressly delegated to the Service the authority to investigate violations of federal drug laws and therefore the Service cannot make a predicate finding of “trafficking” necessary to deny deductions under § 280E. The taxpayers' arguments primarily stemmed (*no pun intended*) from the Service's notice of deficiency which contained conclusory language that the taxpayer had “committed the crime of trafficking in controlled substances.” Basically, the Service argued in response that regardless of the conclusory language in the notice of deficiency, the taxpayer's argument was misplaced as it related to the Service's authority to disallow deductions under § 280E. The Tenth Circuit agreed with the Service, relying in part upon *Green Solution Retail* (discussed above). The court, with Judge McHugh writing for the three-judge panel, held that the Service acted within its statutory authority by determining, as a matter of civil tax law, whether the taxpayers had trafficked in controlled substances for purposes of § 280E. Thus, the court denied the taxpayer's refund claim.

c. *You must be high! Marijuana business conducted via an S corporation subjects taxpayer-shareholders to “double taxation” due to the application of § 280E.* [Loughman v.](#)

[Commissioner](#), T.C. Memo. 2018-85 (6/18/18). The taxpayers were the sole owners of a Colorado-based S corporation licensed to grow and sell medical marijuana. For the years in question, the taxpayers' S corporation claimed deductions under § 162 for items such as compensation, repairs and maintenance, rents, state and local taxes, licenses, interest, depreciation, advertising, and employee benefits. The Service disallowed most of these deductions under § 280E, but permitted the taxpayer to take into account certain expenses attributable to costs of goods sold for purposes of § 471 and inventory accounting. See *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173, 180 (2007). The primary deduction disallowed by the Service under § 280E consisted of wages paid to the taxpayer-shareholders. Of course, this disallowance resulted in the taxpayers being taxed not only on their allocable shares of the S corporation's income (without deduction for wages), but also for the amount of the wages actually paid to the taxpayer-shareholders. In effect, then, the taxpayer-shareholders were taxed twice on the same revenue even though the business was conducted via an S corporation. The taxpayers argued that this result was "discriminatory in violation of subchapter S." The Tax Court, Judge Kerrigan, dismissed this argument on the basis that the determination of taxable income is a function of statutory provisions in the Code and is not "discriminatory." In particular, § 1366 determines a shareholder's allocable share of income (after allowable deductions) from an S corporation, while § 61(a)(1) separately includes compensation in income. Judge Kerrigan acknowledged the taxpayers' "double taxation" hardship as a result of § 280E, but also pointed out that the harsh result was the product of the taxpayers' choice of entity, not a "discriminatory" violation of the principles of subchapter S.

6. *You say "FBAR." We say "FUBAR." Treasury fails to update FBAR regulations resulting in FUBAR law, so the penalty for willful violations could be capped at \$100,000 per account unless and until amended regulations are adopted.* Some taxpayers successfully have argued in U.S. District Court that substantial foreign bank account reporting ("FBAR") penalties assessed by the Service must be reduced. To understand the significance of these cases, some background is necessary. Under 31 U.S.C. § 5321(a)(5)(A), the Secretary of the Treasury "may impose" a penalty for FBAR violations, and pursuant to administrative orders, the authority to impose FBAR penalties has been delegated by the Secretary to the Service. Further, under the *current* version of 31 U.S.C. § 5321(a)(5)(B)(i), the normal penalty for an FBAR violation is \$10,000 per offending account; however, the penalty for a *willful* FBAR violation "shall be increased to the greater of" \$100,000 or 50 percent of the balance in the offending account at the time of the violation. See 31 U.S.C. § 5321(a)(5)(C). These minimum and maximum penalties for willful FBAR violations were changed by the American Jobs Creation Act of 2004 ("AJCA"), Pub. L. No. 108-357, § 821, 118 Stat. 1418 (2004). The prior version of 31 U.S.C. § 5321(a)(5) provided that the penalty for *willful* FBAR violations was the greater of \$25,000 or the balance of the unreported account up to \$100,000. Treasury regulations issued under the pre-AJCA version of 31 U.S.C. § 5321(a)(5), reflecting the law at the time, capped the penalty for willful FBAR violations to \$100,000 per account. See 31 C.F.R. § 1010.820(g). Unfortunately for the Service in the cases summarized below, those pre-AJCA regulations have not been updated to reflect the change in the statute itself.

a. *First taxpayer victory in the FBAR-FUBAR war.* [United States v. Colliot](#), 121 A.F.T.R.2d 2018-1834 (W.D. Tex. 5/16/18). The Service had assessed multiple FBAR penalties totaling over \$745,000 against the taxpayer for willful violations across the years 2007 through 2010. The bulk of the penalties were for violations in 2007 (\$548,773) and in 2008 (\$196,082). Contesting the Service's assessment, the taxpayer argued that the "may impose" language of 31 U.S.C. § 5321(a)(5)(A) leaves the amount of assessable FBAR penalties to the discretion of the Secretary of the Treasury. Further, because the (albeit outdated) Treasury regulations had not been amended to reflect the AJCA's increase in the minimum and maximum FBAR penalties, the Service's authority was limited to the amount prescribed by the existing regulations. As noted above, the existing regulations limit the FBAR penalty for willful violations to \$100,000 per unreported account. The Service argued that notwithstanding Treasury's failure to update the regulations, the amended statute "implicitly superseded or invalidated" the out-of-date regulations. The District Court for the Western District of Texas, Judge Sparks, disagreed with the Service and sided with the taxpayer. Judge Sparks reasoned that, although amended 31 U.S.C. § 5321(a)(5)(C) allows greater penalties for willful FBAR violations than the outdated regulations, the "may impose" language of the statute clearly leaves the Secretary of Treasury with the discretion to do so. Accordingly, because the Secretary of the Treasury

has not exercised his discretion to update the regulations, the Service's authority to assert penalties for willful FBAR violations, the court held, is capped at the greater of \$25,000 or the balance of the unreported account up to \$100,000 until the regulations are amended. Judge Sparks concluded his opinion by ordering the taxpayer and the Service to brief the court on the appropriate remedy that should be granted, so the exact amount of the FBAR penalties (if any) to be imposed upon the taxpayer in *Colliot* was not determined by the court.

- In a subsequent order, the court declined to dismiss the case on the grounds that (1) most of the penalties asserted by the government did not exceed the limit set forth in the regulations, and (2) the appropriate remedy for the one penalty that did exceed the limit was to reduce the penalty to the permissible amount. [United States v. Colliot](#), 122 A.F.T.R.2d 2018-5558 (W.D. Tex. 8/16/18).

b. *Second taxpayer victory in the FBAR-FUBAR war.* [United States v. Wadhan](#), 325 F. Supp. 3d 1136 (D. Colo. 7/18/18). In a very similar case, the U.S. District Court for the District of Colorado (Judge Krieger) held that penalties totaling over \$2 million assessed against a taxpayer for willful FBAR violations across the years 2008 through 2010 must be reduced and capped at \$100,000 per unreported account. Judge Krieger reiterated that although the current version of 31 U.S.C. § 5321(a)(5) permits a higher amount, existing (albeit outdated) Treasury regulations (31 C.F.R. § 1010.820(g)) limit the Service's authority to assess penalties to the greater of \$25,000 or the balance of the unreported account up to \$100,000. Judge Krieger cited the court's decision in *United States v. Colliot* 121 A.F.T.R.2d 2018-1834 (W.D. Tex. 5/16/18), as support for her decision. Judge Krieger further reasoned that, although Treasury has updated other regulations since 2004 to increase FBAR penalties for inflation (*see, e.g.*, 31 C.F.R. § 1010.821), Treasury has not updated the regulations to reflect the increased penalties allowed by amended 31 U.S.C. § 5321(a)(5)(C). Like the court in *United States v. Colliot*, Judge Krieger did not determine the ultimate amount of penalties to be imposed upon the taxpayer other than to hold that the amount should not exceed \$100,000 per unreported account.

c. *But wait! A government victory in the FBAR-FUBAR war.* [Norman v. United States](#), 138 Fed. Cl. 189 (7/31/18). The government assessed a penalty of \$803,500 for failure to file an FBAR in 2007 with respect to a Swiss Bank account. The taxpayer, relying on *United States v. Colliot*, 121 A.F.T.R.2d 2018-1834 (W.D. Tex. 5/16/18), argued that the relevant statute, 31 U.S.C. § 5321(a)(5), provides the Secretary of the Treasury with discretion to determine the amount of assessable FBAR penalties and that, because the outdated Treasury regulations had not been amended to reflect the AJCA's increase in the minimum and maximum FBAR penalties, the Service's authority was limited to the amount prescribed by the existing regulations. The Court of Federal Claims (Judge Damich) rejected this argument. Judge Damich reasoned that the amended statute, which provides that the amount of penalties for willful FBAR violations *shall be* increased to the greater of \$100,000 or 50 percent of the account value, is mandatory and removed Treasury's discretion to provide for a smaller penalty by regulation. Accordingly, the court held, the relevant regulation that provides for a smaller penalty, 31 C.F.R. § 1010.820(g), is invalid.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. *The Service wins three battles but loses the war in this withholding trust fund tax case; a CPA firm may have been the taxpayers' salvation.* [Byrne v. United States](#), 857 F.3d 319 (6th Cir. 5/15/17). The two taxpayers were CEO and President of a manufacturing company that they, the company's controller, and other investors purchased in October 1998. Early in 1999, the taxpayers became aware that the company's controller had mishandled payroll tax payments (i.e., making biweekly instead of semiweekly payments) for several months resulting in a large penalty assessment by the Service. As a result of the controller's continued mishandling of the company's finances, in April and July of 2000 the taxpayers hired two new employees to assist the controller. In October 2000, the Service sent the company a notice of a penalty for \$98,622.32 for unpaid trust-fund taxes for the first quarter of 2000. These unpaid taxes plus interest were paid in November 2000. In December 2000, the company's independent CPA firm issued a "clean" audit letter regarding the company's financial statements through September 30, 2000; however, the letter noted that the company had "flaws" in its

accounting practices. Subsequently, in January of 2001, the company's lender discovered that not only had the company missed payroll tax payments for the last three quarters of 2000, but the controller had falsely overstated accounts receivable records to hide the company's financial difficulties. In April 2001, the company filed for bankruptcy protection and ultimately was liquidated. Then, in July 2005, the Service assessed \$855,668.35 responsible person penalty taxes against the taxpayers under § 6672. The taxpayers subsequently paid a portion of the penalty taxes and filed refund claims instituting this action. The U.S. Court of Appeals for the Sixth Circuit previously had affirmed the District Court's ruling that the taxpayers were responsible persons for purposes of § 6672(a), but remanded the case to the District Court to determine if the taxpayers had acted willfully as required by the statute. *Byrne v. United States*, 498 Fed. Appx. 555 (6th Cir. 2012). After a bench trial, the District Court held that the taxpayers had acted willfully because they recklessly disregarded the risk that the trust fund taxes were not being paid. In an opinion by Judge Batchelder, a three-judge panel of the Sixth Circuit reversed the District Court and held as a matter of first impression that (i) a determination of "willfulness" under § 6672 is a question of "ultimate fact" subject to de novo review on appeal, and (ii) even if the taxpayers were negligent, and possibly even reckless, in their failure to determine whether trust fund taxes were being paid, their belief that the trust fund taxes had been paid was reasonable under the circumstances and therefore they had not acted willfully within the meaning of § 6672. In particular, the Sixth Circuit pointed to the hiring of two employees to assist the controller in 2000 and the taxpayers' reliance upon the "clean" audit letter issued by the company's CPA firm in December 2000.

In reaching its decision, the Sixth Circuit apparently aligns itself with a similar "reasonable belief" exception adopted by the Second Circuit, noting:

In many circuits, "[r]eckless disregard includes failure to investigate or correct mismanagement after being notified that withholding taxes have not been paid." *Morgan v. United States*, 937 F.2d 281, 286 (5th Cir. 1991) (per curiam); see also *Greenberg v. United States*, 46 F.3d 239, 244 (3rd Cir. 1994); *Denbo v. United States*, 988 F.2d 1029, 1033 (10th Cir. 1993); *Godfrey v. United States*, 748 F.2d 1568, 1577 (Fed. Cir. 1984) . . . But the Second Circuit recognizes an exception to § 6672(a) liability when a responsible person "believed that the taxes were in fact being paid, so long as that belief was, in the circumstances, a reasonable one." *Id.* (citation and internal quotation marks omitted). The Fifth Circuit has also held that taxpayers who act with reasonable cause may be able to defeat a finding of willfulness. See *Conway v. United States*, 647 F.3d 228, 234, 235 (5th Cir. 2011) (finding that reasonable reliance on the advice of counsel may constitute reasonable cause under some circumstances).

a. *Unlike the taxpayer in Byrne who had a reasonable basis to believe the company was meeting its payroll tax obligations, this taxpayer found out that the ostrich defense will not "fly" (pun intended).* [United States v. Hartman](#), 896 F.3d 759 (6th Cir. 7/25/18). In a case somewhat similar to *Byrne v. United States*, 857 F.3d 319 (6th Cir. 5/15/17), the Sixth Circuit (in an opinion by Judge Sutton) upheld a federal district court decision imposing liability on the taxpayer under § 6672 for an amount equal to the business's unpaid withholding taxes. The taxpayer and another individual had founded the company, and the taxpayer had placed the other individual in charge of payroll. Unfortunately, though, the other individual did not do well in this role, and eventually the taxpayer discovered that the company had not paid payroll taxes to the Service. After both founders met with the Service, the taxpayer directed the other individual founder to pay all delinquencies as well as future payroll taxes on a timely basis; however, the taxpayer did not follow up and subsequently became aware (finding a number of unmailed checks to the Service as well as learning other clues) that payroll taxes were not being paid. The District Court held on a motion for summary judgment that the taxpayer "recklessly" disregarded the company's payroll obligations, which was tantamount to willfulness, even if the taxpayer did not have actual knowledge that payroll taxes were not being paid to the Service. The Sixth Circuit upheld the District Court's ruling, holding that although neither negligence nor gross negligence constitutes willfulness, reckless disregard is tantamount to willfulness. The Sixth Circuit concluded that the taxpayer was reckless because he had actual knowledge of the other individual founder's "extensive track record of misconduct." Coupled with other facts of which the taxpayer was aware and which indicated payroll taxes had not been paid, the Sixth Circuit determined that the

taxpayer “had no plausible basis” for believing that the company’s payroll tax obligations were being met. Yet, despite this knowledge, the taxpayer did nothing to correct the situation. These facts, the Sixth Circuit wrote, distinguished this case from *Byrne* where the taxpayers took meaningful steps (by hiring an accounting firm and in-house accountant) to address unpaid payroll taxes.

B. Self-employment Taxes

1. *In this employment tax refund case concerning non-qualified stock options, Judge Posner tells railroads to take a hike, but Judge Manion dissents because “money remuneration” and “stock” were different in 1934; however, both apparently agree that “wampum” and “sheep” can be money (and no, we are not making this up)! Wisconsin Central Ltd. v. United States*, 856 F.3d 490 (7th Cir. 5/8/17). Beginning in 1996, the taxpayer railroad companies began including non-qualified stock options in the compensation plans for their employees. The taxpayers previously had withheld and paid employment taxes (under the Railroad Retirement Tax Act, § 3231) when employees exercised non-qualified stock options, but subsequently the taxpayers filed claims for refunds with the Service, which were denied. The United States District Court for the Northern District of Illinois (Judge Feinerman) also denied the taxpayers’ refund claim, and the taxpayers appealed to the Seventh Circuit. The taxpayers argued that stock options are not “compensation” because they are not “money remuneration” within the meaning of § 3231. Section 3231(e)(1) defines taxable compensation as “any form of money remuneration paid to an individual for services rendered as an employee to one or more employers.” Based upon this language, Judge Posner, writing for the majority, explained that even though the term “money remuneration” may not have commonly been understood to include stock when the Railroad Retirement Tax Act was passed in 1937, today stock and stock options are well-accepted forms of compensation and hence taxable under § 3231. Judge Posner wrote, “The dictionary definition of money may remain constant while the instruments that comprise it change over time: sheep may have once been a form of money; now stock is.” In short, Judge Posner interprets the term “money remuneration” in § 3231 to be an evolving concept that changes with the times. Judge Manion, however, dissented, arguing that the 1934 edition of Webster’s Dictionary defined money as “[a]nything customarily used as a medium of exchange and measure of value, as sheep, wampum, copper rings, quills of salt or of gold dust, shovel blades, etc.” Thus, in Judge Manion’s view, non-qualified stock options are not “money remuneration” and hence not subject to tax under § 3231. *We presume, somewhat sarcastically, that Judge Posner and Judge Manion would agree that “wampum” and “sheep” were taxable in 1937 under § 3231 and would be taxable today as well, although according to their opinions the law is unsettled on this point.*

a. *The U.S. Supreme Court has reversed the Seventh Circuit and held that non-qualified stock options are not “money remuneration” and therefore are not taxable compensation for purposes of the Railroad Retirement Tax Act. Wisconsin Central Ltd. v. United States*, ___ U.S. ___, 138 S. Ct. 2067 (6/21/18). In an opinion by Justice Gorsuch (joined by Justices Roberts, Kennedy, Thomas, and Alito), the U.S. Supreme Court reversed the decision of the Seventh Circuit and held that non-qualified stock options are not “compensation” within the meaning of § 3221 and therefore are not subject to taxation under the Railroad Retirement Tax Act. The Court focused on the definition of the term “compensation” in § 3231(e)(1), which defines compensation as “any form of money remuneration paid to an individual for services rendered as an employee to one or more employers.” The Court looked for guidance to several dictionary definitions of the term “money” that existed contemporaneously with Congress’s 1937 enactment of the Railroad Retirement Tax Act. These definitions generally defined money as currency issued by a recognized authority and used as a medium of exchange. Stock options, the court reasoned,

do not fall within that definition. While stock can be bought or sold for money, few of us buy groceries or pay rent or value goods and services in terms of stock. When was the last time you heard a friend say his new car cost “2,450 shares of Microsoft”? Good luck, too, trying to convince the IRS to treat your stock options as a medium of exchange at tax time.

The Court also noted the difference in the language used in the Railroad Retirement Tax Act and in the Federal Insurance Contributions Act (FICA), both of which were enacted by the same Congress. The Railroad Retirement Tax Act taxes “money remuneration.” In contrast, FICA taxes “all

remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash.” According to the Court, “[t]he Congress that enacted both of these pension schemes knew well the difference between ‘money’ and ‘all’ forms of remuneration.” The Court declined to give *Chevron* deference to Reg. § 31.3231(e)-1, which provides, “except as specifically limited by the Railroad Retirement Tax Act,” that the term “compensation” in the Railroad Retirement Tax Act has the same meaning as the term “wages” in FICA. The statutory definition of “compensation,” the Court held, is clear and leaves no room for agency interpretation.

- Justice Breyer, joined by Justices Ginsburg, Sotomayor, and Kagan, dissented. Justice Breyer characterized the railroads as “engaging in (and winning) a war of 1930’s dictionaries.” In Justice Breyer’s view, the statutory definition of “money remuneration” is ambiguous, and therefore the Court should have deferred to the Treasury Department’s interpretation of the statute. The Treasury Department, Justice Breyer argued, has consistently interpreted the term “money remuneration” in a manner that supports treating stock options as a form of money remuneration.

C. *Excise Taxes*

XII. TAX LEGISLATION

A. *Enacted*

1. *Congress has enacted technical corrections to the centralized partnership audit regime.* The [Consolidated Appropriations Act, 2018, Public Law No: 115-141](#), was signed by the President on March 23, 2018. Part of the Act makes much-needed technical corrections to the new centralized partnership audit regime. These amendments to the centralized partnership audit regime are effective for taxable years beginning after December 31, 2017, as if enacted as part of The Bipartisan Budget Act of 2015.