Message from the Chair

Your Taxation Committee has been busy! We now have three ABA webinars under our belt this year on topical subjects of challenging dubious treasury regulations, succession planning and corporate inversions. If you missed the live broadcast, you can access the recorded versions on our Tax Committee page.

Our newest law school volunteer, Jacob Heyka from the McGill Faculty of Law in Montreal, has also been busy helping us plan our Montreal events. We have two CLE programs coming up for the Spring meetings in April: An Introduction to Tax Aspects of M&A Transactions, co-sponsored with the M&A Committee; and Buying & Selling Trouble: Distressed M&A, Tax Issues and Protecting Clients, co-sponsored by the Bankruptcy Committee. We will also be planning our usual committee meeting to discuss committee business and also for a non-CLE presentation on US Canada Employment tax issues (which will be broadcasted).

This has been a very active year for the Tax Committee so far and we hope to keep the momentum going into the fall meetings, for which we seek suggestions, content and speakers. As always, we encourage the younger lawyers to take an active role and use this Committee as an opportunity to gain exposure or sharpen skills.

I am looking forward to seeing you in Montreal.

Roger Royse
Chair, Taxation Committee

Feature Articles

- The PATH (Act) Ahead: Foreign Investors Forge Ahead with Expanded FIRPTA Relief But It’s the End of the Road for REIT Spin-Offs
- Tax Advantages for Angel Investors
- New Partnership Audit Rules Impact Both Existing and New Partnership and LLC Operating Agreements
- The ACA’s Cadillac Tax
- U.S. Persons’ Passports and Passport Eligibility
- Protecting Privileged Documents From the IRS

Important Dates

Business Law Section Annual Meeting
September 8-10, 2016
Boston, MA

From the Editors

If the Spring Meeting of the Business Law Section represents the unofficial opening of Spring, then as we anxiously anticipate the imminent commencement of the Spring Meeting, we are pleased to present the not-untimely Winter issue of Business Tax Quarterly.

In this issue, we present an article summarizing important changes for foreign investors in real estate under the recently enacted PATH Act. The “Angel
Investors” piece describes the PATH Act's enhancements to the tax benefits of Qualified Small Business Stock, an often overlooked but potentially extremely useful tax subsidy for investments in early stage companies. Sticking with recent legislative changes, in a different piece of legislation, Congress enacted significant and controversial changes to the way IRS will audit partnerships, and our authors identify consequences for drafting and implementing partnership and LLC agreements.

While it’s been several years since Congress enacted the Affordable Care Act, we are still in the process of digesting and helping our clients implement its provisions. In that vein, we have an article on ACA’s so-called Cadillac Tax that, when implemented, will impose a stiff excise tax on generous health insurance plans.

Referring to yet another piece of recent legislation, one of our articles describes a new law authorizing the State Department to deny passport privileges to US citizens found to owe significant amounts of tax to the IRS. And finally, we present an article discussing a recent Second Circuit decision on the protection of documents from IRS scrutiny under the privilege doctrine.

As always, our goal is to serve up short, topical articles that will be informative and useful for the business lawyer. Our members’ practices are varied, but if we are doing our job right, each of you should find several (but likely not all) of the articles in each issue to be relevant to your practice. We encourage your feedback as to how we’re doing in this respect, and would love to hear your suggestions about improving Business Tax Quarterly. And of course, please let us know if you might be interested in helping with the editorial and publication process, including writing an article.

Best wishes, and we look forward to seeing many of you in Montreal,

Michael Kliegman and Jennifer Riley, Editors.

Feature Articles

The PATH (Act) Ahead: Foreign Investors Forge Ahead with Expanded FIRPTA Relief But It’s the End of the Road for REIT Spin-Offs
By Prentiss E. Feagles, Shawna R. Tunnell, Cameron N. Cosby, and Nicole D. Brown

Generally, foreign investors are exempt from U.S. tax on the capital gain they recognize on the sale of stock or debt instruments issued by U.S. corporations (if the gain is not effectively connected with the conduct of a U.S. trade or business). Foreign investment in U.S. real property is treated differently. Since 1980, the Foreign Investment in Real Property Tax Act (FIRPTA) has required foreign investors to file a U.S. tax return and pay U.S. tax on gain from the disposition of U.S. real property interests (USRPIs), which include interests in...
real property and interests in corporations (including REITs) that own substantial U.S. real property. Subject to the exceptions discussed immediately below, distributions (whether liquidating or non-liquidating) by real estate investment trusts (REITs) to foreign investors of net capital gain are also subject to FIRPTA tax if attributable to the disposition by the REIT of any of its USRPIs.

Read more....

**Tax Advantages for Angel Investors**

Angel investors should be excited about recent legislative changes that are likely to improve the overall after-tax returns on their investment portfolios. As a result of the Protecting Americans from Tax Hikes Act (PATH), Congress changed the taxability of certain investments, specifically on the gains related to Qualified Small Business Stock (QSBS). On a now permanent basis, and subject to certain limits and requirements, 100 percent of the gains from the sale of QSBS will be excluded from taxable income and from inclusion in the alternative minimum tax calculation. Additionally, investors can utilize a portion of their QSBS losses in a more tax advantageous way than permitted for most other investments.

Read more....

**New Partnership Audit Rules Impact Both Existing and New Partnership and LLC Operating Agreements**

By Thomas W. Giegerich, Gary C. Karch, Kevin Spencer, and Madeline Chiampou Tully

On November 2, 2015, President Barack Obama signed the Bipartisan Budget Act of 2015 (the Act) into law, instituting for tax years commencing after 2017 significant changes to the rules governing federal tax audits of entities that are treated as partnerships for U.S. federal income tax purposes. The new rules impose an entity-level liability for taxes on partnerships (and concomitantly, in the case of a general or limited partnership, the general partner) in respect of Internal Revenue Service (IRS) audit adjustments, absent election of an alternative regime described below under which the tax liability is imposed at the partner level. The new rules constitute a significant change from existing law and will require clarification through guidance from the U.S. Department of the Treasury (Treasury).

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**The ACA’s Cadillac Tax**

The Affordable Care Act (ACA) added Code Section 4980I to the Internal Revenue Code. The Cadillac Tax is an excise tax of 40 percent which will be imposed on the cost of employer-sponsored health coverage that exceeds an annual limit. This tax will impose a penalty on employers, health insurers and “persons who administer plan benefits” with regard to high-cost health care coverage. The tax is scheduled to go into effect on January 1, 2020. Originally
the tax was effective for tax years beginning on or after January 1, 2018, but after employer and other stakeholder opposition to the Cadillac Tax grew into bipartisan support from Congress, President Obama signed into law a two-year delay of the Cadillac Tax on December 18, 2015. This two-year delay is part of Congress’s $1.8 trillion omnibus spending deal, the Consolidated Appropriations Act, 2016 (the Act). The Act authorized the U.S. comptroller general and the National Association of Insurance Commissioners to study whether the ACA uses appropriate benchmarks to determine whether the tax should be adjusted to reflect age and gender factors when setting excise tax thresholds.

Read more....

U.S. Persons’ Passports and Passport Eligibility

In the past history of the country, U.S. persons’ passports and passport eligibility rarely could be affected by Federal tax considerations. Not anymore. Pursuant to Section 32101 of the Fixing America’s Surface Transportation Act (PL 114-94; H.R.22, December 4, 2015), the IRS is authorized to certify to the State Department that a U.S. person has at least $50,000.00 of unsatisfied indebtedness to the IRS on December 4, 2015 or any time thereafter, in which case the department will revoke or not issue a U.S. passport. The law has retroactive effect, since it applies to all currently collectible IRS debts no matter when arising. To facilitate certification, Section 32101 contains an express exception to the general rule that the IRS is barred from disclosing to any person a taxpayer’s tax information. As an aside, the State Department has long had powers to revoke or not issue U.S. passports, but limited to uncommon circumstances like denying a passport to a person advocating the violent overthrow of the Federal government, viz, a known enemy of the U.S. At least $50,000.00 debts to the IRS are fairly common by comparison.

Read more....

Protecting Privileged Documents From the IRS
By Jeremy H. Temkin

Before executing complicated financial transactions, taxpayers frequently seek advice from lawyers and accountants regarding their likely tax consequences, and during the course of such transactions, the taxpayers may share analyses prepared by their tax professionals with third parties. In auditing tax returns reporting the transactions in question, the Internal Revenue Service may seek the analyses from those third parties. In order to resist production of the analyses in such circumstances, the taxpayers will need to establish both that the documents in question were privileged and that the applicable privileges were not waived.

Read more....
Generally, foreign investors are exempt from U.S. tax on the capital gain they recognize on the sale of stock or debt instruments issued by U.S. corporations (if the gain is not effectively connected with the conduct of a U.S. trade or business). Foreign investment in U.S. real property is treated differently. Since 1980, the Foreign Investment in Real Property Tax Act (FIRPTA) has required foreign investors to file a U.S. tax return and pay U.S. tax on gain from the disposition of U.S. real property interests (USRPIs), which include interests in real property and interests in corporations (including REITs) that own substantial U.S. real property. Subject to the exceptions discussed immediately below, distributions (whether liquidating or non-liquidating) by real estate investment trusts (REITs) to foreign investors of net capital gain are also subject to FIRPTA tax if attributable to the disposition by the REIT of any of its USRPIs.

Prior to the enactment of the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act), only limited exceptions to FIRPTA tax applied, specifically:

- dispositions of publicly traded REIT stock if the foreign investor (a “portfolio investor”) is a minority (five percent or less) owner;
- net capital gain distributions from a publicly traded REIT if the foreign portfolio investor owns no more than five percent of the REIT’s stock;
- dispositions of the stock of publicly traded or privately owned REITs that are “domestically controlled” (i.e., less than 50 percent owned by foreign investors); and
- dispositions of the stock of publicly traded or privately owned REITs by a foreign government that owns a non-controlling interest.

On December 18, 2015, President Obama signed the PATH Act into law. The PATH Act represents the most significant change to the taxation of foreign investment in U.S. real property since FIRPTA was enacted. The PATH Act significantly facilitates foreign investment in U.S. real estate by (i) fully exempting from FIRPTA tax “qualified” foreign pension funds that own U.S. real estate through a REIT, (ii) increasing from five percent to ten percent the amount of stock a foreign portfolio investor can own in publicly traded REITs without incurring FIRPTA tax, and (iii) permitting certain widely-held, publicly traded foreign investors to qualify for such treatment as portfolio investors in REITs,
regardless of whether the REIT is public or private. The PATH Act pays for these tax benefits in part by restricting some of the rules applicable to REITs, including a prohibition on the recent trend of corporations in industries other than real estate spinning off their real property into entities treated as REITs in tax-free transactions.

“Qualified Foreign Pension Funds” Are Exempt from FIRPTA

The PATH Act creates a new exemption from FIRPTA for qualified foreign pension funds (QFPFs). On or after December 18, 2015, any disposition of a USRPI by a QPF, or any distribution to a QFPF by a REIT, is exempt from FIRPTA.

A QFPF is any foreign trust, corporation, or other organization or arrangement:

- which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees of one or more employers in consideration for services rendered;
- which does not have a single participant or beneficiary with a right to more than five percent of its assets or income;
- which is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates; and
- either:
  - the contributions to such organization or arrangement are tax deductible or excluded from the gross income of such entity or taxed at reduced rates, or
  - the taxation of any investment income of such organization or arrangement is deferred or taxed at a reduced rate.

A QFPF includes a foreign entity wholly-owned by a QFPF.

Observation: There are questions as to which foreign pensions satisfy the requirements to be a QFPF. The requirement that the pension fund provides benefits “to participants or beneficiaries that are current or former employees of one or more employers in consideration for services rendered” may be a significant limitation. The quoted language is taken from the definition of a “broad participation retirement fund” under the Treasury regulations for the Foreign Account Tax Compliance Act of 2010 (FATCA). Many foreign governments provide retirement benefits to citizens, regardless of whether the citizens have been employees. Accordingly, the FIRPTA exemption granted to QFPFs appears to benefit only certain employer-sponsored foreign pension plans and may not benefit foreign pension plans where the right to benefits is premised on citizenship or residency rather than employment status. Each foreign pension fund needs to do its own analysis, with assistance from its tax advisors, to determine whether it qualifies as a QFPF. There may be questions that cannot be resolved until the U.S. Treasury Department and Internal Revenue Service issue guidance on the PATH Act, or if Congress enacts “technical correction” legislation.

Investing through a REIT is an attractive alternative for a QFPF that invests in U.S. real estate. The sale of the REIT stock, and distributions by the REIT to the QFPF that are attributable to the
disposition by the REIT of its USPRIs, are exempt from FIRPTA. It is important to note that, although QFPFs are exempt from FIRPTA tax, they are not exempt from other U.S. withholding taxes. For example, a U.S. dividend withholding tax of 30 percent (subject to reduction by treaty or exempt from taxation in the case of foreign governments) continues to apply. In addition, a QFPF should be prepared to certify to the REIT stock purchaser (or the REIT) that it is a QFPF to avoid FIRPTA tax withholding.

**FIRPTA Exemption Expanded to Ten Percent Portfolio Investors**

Pre-PATH Act, if a class of a REIT’s shares were “regularly traded” on an established securities market and a foreign portfolio investor held five percent or less of that class of shares during the five-year period ending on the date of the sale (or, if shorter, the duration of the ownership of the shares), the sale of those shares would not be subject to tax under FIRPTA. In addition, pre-PATH Act, a REIT’s distributions with respect to any class of such “regularly traded” stock were not subject to tax under FIRPTA if paid to a foreign portfolio investor who held five percent or less of that class of stock at any time during the one-year period ending on the date of the distribution. Those distributions instead were treated as ordinary income dividends paid by the REIT and subject to U.S. dividend withholding tax of 30 percent (subject to reduction by treaty or exempt from taxation in the case of foreign governments). The PATH Act increases the five percent threshold in both cases for such portfolio investors to ten percent or less, effective for dispositions or distributions on or after December 18, 2015.

**Certain Widely Held, Publicly Traded Foreign Investors Are Exempt from FIRPTA**

The PATH Act creates an exemption from FIRPTA tax for REIT stock held by certain publicly traded foreign entities, such as listed Australian property trusts (Qualified Shareholders), except to the extent that a foreign investor in a Qualified Shareholder holds more than ten percent of the REIT’s stock, whether or not by reason of such investor’s ownership interest in the Qualified Shareholder. If a foreign investor in a Qualified Shareholder directly or indirectly holds more than ten percent of the REIT’s stock, then a portion of the REIT stock held by the Qualified Shareholder (based on the foreign investor’s percentage ownership of the Qualified Shareholder) is treated as a USRPI in the hands of the Qualified Shareholder and is subject to FIRPTA tax.

A Qualified Shareholder is a foreign person that:

- either is:
  - eligible for the benefits of a comprehensive income tax treaty with the United States and whose interests are listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty); or
  - a foreign limited partnership in a jurisdiction that has an agreement with respect to taxes with the United States and that has more than 50 percent of its limited partnership interests regularly traded on the NYSE or NASDAQ markets;

- maintains records on the identity of each person who is the direct owner of five percent or more of the interests in such foreign person; and

- meets one of the following requirements:
  - it would be eligible for a reduced rate of withholding under a comprehensive income tax treaty with the United States, even if such foreign person holds more than ten
percent of the REIT stock (for example, the U.S. tax treaties with Australia and the Netherlands);

- it is publicly traded, treated as a partnership for U.S. tax purposes, is a withholding foreign partnership and would be treated as a “United States real property holding corporation” if it were a U.S. corporation; or

- it is designated by the Secretary of the Treasury and is either (i) “fiscally transparent” within the meaning of Section 894 of the Internal Revenue Code or (ii) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.

If a Qualified Shareholder owns REIT stock and no foreign investor in the Qualified Shareholder directly or indirectly owns more than ten percent of the REIT stock (for example, the Qualified Shareholder is widely held and the foreign investors in the Qualified Shareholder do not own the REIT stock other than through the Qualified Shareholder), the Qualified Shareholder may own and dispose of the REIT stock without the application of FIRPTA tax. That exemption applies regardless of whether the REIT stock is publicly traded and regardless of whether the REIT is “domestically controlled.” Thus, certain widely-held, publicly traded foreign entities can make investments in U.S. real estate through private REITs and will not be subject to tax under FIRPTA on gain on the sale of the REIT stock.

A special rule applies to certain REIT distributions that are treated as sales or exchanges of REIT stock with respect to a Qualified Shareholder (for example, if a REIT makes a liquidating distribution to a Qualified Shareholder). In that case, if there are foreign investors in the Qualified Shareholder that own directly or indirectly more than ten percent of the REIT stock, then a portion of the REIT stock held by the Qualified Shareholder is subject to FIRPTA tax as described above. In addition, in the case of any other REIT shareholder, a REIT distribution that is treated as a sale or exchange of REIT stock with respect to that other shareholder is taxed as a dividend even though it otherwise would have been taxed as capital gain to such shareholder.

“Pay Fors”

To offset the tax revenue losses from the changes to the FIRPTA rules, Congress enacted certain changes to the rules applicable to REITs that are expected to raise tax revenues. The more significant “pay fors” are described below.

- **End to Tax-Free Spinoffs Involving REITs**

The PATH Act intends to ensure that assets held by corporations are subject to corporate level taxation by eliminating tax-free spin-offs in which a REIT is either the distributing or controlled corporation. Thus, effective for distributions on or after December 7, 2015, the recent “opco-propco” REIT spin-off transactions by Penn National, Windstream and Darden are not possible on a tax-deferred basis. In these transactions, an operating company in an industry other than real estate — in this case, the gaming, telecommunications and restaurant industries, respectively — attempts to unlock value by spinning off, in a tax-free transaction, its real property into an entity that elects tax treatment as a REIT (the property company), with the REIT then leasing the real property back to the operating company. The consequence is that the REIT’s profits that it distributes to its shareholders escape taxation at the entity level.

The prohibition is effective for distributions on or after December 7, 2015 but does not apply to distributions described in private letter ruling requests initially submitted to the Internal Revenue Service on or before that date. Private letter rulings generally are made public three months after
they are received by the taxpayer who requested them, so, in time, we should know who is still eligible to do a tax-free spin-off transaction. Hilton Worldwide Holdings recently announced that it received a private letter ruling regarding an opco-propco REIT spin-off transaction involving its hotel properties.

The PATH Act clarified that a REIT may still spin off a taxable REIT subsidiary (a TRS) or a subsidiary REIT if certain requirements are satisfied, including a spin-off transaction in which the REIT holds its interest in the TRS or subsidiary REIT through its operating partnership.

- **TRS Asset Test Limit Reduced from Twenty-Five Percent to Twenty Percent**

  The PATH Act reduces the percentage of a REIT’s total assets that may be securities of a TRS from twenty-five percent to twenty percent, effective for taxable years beginning after December 31, 2017.

- **FIRPTA Withholding Rate Increased from Ten Percent to Fifteen Percent**

  The PATH Act increases the FIRPTA withholding rate imposed on the disposition or distribution of a USRPI (including REIT stock) from ten percent to fifteen percent, effective for dispositions/distributions after February 16, 2016. After February 16, 2016, sales of residences are subject to different FIRPTA withholding rates, summarized below:

<table>
<thead>
<tr>
<th>Amount Realized from Sale of Residence</th>
<th>FIRPTA Withholding Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not more than $300,000</td>
<td>0%</td>
</tr>
<tr>
<td>More than $300,000, but not more than $1 million</td>
<td>10%</td>
</tr>
<tr>
<td>More than $1 million</td>
<td>15%</td>
</tr>
</tbody>
</table>

THIS ARTICLE BRIEFLY SUMMARIZES CERTAIN CHANGES TO THE U.S. TAX LAWS BY THE PATH ACT. IT WAS WRITTEN BY HOGAN LOVELLS LAWYERS FOR EDUCATIONAL AND INFORMATIONAL PURPOSES ONLY AND IS NOT INTENDED, AND SHOULD NOT BE CONSTRUED, AS LEGAL ADVICE.

* * *
Tax Advantages for Angel Investors

February 1, 2016
Advisory

Angel investors should be excited about recent legislative changes that are likely to improve the overall after-tax returns on their investment portfolios. As a result of the Protecting Americans from Tax Hikes Act (PATH), Congress changed the taxability of certain investments, specifically on the gains related to Qualified Small Business Stock (QSBS). On a now permanent basis, and subject to certain limits and requirements, 100 percent of the gains from the sale of QSBS will be excluded from taxable income and from inclusion in the alternative minimum tax calculation. Additionally, investors can utilize a portion of their QSBS losses in a more tax advantageous way than permitted for most other investments.

Overview

For over 15 years, Congress has, on a mostly annual basis, provided for partial or total exclusion of the gains related to sales of QSBS holdings. As might be expected, this preferential tax treatment was intended to increase investments in small businesses by producing higher after-tax returns to compensate for the high risk nature of such investments. However, because Congress played an annual political football game with the availability and quantity of the gain exclusion, angel investors have had little certainty around long term portfolio planning. Since PATH was passed, however, things have drastically improved. Angel investors now know that their successful small business investments will not be taxed at the federal level, as long as such investments qualify as QSBS.

Qualified Small Business Stock is defined in Section 1202(c) of the Internal Revenue Code. In order to qualify as QSBS, the investments must include the following requirements:

- The stock has been held for at least five years;
- The issuer has been a “Qualified Small Business” that is, a domestic C corporation with less than $50 million in assets, during substantially all of the taxpayer's holding period for the stock;
- At least 80 percent of the assets of the issuer are used in the active conduct of one or more qualified trades or businesses (which doesn’t include health, law, accounting, and banking services);
- The stock was issued directly by the issuer or through an underwriter to the taxpayer; and
- The stock was issued in exchange for money or other property other than stock, or as compensation for services provided to the corporation, other than for underwriting services.
- For the 100 percent gain exclusion to apply, the QSBS investment must have been acquired after September 27, 2010. Certain lower exclusions may apply for QSBS investments acquired in other periods.

Tax Treatment, Limits and Losses

The most crucial part of PATH is that gains from the sale of QSBS investments will not be taxed, at least at the federal level, and are excluded from inclusion in the calculation of income for Alternative Minimum Tax (AMT) purposes. In the absence of such an exclusion, gains from sales of capital assets held for more than a year would be taxed as long-term capital gains at the current federal rate of 15-20 percent, depending on the investment and the taxpayer’s income tax bracket. Such gains would also be included for AMT purposes and would potentially be subject to the 3.8 percent net investment income tax (often referred to as the “Medicare Tax”).

This exclusion maxes out for each taxable year at the greater of $10 million or 10 times the initial investment. Gains over such amounts will be taxed as long-term capital gains.

The HALO Report, which primarily tracks high risk / high yield investing in technology, life sciences and consumer products, typically reports that angels hold their investments for more than five years, and that such investments often yield between 2-10x invested capital over such period. As this is a near perfect match with the QSBS requirements,
the gain exclusions promised by PATH have the potential to dramatically improve after-tax portfolio performance for most angels.

It is also important for angel investors to revisit how losses on unsuccessful QSBS investments are treated. Generally, losses on investments are capital losses, and therefore, they may only offset capital gains. Since capital gains are taxed at rates lower than ordinary income, it is almost always more beneficial to have losses that are usable to offset ordinary income. Luckily, Congress has set out an exception for losses on QSBS investments. For each taxable year, taxpayers may treat up to $50,000 in losses from QSBS investments as ordinary losses which will offset ordinary income. Thus, in the event that an angel investor has an unsuccessful QSBS investment, the loss results in a more valuable tax asset than those generated by non-QSBS investments.

Whether or not gains from the sale of QSBS investments will be taxed on a state level depends entirely upon the state. While some states automatically adopt the Internal Revenue Code and its amendments as they are made, other states have their own set of tax laws entirely. Generally, state tax rates for gains from the sale of QSBS investments vary from 0-8.0 percent.

Conclusion

In evaluating the potential for superior returns in the angel investment asset class, investors should consider not only the gross returns on investment (ROI) and internal rates of return (IRR) of the portfolio, but should also evaluate the tax treatment of such assets. The exclusion of QSBS gains has the potential to substantially improve the after-tax performance of the asset class and will continue to serve as a significant incentive to drive future angel investments.

This advisory was prepared by the Tax Department at Nutter McClennen & Fish LLP. For more information, please contact your Nutter attorney at 617.439.2000.

This advisory is for information purposes only and should not be construed as legal advice on any specific facts or circumstances. Under the rules of the Supreme Judicial Court of Massachusetts, this material may be considered as advertising.

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On November 2, 2015, President Barack Obama signed the Bipartisan Budget Act of 2015 (the Act) into law, instituting for tax years commencing after 2017 significant changes to the rules governing federal tax audits of entities that are treated as partnerships for U.S. federal income tax purposes. The new rules impose an entity-level liability for taxes on partnerships (and concomitantly, in the case of a general or limited partnership, the general partner) in respect of Internal Revenue Service (IRS) audit adjustments, absent election of an alternative regime described below under which the tax liability is imposed at the partner level. The new rules constitute a significant change from existing law and will require clarification through guidance from the U.S. Department of the Treasury (Treasury).

Certain small partnerships are eligible to elect out of the provisions altogether for a given taxable year, with the result that any adjustments to such a partnership’s items can be made only at the partner level. This election may be made only by partnerships with 100 or fewer partners, each of which is an individual, a C corporation, an S corporation or an estate of a deceased partner. Accordingly, for example, any partnership having another partnership as a partner is not eligible to elect out of the new audit regime.

Under the new rules, in general, audit adjustment to items of partnership income, gain, loss, deduction or credit, and any partner’s distributive share thereof, are determined at the partnership level. Subject to election of the alternative regime discussed below, the associated "imputed underpayment"—the tax deficiency arising from a partnership-level adjustment with respect to a partnership tax year (a reviewed year)—is calculated using the maximum statutory income tax rate and is assessed against and collected from the partnership in the year that such audit or any judicial review is completed (the adjustment year). In addition, the partnership is directly liable for any related penalties and interest, calculated as if the partnership had been originally liable for the tax in the audited year.

The Act directs the Treasury to establish procedures under which the amount of the imputed underpayment may be modified in certain circumstances. If one or more partners file tax returns for the reviewed year that take the audit adjustments into account and pay the associated taxes, the imputed underpayment amount should be determined without regard to the portion of the adjustments so taken into account. If the partnership demonstrates that a portion of the imputed underpayment is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity the procedures are to provide that the imputed underpayment is to be determined without regard to that portion. The Act also directs that these procedures take into account reduced corporate, capital gain and qualified dividend rates as to the portion of any imputed underpayment allocable to a partner to which pertinent.

Under an alternative regime, if the partnership makes a timely election with respect to an imputed underpayment (a push-out election) and furnishes to each partner of the partnership for the reviewed year, and to the Treasury, a statement of the partner’s share of any adjustment to income, gain, loss, deduction or credit, the rules requiring partnership level assessment will not apply with respect to the underpayment and each affected partner will be required to take the adjustment into account on the partner’s individual tax return, and pay an increased tax, for the taxable year in which the partner receives the adjusted information return. Under
this alternative, the reviewed year partners (rather than the partnership) are liable for any related penalties and interest, with deficiency interest calculated at an increased rate and running from the reviewed year.

The Act also institutes significant changes to procedural aspects of partnership audits. Among other things, the “tax matters partner” role under prior law is replaced with an expanded “partnership representative” role. The partnership representative, which is not required to be a partner, will have sole authority to act on behalf of the partnership in an audit proceeding, and will bind both the partnership and the partners by its actions in the audit. The IRS no longer will be required to notify partners of partnership audit proceedings or adjustments, and partners will be bound by determinations made at the partnership level. It appears that partners neither will have rights to participate in partnership audits or related judicial proceedings, nor standing to bring a judicial action if the partnership representative does not challenge an assessment. Partnerships challenging an assessment in a district court or the U.S. Court of Federal Claims will be required to deposit the entire amount of the partnership’s imputed liability (in contrast to existing rules that only require a deposit of the petitioning partner’s liability). Also, the statute of limitations for adjustments will be calculated solely with reference to the date the partnership filed its return.

As noted, the Act’s new partnership audit regime applies to tax returns filed for partnership taxable years beginning after December 31, 2017. The delayed effective date affords taxpayers time to consider the potential effects of the new rules on entities taxed as partnerships and their operative agreements and to evaluate options for addressing them. While the Act provides that a partnership may opt for the Act’s amendments to the partnership audit rules to apply to any return of the partnership filed for taxable years beginning after the date of enactment of the Act, it is unlikely many partnerships will make such an election, at a minimum until such time as much needed Treasury guidance is produced.

OPEN ISSUES

Among the questions left unanswered for the moment are these:

1. Are the elections such as the push-out election self-executing, or is there a need for an issuance of regulations for such elections to be effective?

2. Will the ability to elect out of these new rules under the small partnership exception be available if a partnership has among its members a single-member limited liability company or a grantor trust?

3. In the absence of a push-out election (and assuming the small partnership exemption is unavailable):
   A. How do adjustments to income/deduction flow out to partners?
   B. Since the associated tax will have been paid by the partnership already, by what mechanism do the partners avoid paying tax on the same income at the partner level?
   C. How do these rules work with items allocated by a partnership that are determined at the partner level?
   D. If there is an item of income flowing from an IRS adjustment to the partners, do the partners increase their outside basis in their partnership interests to reflect their shares of the income?
   E. How does the IRS prevent gamesmanship in instances where there are significant shifts in partnership interests between the reviewed year and the adjustment year?
F. How are the rules intended to work in the case of a constructive partnership? What if the constructive tax partnership does not constitute a state law partnership? Since there is no juridical entity, is nobody liable for the taxes flowing from the IRS adjustments? If the constructive partnership is a state law partnership (and therefore a general partnership) is each partner liable for the totality of the tax? Can a push-out election be made on a protective basis (i.e., without conceding to the existence of a partnership) in order to avoid such an outcome? Who would make it?

G. Are partners ultimately liable under any circumstances for adjustments, where the partnership is insolvent or otherwise cannot satisfy the adjustments (for example, under transferee liability principles)?

H. What will be the state income tax consequences of federal audit adjustments?

4. If a push-out election is made:
   A. Can partners take their loss carryovers and other tax attributes into account in calculating the associated tax?
   B. What happens if one or more partners do not pay the associated tax? Does the partnership have a residual exposure?

5. As to the appointment of a partnership representative:
   A. Is it possible to replace a partnership representative once an audit has commenced?
   B. If the IRS appoints a partnership representative, does the appointee need to have some connection to the partnership?
   C. Presumably appointees by the IRS can refuse the appointment; what can we expect to be the IRS’ backup plan?

POTENTIAL CONTRACTUAL PROVISIONS TO TAKE THE NEW RULES INTO ACCOUNT

Set forth below are suggestions for the inclusion of provisions in partnership agreements in light of the new law. No single set of provisions can fit all circumstances, and, of course, the desirability of some of these provisions will depend on the partner’s frame of reference; the partnership representative is going to have different objectives than is a minority partner, for example. Possible contractual provisions include the following:

1. Use the small partnership exception, if available, and notify all partners of its election.
   A. Consider restricting eligible new partners to those that do not undercut the availability of this exception.
   B. Consider prohibiting transfers that would terminate eligibility for the exception.

2. If the small partnership exception is not available, require the push-out election, and place contractual obligations on partners related thereto. Require partners to execute an acknowledgement and agreement that sets forth the import of the election.

3. In the absence of a small partnership exception or push-out election, agree on the economic sharing of partnership-level tax payments. For example:
   A. Provide that partnership-level tax payments in an adjustment year will be economically borne in proportion to the partners’ income in the reviewed year, taking into account characteristics of a partner that reduce the payment.
B. State whether partners’ shares of tax payments will be collected from them by current payment or by offset against distributions.

C. Provide that departed or reduced interest partners agree to make payments for their shares of tax payments that cannot be offset against distributions.

D. Permit a holdback of distributions in the event of pending or expected tax audits.

E. Provide for the allocation of tax amounts that cannot be recovered from departed or reduced interest partners.

4. Provide that the existing governance mechanisms of the partnership (whether managing partner or member, management committee or board) control tax decisions and the appointment, replacement and direction of the partnership representative. Authorize or require the partnership representative, acting at the direction of the board or other governing authority, to do some or all of the following:

   A. Notify all partners upon the commencement of an IRS audit.
   
   B. Inform partners of the progress of the audit and consult with the partners before taking positions in response to proposed adjustments.
   
   C. Resolve IRS audits in its sole discretion. Alternatively, condition authority on a certain level of partner consent and exonerate the partnership representative and the board from liability if the partnership representative proceeds on the basis of such consent.
   
   D. Require partners to provide the partnership representative timely partner-level information to mitigate partnership level tax.
   
   E. Secure partners’ agreement to file amended returns at the partnership representative’s request.
   
   F. Make all elections and other decisions called for under the new rules in the exercise of its sole discretion. Alternatively, require the partnership representative to seek authorization for each such decision and action before taking it (perhaps on the basis of majority rule).

CONCLUSION

As the foregoing list demonstrates, it is not too early for affected taxpayers to start turning their attention to the practical steps they should be considering to address the implications of the new rules. Certainly, drafters of new partnership agreements and LLC operating agreements should consider including provisions such as those identified above. Moreover, a determination will need to be made as to whether existing partnership and LLC operating agreements should be amended in light of the new rules and, if so, how and with what implications (for example, in terms of required consents). In the context of mergers and acquisitions, potential purchasers of partnership interests are likely to require that the partnership commit to make the push-out election in the event of an audit. In short, the new partnership audit rules were enacted into law with little fanfare, and seemingly in short order, but with considerable consequences to the business community for years to come.
The ACA’s Cadillac Tax

The Affordable Care Act (ACA) added Code Section 4980I to the Internal Revenue Code. The Cadillac Tax is an excise tax of 40 percent which will be imposed on the cost of employer-sponsored health coverage that exceeds an annual limit. This tax will impose a penalty on employers, health insurers and “persons who administer plan benefits” with regard to high-cost health care coverage. The tax is scheduled to go into effect on January 1, 2020. Originally the tax was effective for tax years beginning on or after January 1, 2018, but after employer and other stakeholder opposition to the Cadillac Tax grew into bipartisan support from Congress, President Obama signed into law a two-year delay of the Cadillac Tax on December 18, 2015. This two-year delay is part of Congress’s $1.8 trillion omnibus spending deal, the Consolidated Appropriations Act, 2016 (the Act). The Act authorized the U.S. comptroller general and the National Association of Insurance Commissioners to study whether the ACA uses appropriate benchmarks to determine whether the tax should be adjusted to reflect age and gender factors when setting excise tax thresholds.

On July 30, 2015, the Internal Revenue Service (IRS) issued guidance on the Cadillac Tax in Notice 2015-52, supplementing Notice 2015-16, which was released on February 23, 2015.

In Notice 2015-52, the IRS addresses the following issues:

- Who must pay the Cadillac Tax
- How employers are aggregated
- How the tax is calculated
- How the tax is paid
- Who Must Pay the Cadillac Tax?

Who Must Pay the Cadillac Tax?

The Code defines the “coverage provider” as the taxpayer liable for paying the Cadillac Tax. For purposes of an insured group health plan, the coverage provider is the health insurance issuer. For purposes of a Health Savings Account (HSA) or an Archer medical savings account (MSA), the coverage provider is the employer. For all other types of applicable coverage, the coverage provider is defined as “the person who administers the plan benefits.” The term “person who administers the plan benefits” is not used elsewhere in the Code or the ACA. As a result, the IRS is considering two approaches to defining this term. Notice 2015-52 outlines these approaches.

First Approach

Under the first approach, the “person who administers the plan benefits” would be the person responsible for performing the day-to-day functions that constitute the administration of plan benefits, such as receiving and processing claims for benefits, responding to inquiries or providing a technology platform for benefits information. The IRS anticipates that this person generally would be a third-party administrator for self-insured benefits.

Second Approach
Under the second approach, the “person who administers the plan benefits” would be the person who has the ultimate authority or responsibility under the plan or arrangement with respect to the administration of the plan benefits. The IRS anticipates that this person would be identified in the applicable plan documents and would not likely be the person who performs the routine administrative functions of the plan. This would likely be the “Plan Administrator” or its delegate for ERISA-covered plans.

**How Are Employers Aggregated for Purposes of the Cadillac Tax?**

Employers aggregated under the Internal Revenue Code’s controlled group and affiliated service group rules—Code Section 414(b), (c), (m) or (o)—are treated as a single employer for purposes of the Cadillac Tax. In addition, there is a special rule for multi-employer plans. The plan sponsor of a multi-employer plan (as defined in Section 414(f)) is responsible for making the calculations and for providing the notice.

The IRS requests comments on the application of these aggregation rules to the following:

- Identification of the applicable coverage taken into account as made available by an employer
- Identification of the employees taken into account for the age and gender adjustment, and the adjustment for employees in high-risk professions and employees who repair and install electrical or telecommunication lines
- Identification of the taxpayer responsible for calculating and reporting the excess benefit
- Identification of the employer liable for any penalty for failure to properly calculate the Cadillac Tax

**Additional Issues in Calculating the Cadillac Tax**

**Taxable Period**

The Cadillac Tax imposes a 40 percent penalty on any “excess benefit” provided to an employee for any taxable period. An employee includes a former employee, surviving spouse, or other primary insured individual. An “excess benefit” is defined as the excess of the aggregate cost of applicable coverage over the annual applicable dollar limit for an employee. The applicable dollar limit for high-cost plans was set at $10,200 for individual coverage and $27,500 for family coverage. These dollar limits will be updated for inflation when the 2020 final regulations are issued and thereafter indexed for inflation in future years. The IRS anticipates that the “taxable period” will be the calendar year for all taxpayers; however, the regulations provide that the “taxable period” can be a shorter period as prescribed by the Secretary, and permit the Secretary to prescribe different taxable periods for employers of varying sizes.

In order to determine the amount of tax owed for a taxable period, the employer must determine the extent any applicable coverage exceeded the dollar limit in a given month. The employer then must notify both the IRS and the coverage provider, and the coverage provider then must
pay the tax. As a result, employers will need to determine the amount of tax soon after the close of the taxable year so that coverage providers may pay the tax in a reasonably timely manner.

The IRS anticipates a host of timing issues to arise for different fully insured and self-insured plan structures, and requests comments on any such issues.

The Code §275(a)(6) prohibition on deductions will not apply to the Cadillac Tax, thus the Cadillac tax will be deductible as a business expense.

**Calculating the Cost**

The cost of the applicable coverage is to be determined using rules “similar to the rules of section 4980B(f)(4)” regarding the determination of the COBRA applicable premium. The cost of applicable employer-sponsored coverage does not take into account any portion of the cost of the coverage that is attributable to the Cadillac Tax. Separate costs for self-only and other-than-self-only coverage will need to be calculated.

**Cost of Coverage Transferred to Employer**

While the coverage provider will pay the Cadillac Tax for fully insured coverage, the IRS anticipates that the cost of the tax will be passed through to the employer. Any reimbursement received by the coverage provider from the employer will be additional taxable income to the coverage provider. As a result, it is likely that a coverage provider will pass along both the Cadillac Tax reimbursement and the additional income tax (the “income tax reimbursement”) to the employer. While the Cadillac Tax reimbursement will be excluded for purposes of determining the cost of applicable coverage, the Code is not clear on whether to recognize the income tax reimbursement.

The IRS anticipates that coverage providers will be permitted to exclude the amount of excise tax or income tax reimbursement only if it is separately billed and identified as attributable to the cost of the excise tax. If the IRS concludes that an income tax reimbursement can be excluded from the cost of coverage, it is anticipated that the amount of the income tax reimbursement would be determined using a formula commonly used to calculate “tax gross-ups.” The IRS is still considering whether this reimbursement should be excluded as well. However, Treasury and IRS are concerned that a methodology for excluding an income tax reimbursement may not be administrable, given the potential variability of tax rates and other factors among different coverage providers, as well as potential difficulties in determining and excluding the reimbursement amount. Nonetheless, comments are requested on administrable methods for exclusion of the income tax reimbursement.

**Contributions to HSAs, Archer MSAs, FSAs and HRAs**

Account-based plans, such as HSAs, Archer MSAs, Flexible Spending Accounts (FSAs) and Health Reimbursement Arrangements (HRAs), pose a unique problem because contributions to such accounts may be difficult to track. The IRS is considering an approach under which contributions to account-based plans would be allocated on a pro rata basis over the period to which the contribution relates (generally the plan year), regardless of the timing of the contributions.
Experience-Rated Arrangements

In addition to the above, experience-rated arrangements provide some dilemmas for the IRS. In an experience-rated scenario, the insurer may provide payments to the policyholder after the end of a coverage period. These payments relate to the coverage provided during that coverage period. In other instances, the equivalent of those types of payments may be made through a premium discount or premium holiday for the next coverage period. The IRS is requesting comments on how those payments or discounts may be reflected in the cost of applicable coverage, including comments on any administrative issues that might arise if, for purposes of determining the cost of applicable coverage, the payments or discounts are attributed back to the original period of coverage (for which the taxable year might have ended) rather than accounted for during the period of coverage in which the amounts are paid or the discount applied. In addition, comments are requested on how employers are addressing these payments or discounts currently for purposes of determining their plan’s COBRA applicable premiums.

FSAs with Employer Flex Credits

FSAs also pose a problem because employees may often carry forward salary reduction amounts from one year to the next. To avoid double counting, the IRS is considering providing a safe harbor by which the cost of an employee’s salary reduction would be included in the cost of applicable coverage for that year, regardless of whether any amount was carried to the next year.

Age and Gender Adjustment to the Dollar Limit

As described previously, the dollar limit that determines the onset of the Cadillac Tax for 2020 is $10,200 for self-only coverage and $27,500 indexed for inflation, for anything other than self-only coverage. However, these limits may be increased based on the age and gender characteristics of a particular workforce. The IRS is considering using the Current Population Survey (Table A-8a), Employed Persons and Employment-Population Ratios by Age and Sex, Seasonally Adjusted (Table A-8a), published annually by the U.S. Department of Labor Bureau of Labor Statistics. For applicable coverage provided to retired employees, employers may elect to treat a retired employee who has not attained the age of 65, and a retired employee who has attained the age of 65, as similarly situated beneficiaries.

In order to determine the age and gender characteristics of an employer’s population, the IRS is considering requiring an employer to determine the age and gender of each employee as of the first day of the plan year for purposes of determining the population for the entirety of the year.

Notice and Payment of the Tax

In addition to calculating the tax, employers must notify the IRS and each coverage provider of the amount. In addition to any excise tax imposed, the employer or plan sponsor will have to pay a penalty in an amount equal to the excess tax, plus interest under the Code’s §6621 underpayment rate determined for the period beginning on the due date for the payment of the excise tax to which the excess relates, and ending on the date of payment of the penalty. Note that the insurance company providing health plan coverage will not have to pay a penalty for inaccurate calculation of the excise tax, while the employer or plan sponsor will be liable for interest on the amount of the under calculation of the tax. Fortunately, no penalty will be
imposed on the employer or plan sponsor for any failure to properly calculate the excess benefit during any period for which it is established to IRS's satisfaction that the employer or plan sponsor neither knew, nor exercising reasonable diligence would have known, that such failure existed. In addition, no penalty will be imposed on the employer or plan sponsor for any failure due to reasonable cause and not to willful neglect, if the failure is corrected during the 30-day period beginning on the first date that the employer knew, or exercising reasonable diligence would have known, that the failure existed. For any such failure due to reasonable cause and not to willful neglect, the IRS may waive part or the entire penalty, to the extent that the payment of the penalty would be excessive or otherwise inequitable relative to the failure involved.

Recommendations

Although the Cadillac Tax has been pushed back until 2020, we suggest that employers continue to monitor the guidance and take such information into account with respect to their future tax planning.

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U.S. Persons’ Passports and Passport Eligibility
Now Affected by Federal Tax Considerations.
By Robert S. Schwartz, Esq. ¹

In the past history of the country, U.S. persons’ passports and passport eligibility rarely could not be affected by Federal tax considerations. Not anymore. Pursuant to Section 32101 of the Fixing America’s Surface Transportation Act (PL 114-94; H.R.22, December 4, 2015), the IRS is authorized to certify to the State Department that a U.S. person has at least $50,000.00 of unsatisfied indebtedness to the IRS on December 4, 2015 or any time thereafter, in which case the department will revoke or not issue a U. S. passport. The law has retroactive effect, since it applies to all currently collectible IRS debts no matter when arising. To facilitate certification, Section 32101 contains an express exception to the general rule that the IRS is barred from disclosing to any person a taxpayer’s tax information. As an aside, the State Department has long had powers to revoke or not issue U.S. passports, but limited to uncommon circumstances like denying a passport to a person advocating the violent overthrow of the Federal government, viz, a known enemy of the U.S. At least $50,000.00 debts to the IRS are fairly common by comparison.

Section 32101 commands that upon receipt of an IRS certification the State Department shall not issue a U.S. Passport to the identified person. Such a person, for example, would be a U.S. expatriate living abroad with an expired passport while in debt to the IRS. That person might also be your new business client unable to timely travel back to the U.S. for important business negotiations. Also, coming up with an explanation for postponing the meetings may strain the nerves of the more delicate client faced with a counterpart’s quest for adequate explanation. No business person would ordinarily would want to disclose, apparently I’ve got to pay the IRS over $50,000.00 in past due debts before I am allowed back in the U.S. Section

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Section 32101 provides the State Department may also “limit” a U.S. passport. A narrow statutory construction would extend this limitation power over only (1) discretionary issuance of a U.S. Passport for a one way trip back into the U.S. or (2) discretionary revocation after, rather than before, entry into the U.S. Practically speaking, the exercise of either power means a U.S. tax delinquent may travel into or back into, but cannot travel out of the U.S. without first settling with the IRS. Perhaps, the “limitation of a passport” language will be more broadly construed by the State Department to allow for such actions as issuance of specifically short time limited U.S. passports. The import of this, as well as “not issue” compared to “revoked” dichotomy, is yet to be administratively procedures for temporary relief that may be somewhat different as between “not issue” verses “revoked” situations. Either way, time delaying or consuming events are going to affect tax indebted U.S. persons and persons with whom they are dealing. The engagement of tax attorneys for representation before the State Department and/or IRS can be easily foreseen.

The technical predicates for IRS certification leading to denial or revocation are straightforward and are laid out in new Internal Code Section 7345. These predicates should be viewed as a given, merely to be verified by counsel, in nearly every case: the IRS had “assessed” taxes, penalties and/or interest concerning which the outstanding, accreting amount presently is greater than $50,000.00; there is no valid payment plan now in effect; the taxpayer had had an opportunity for a collection due process appeal with respect to previous IRS notices of intention to lien and/or levy; assuming timely taken advantage of, the appeal did not resolve the liability via an offer in compromise, payment plan or other collection alternative to lien or levy. Section 32101 intentionally does not bar IRS certification, in the event the US person appeals (as of
right) an unagreed collection due process case to the United States Tax Court. However, assuming the U.S. Person actually receives Section 32101 mandated, contemporaneous notice (note: Congress did not enact a prior notice rule) of IRS certification, and assuming administrative level initiatives are ineffective, a U.S. Person may file an action either in a Federal district court or in the U.S. Tax Court expressly to contest either an erroneous certification or that the IRS erroneously failed to reverse a certification. Section 32101 also provides that if the debt is paid, or otherwise provided for, or the U.S. person becomes eligible for, then seeks, “innocent spouse” relief pursuant Internal Revenue Code 6515, or the certificate was simply a mistake, but in any such situation the IRS will not revoke it, there is recourse to court. Moreover, Section 32101 does not state a jurisdictional filing deadline. Since Section 32101 clearly contemplates the IRS can issue a certification to the State Department in doubtful situations, Congress has empowered the IRS to shoot first and ask questions later, in which case recourse to the courts will be sometimes necessary. Section 32101 expands the Tax Court’s limited jurisdiction.

As alluded to above, Section 32101 allows leeway for IRS administrative rules that would, in effect, allow a U.S. Person to last minute satisfy the liability in full or gain an IRS payment plan or offer in compromise before the IRS mails a certification to the State Department. It remains to be seen whether and to what extent IRS and maybe also State Department administrative rules will allow for such last ditch efforts. It is interesting to consider that Section 32101 is found in the “Offsets” title of H.R. 22, meaning the 114th Congress intends to partly pay for the appropriations set forth in other titles of the bill with tax money collected via passport administration. A review of Section 32101’s way through Congress e.g., H.R. 644, shows it did not readily pass into law because some members had obvious reservations about coupling the historic right of U.S. citizens to travel in and out of the U.S. with non-criminal tax matters. In this light, Section 32101 raises the question of whether now is the time for a Federal tax amnesty program modeled after one or more of the many successful state tax amnesty programs.
Protecting Privileged Documents From the IRS

By Jeremy H. Temkin

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Before executing complicated financial transactions, taxpayers frequently seek advice from lawyers and accountants regarding their likely tax consequences, and during the course of such transactions, the taxpayers may share analyses prepared by their tax professionals with third parties. In auditing tax returns reporting the transactions in question, the Internal Revenue Service may seek the analyses from those third parties. In order to resist production of the analyses in such circumstances, the taxpayers will need to establish both that the documents in question were privileged and that the applicable privileges were not waived.

In the past six months, the U.S. Court of Appeals for the Second Circuit has addressed assertions of privilege in two cases arising out of IRS audits, in both instances reversing district court decisions rejecting the taxpayers’ assertion of privilege. These cases are instructive of the need to act vigilantly to protect the privileges at issue.

Background

Under section 6201 of the Internal Revenue Code, the IRS is “authorized and required to make the inquiries, determinations, and assessments of all taxes” imposed by the Code. To effectuate this role, Congress has given the IRS “expansive information-gathering authority.”1 Thus, in the course of auditing returns, the IRS regularly issues summonses to taxpayers and third parties “[f]or the purpose of ascertaining the correctness of [the return in question]…, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability.”2

Issues relating to the scope and validity of a summons are litigated in federal district court, either through a petition to quash brought by either the summoned party or the affected taxpayer3 or through a petition by the IRS seeking to enforce the summons.4 When litigating the validity of a summons, the IRS bears the initial burden of demonstrating the four factors identified in United States v. Powell:5 (1) “that the investigation will be conducted pursuant to a legitimate purpose,” (2) “that the inquiry may be relevant to the purpose,” (3) “that the information sought is not already within the [IRS’s] possession,” and (4) “that the administrative steps required by the [Internal Revenue] Code have been followed.”6

Once the IRS meets this minimal burden, the burden shifts to the party resisting the summons to disprove one of the Powell factors or to establish some other “appropriate ground” to quash the summons.7 One such appropriate ground is that the summons in question calls for materials that are either subject to the attorney-client privilege or immune from discovery pursuant to the attorney’s work-product doctrine.
Highland Capital Case

In *Highland Capital Management v. United States,* a hedge fund had engaged in a series of transactions with Barclays Bank. Two of those transactions generated substantial losses, which Highland claimed on its 2008 income tax returns. The two transactions (and others) were the subject of litigation between Highland and Barclays, which was settled in 2012. In the course of auditing Highland’s 2008 returns, the IRS repeatedly asked Highland for a copy of its settlement agreement with Barclays. Highland resisted the IRS’s requests, asserting that the settlement agreement included a confidentiality provision that would require it to give Barclays notice of the IRS’s demand.

Apparently tired of Highland’s delay, the IRS first obtained the settlement agreement from Barclays and then served a third-party summons on that bank seeking, among other things, “[a] ny documents, including but not limited to any tax opinions, tax analysis or similar information provided to you by an outside party/third party with respect to” various transactions.

Highland moved to quash the third-party summons on a number of grounds including that it sought privileged information, and requested the opportunity to review any documents responsive to the requests seeking the potentially privileged information before they were produced to the IRS. In response, the IRS argued that Highland’s claim lacked specificity, as it did not identify particular documents that may be privileged. It also contended that it was unlikely that Barclays held any privileged material given that its relationship with Highland had become contentious. The district court rejected the motion to quash, albeit without expressly addressing Highland’s claim of privilege.

In an unpublished opinion, the Second Circuit affirmed the district court’s rejection of many of Highland’s arguments, but vacated and remanded for consideration of Highland’s assertion of privilege. Despite the fact that Highland and Barclays had become adversaries in litigation, the Second Circuit noted that “[w]hen parties disagree whether a privilege applies, courts often review the contested materials in camera,” and added that “requiring a litigant to turn over documents subject to a claim of attorney-client privilege…, without a judicial ruling on the merits of the claim, will undermine the attorney-client privilege and is therefore impermissible.” Thus, the Second Circuit remanded the issue for reconsideration, “including whatever in camera review of the documents at issue may be appropriate in the circumstances presented.”

‘Schaeffler v. United States’

Approximately six weeks after deciding *Highland Capital,* the Second Circuit issued its opinion in *Schaeffler v. United States,* which addressed another claim of privilege with respect to tax analyses that had been provided to banks that had an interest in the outcome of a transaction. In *Schaeffler,* the taxpayer, Georg Schaeffler, was a U.S. businessman who owned 80 percent of a German automotive and industrial parts supplier through several entities known as the Schaeffler Group. In 2008, the Schaeffler Group made a tender offer for shares of a German company. While the offer, which was financed by a consortium of banks, was designed to acquire a
minority interest in the company, as a result of the intervening global financial meltdown, its terms were far more attractive than had been intended and the offer was substantially oversubscribed.

The ballooning cost of the acquisition in conjunction with poor economic conditions led to concerns about the Schaeffler Group’s solvency and its ability to service the debt. As a result of these concerns, Mr. Schaeffler, the Schaeffler Group and the consortium decided to refinance the debt and restructure the Schaeffler Group, which had significant tax consequences. Among other tax advisors, the Schaeffler Group retained Ernst & Young (E&Y) “to advise on the federal tax implications of the transactions and possible future litigation with the IRS.”

E&Y prepared a 58-page memorandum “that identified potential U.S. tax consequences of the refinancing and restructuring, identified and analyzed possible IRS challenges to the [proposed] tax treatment of the transactions, and discussed in detail the relevant statutory provisions, U.S. Treasury regulations, judicial decisions, and IRS rulings.” The Schaeffler Group shared E&Y’s memorandum and other privileged documents with the bank consortium, pursuant to an “Attorney Client Privilege Agreement” in which the consortium committed to maintain the confidentiality of the documents with respect to third parties.

As expected, the IRS audited Mr. Schaeffler’s returns and, in connection with its audit, issued a summons to E&Y requesting, among other things, “legal opinions, analysis and appraisals” related to the restructuring and refinancing transactions. Mr. Schaeffler and the Schaeffler Group petitioned to quash the summons on the ground that it sought materials subject to both the attorney-client privilege and the attorney work-product doctrine. The district court denied the petition, finding that the Schaeffler Group had waived the attorney-client privilege by sharing the documents with the bank consortium.

The district court further held that, although the E&Y memorandum was prepared at a time when the Schaeffler Group anticipated litigation and analyzed the strengths and weaknesses of its positions, given the size and complexity of the transaction, the Schaeffler Group would have sought and obtained advice in essentially similar form even if it had not anticipated litigation.

On appeal, the Second Circuit rejected both of these findings. First, the court addressed the Schaeffler Group’s argument that sharing the documents in question with the bank consortium did not waive the attorney-client privilege given their “common legal interest.” The court rejected the district court’s view that the “common interest” or “joint defense” exception to the waiver doctrine was inapplicable because the consortium “lack[ed]…any common legal stake in Schaeffler’s putative litigation with the IRS, because it would not be named as a co-defendant in the anticipated litigation and ‘only the [c]onsortium’s economic interests,’ as opposed to its legal interests, ‘were in jeopardy.’” Given that the Schaeffler Group and the consortium “could avoid…mutual financial disaster by cooperating in securing a particular tax treatment of a refinancing and restructuring,” which would “likely involve a legal encounter with the IRS,” the Second Circuit concluded that they shared “a strong common interest in the outcome of that legal encounter.”

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The court noted that it had found “[n]o caselaw in this or another circuit [that] compels us to hold that the [c]onsortium’s interest in appellants’ obtaining favorable tax treatment for the refinancing and restructuring transaction is not a sufficient common legal interest.”23 The court reasoned that “[a] financial interest of a party, no matter how large, does not preclude a court from finding a legal interest shared with another party where the legal aspects materially affect the financial interests.”24 The court further noted that courts have held that insurers hold a common legal interest with the insured in the outcome of litigation and that the consortium “essentially insured” Schaeffler by “retain[ing] control over Mr. Schaeffler’s legal decisions to settle, pay, or sue.”25

After holding that the attorney-client privilege had not been waived, the Second Circuit turned to the district court’s finding that E&Y’s memorandum was not entitled to work product protection. The court noted that, under United States v. Adlman,26 a document is protected if it “can fairly be said to have been prepared or obtained because of the prospect of litigation.” Conversely, a document “prepared in the ordinary course of business in a form that would not vary regardless of whether litigation was expected” is not afforded protection.27 The court found that the E&Y documents fell into the former category, as they were “specifically aimed at addressing the urgent circumstances arising from the need for refinancing and restructuring and [were] necessarily geared to an anticipated audit and subsequent litigation, which was on this record highly likely.”28

The appellate court rejected the district court’s view that E&Y provided advice that they were “ethically and legally required to give…even in the absence of anticipated litigation,” finding that no law or regulation required the “highly detailed, litigation-focused analysis and advice” contained in E&Y’s memorandum.29 The court also found that “[t]he size of a transaction and the complexity and ambiguity of the appropriate tax treatment are important variables that govern the probability of the IRS’s heightened scrutiny and, therefore, the likelihood of litigation,” and concluded that the district court’s implication that “tax analyses and opinions created to assist in complex transactions with uncertain tax consequences can never have work-product protection” was inconsistent with Adlman.30

Conclusion

The Second Circuit’s recent decisions in Highland Capital and Schaeffler are important reminders of the need to rigorously analyze claims that a taxpayer waived the attorney-client privilege or work-product protection by sharing documents with third parties. In light of these decisions, practitioners representing taxpayers in audits need to carefully consider whether they can assert a privilege notwithstanding the fact that a document may be found in a third party’s files.

6. Id. at 57-58.

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10. Id. at 11.
13. Highland Capital, 2015 WL 5692377, at *3 (citation and emphasis omitted).
14. Id.
15. 806 F.3d 34 (2d Cir. 2015).
16. Id. at 37. Pursuant to 26 U.S.C. §7525, communications between a taxpayer and an accountant may be deemed privileged. The scope and waiver of the tax practitioner privilege is "essentially coterminous with the attorney-client privilege" and can also serve as grounds to quash summons requests. See Schaeffler, 806 F.3d at 38 n.3.
17. Id. at 38.
18. Id.
20. Id. at 337-40. In reaching this conclusion, the district court noted that tax practitioners are precluded from considering the possibility that a return will go unaudited in advising clients regarding the tax consequences of transactions. Id. at 339-40 (citing Treasury Department Circular 230 §10.35(c)(3)(iii) and 26 C.F.R. §1.6694-2(b)).
22. Id. at 41.
23. Id. at 42.
24. Id.
25. Id.
26. 134 F.3d 1194 (2d Cir. 1998).
27. Schaeffler, 806 F.3d at 43-44.
28. Id. at 44.
29. Id.
30. Id. at 44-45.
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The PATH (Act) Ahead: Foreign Investors Forge Ahead with Expanded FIRPTA Relief But It’s the End of the Road for REIT Spin-Offs

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Generally, foreign investors are exempt from U.S. tax on the capital gain they recognize on the sale of stock or debt instruments issued by U.S. corporations (if the gain is not effectively connected with the conduct of a U.S. trade or business). Foreign investment in U.S. real property is treated differently. Since 1980, the Foreign Investment in Real Property Tax Act (FIRPTA) has required foreign investors to file a U.S. tax return and pay U.S. tax on gain from the disposition of U.S. real property interests (USRPIs), which include interests in real property and interests in corporations (including REITs) that own substantial U.S. real property. Subject to the exceptions discussed immediately below, distributions (whether liquidating or non-liquidating) by real estate investment trusts (REITs) to foreign investors of net capital gain are also subject to FIRPTA tax if attributable to the disposition by the REIT of any of its USRPIs.

Prior to the enactment of the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act), only limited exceptions to FIRPTA tax applied, specifically:

- dispositions of publicly traded REIT stock if the foreign investor (a “portfolio investor”) is a minority (five percent or less) owner;
- net capital gain distributions from a publicly traded REIT if the foreign portfolio investor owns no more than five percent of the REIT’s stock;
- dispositions of the stock of publicly traded or privately owned REITs that are “domestically controlled” (i.e., less than 50 percent owned by foreign investors); and
- dispositions of the stock of publicly traded or privately owned REITs by a foreign government that owns a non-controlling interest.

On December 18, 2015, President Obama signed the PATH Act into law. The PATH Act represents the most significant change to the taxation of foreign investment in U.S. real property since FIRPTA was enacted. The PATH Act significantly facilitates foreign investment in U.S. real estate by (i) fully exempting from FIRPTA tax “qualified” foreign pension funds that own U.S. real estate through a REIT, (ii) increasing from five percent to ten percent the amount of stock a foreign portfolio investor can own in publicly traded REITs without incurring FIRPTA tax, and (iii) permitting certain widely-held, publicly traded foreign investors to qualify for such treatment as portfolio investors in REITs.
regardless of whether the REIT is public or private. The PATH Act pays for these tax benefits in part by restricting some of the rules applicable to REITs, including a prohibition on the recent trend of corporations in industries other than real estate spinning off their real property into entities treated as REITs in tax-free transactions.

“Qualified Foreign Pension Funds” Are Exempt from FIRPTA

The PATH Act creates a new exemption from FIRPTA for qualified foreign pension funds (QFPFs). On or after December 18, 2015, any disposition of a USRPI by a QPF, or any distribution to a QPF by a REIT, is exempt from FIRPTA.

A QPF is any foreign trust, corporation, or other organization or arrangement:

- which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees of one or more employers in consideration for services rendered;
- which does not have a single participant or beneficiary with a right to more than five percent of its assets or income;
- which is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates; and
- either:
  - the contributions to such organization or arrangement are tax deductible or excluded from the gross income of such entity or taxed at reduced rates, or
  - the taxation of any investment income of such organization or arrangement is deferred or taxed at a reduced rate.

A QPF includes a foreign entity wholly-owned by a QPF.

**Observation:** There are questions as to which foreign pensions satisfy the requirements to be a QPF. The requirement that the pension fund provides benefits “to participants or beneficiaries that are current or former employees of one or more employers in consideration for services rendered” may be a significant limitation. The quoted language is taken from the definition of a “broad participation retirement fund” under the Treasury regulations for the Foreign Account Tax Compliance Act of 2010 (FATCA). Many foreign governments provide retirement benefits to citizens, regardless of whether the citizens have been employees. Accordingly, the FIRPTA exemption granted to QPFs appears to benefit only certain employer-sponsored foreign pension plans and may not benefit foreign pension plans where the right to benefits is premised on citizenship or residency rather than employment status. Each foreign pension fund needs to do its own analysis, with assistance from its tax advisors, to determine whether it qualifies as a QPF. There may be questions that cannot be resolved until the U.S. Treasury Department and Internal Revenue Service issue guidance on the PATH Act, or if Congress enacts “technical correction” legislation.

Investing through a REIT is an attractive alternative for a QPF that invests in U.S. real estate. The sale of the REIT stock, and distributions by the REIT to the QPF that are attributable to the
disposition by the REIT of its USPRIs, are exempt from FIRPTA. It is important to note that, although QFPFs are exempt from FIRPTA tax, they are not exempt from other U.S. withholding taxes. For example, a U.S. dividend withholding tax of 30 percent (subject to reduction by treaty or exempt from taxation in the case of foreign governments) continues to apply. In addition, a QFPF should be prepared to certify to the REIT stock purchaser (or the REIT) that it is a QFPF to avoid FIRPTA tax withholding.

**FIRPTA Exemption Expanded to Ten Percent Portfolio Investors**

Pre-PATH Act, if a class of a REIT’s shares were “regularly traded” on an established securities market and a foreign portfolio investor held five percent or less of that class of shares during the five-year period ending on the date of the sale (or, if shorter, the duration of the ownership of the shares), the sale of those shares would not be subject to tax under FIRPTA. In addition, pre-PATH Act, a REIT’s distributions with respect to any class of such “regularly traded” stock were not subject to tax under FIRPTA if paid to a foreign portfolio investor who held five percent or less of that class of stock at any time during the one-year period ending on the date of the distribution. Those distributions instead were treated as ordinary income dividends paid by the REIT and subject to U.S. dividend withholding tax of 30 percent (subject to reduction by treaty or exempt from taxation in the case of foreign governments). The PATH Act increases the five percent threshold in both cases for such portfolio investors to ten percent or less, effective for dispositions or distributions on or after December 18, 2015.

**Certain Widely Held, Publicly Traded Foreign Investors Are Exempt from FIRPTA**

The PATH Act creates an exemption from FIRPTA tax for REIT stock held by certain publicly traded foreign entities, such as listed Australian property trusts (Qualified Shareholders), except to the extent that a foreign investor in a Qualified Shareholder holds more than ten percent of the REIT’s stock, whether or not by reason of such investor’s ownership interest in the Qualified Shareholder. If a foreign investor in a Qualified Shareholder directly or indirectly holds more than ten percent of the REIT’s stock, then a portion of the REIT stock held by the Qualified Shareholder (based on the foreign investor’s percentage ownership of the Qualified Shareholder) is treated as a USRPI in the hands of the Qualified Shareholder and is subject to FIRPTA tax.

A Qualified Shareholder is a foreign person that:

- **either is:**
  - eligible for the benefits of a comprehensive income tax treaty with the United States and whose interests are listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty); or
  - a foreign limited partnership in a jurisdiction that has an agreement with respect to taxes with the United States and that has more than 50 percent of its limited partnership interests regularly traded on the NYSE or NASDAQ markets;

- maintains records on the identity of each person who is the direct owner of five percent or more of the interests in such foreign person; and

- meets one of the following requirements:
  - it would be eligible for a reduced rate of withholding under a comprehensive income tax treaty with the United States, even if such foreign person holds more than ten
percent of the REIT stock (for example, the U.S. tax treaties with Australia and the Netherlands);

- it is publicly traded, treated as a partnership for U.S. tax purposes, is a withholding foreign partnership and would be treated as a “United States real property holding corporation” if it were a U.S. corporation; or
- it is designated by the Secretary of the Treasury and is either (i) “fiscally transparent” within the meaning of Section 894 of the Internal Revenue Code or (ii) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.

If a Qualified Shareholder owns REIT stock and no foreign investor in the Qualified Shareholder directly or indirectly owns more than ten percent of the REIT stock (for example, the Qualified Shareholder is widely held and the foreign investors in the Qualified Shareholder do not own the REIT stock other than through the Qualified Shareholder), the Qualified Shareholder may own and dispose of the REIT stock without the application of FIRPTA tax. That exemption applies regardless of whether the REIT stock is publicly traded and regardless of whether the REIT is “domestically controlled.” Thus, certain widely-held, publicly traded foreign entities can make investments in U.S. real estate through private REITs and will not be subject to tax under FIRPTA on gain on the sale of the REIT stock.

A special rule applies to certain REIT distributions that are treated as sales or exchanges of REIT stock with respect to a Qualified Shareholder (for example, if a REIT makes a liquidating distribution to a Qualified Shareholder). In that case, if there are foreign investors in the Qualified Shareholder that own directly or indirectly more than ten percent of the REIT stock, then a portion of the REIT stock held by the Qualified Shareholder is subject to FIRPTA tax as described above. In addition, in the case of any other REIT shareholder, a REIT distribution that is treated as a sale or exchange of REIT stock with respect to that other shareholder is taxed as a dividend even though it otherwise would have been taxed as capital gain to such shareholder.

“Pay Fors”

To offset the tax revenue losses from the changes to the FIRPTA rules, Congress enacted certain changes to the rules applicable to REITs that are expected to raise tax revenues. The more significant “pay fors” are described below.

- **End to Tax-Free Spinoffs Involving REITs**

The PATH Act intends to ensure that assets held by corporations are subject to corporate level taxation by eliminating tax-free spin-offs in which a REIT is either the distributing or controlled corporation. Thus, effective for distributions on or after December 7, 2015, the recent “opco-propco” REIT spin-off transactions by Penn National, Windstream and Darden are not possible on a tax-deferred basis. In these transactions, an operating company in an industry other than real estate — in this case, the gaming, telecommunications and restaurant industries, respectively — attempts to unlock value by spinning off, in a tax-free transaction, its real property into an entity that elects tax treatment as a REIT (the property company), with the REIT then leasing the real property back to the operating company. The consequence is that the REIT’s profits that it distributes to its shareholders escape taxation at the entity level.

The prohibition is effective for distributions on or after December 7, 2015 but does not apply to distributions described in private letter ruling requests initially submitted to the Internal Revenue Service on or before that date. Private letter rulings generally are made public three months after
they are received by the taxpayer who requested them, so, in time, we should know who is still eligible to do a tax-free spin-off transaction. Hilton Worldwide Holdings recently announced that it received a private letter ruling regarding an opco-propco REIT spin-off transaction involving its hotel properties.

The PATH Act clarified that a REIT may still spin off a taxable REIT subsidiary (a TRS) or a subsidiary REIT if certain requirements are satisfied, including a spin-off transaction in which the REIT holds its interest in the TRS or subsidiary REIT through its operating partnership.

- **TRS Asset Test Limit Reduced from Twenty-Five Percent to Twenty Percent**

The PATH Act reduces the percentage of a REIT’s total assets that may be securities of a TRS from twenty-five percent to twenty percent, effective for taxable years beginning after December 31, 2017.

- **FIRPTA Withholding Rate Increased from Ten Percent to Fifteen Percent**

The PATH Act increases the FIRPTA withholding rate imposed on the disposition or distribution of a USRPI (including REIT stock) from ten percent to fifteen percent, effective for dispositions/distributions after February 16, 2016. After February 16, 2016, sales of residences are subject to different FIRPTA withholding rates, summarized below:

<table>
<thead>
<tr>
<th>Amount Realized from Sale of Residence</th>
<th>FIRPTA Withholding Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not more than $300,000</td>
<td>0%</td>
</tr>
<tr>
<td>More than $300,000, but not more than $1 million</td>
<td>10%</td>
</tr>
<tr>
<td>More than $1 million</td>
<td>15%</td>
</tr>
</tbody>
</table>

THIS ARTICLE BRIEFLY SUMMARIZES CERTAIN CHANGES TO THE U.S. TAX LAWS BY THE PATH ACT. IT WAS WRITTEN BY HOGAN LOVELLS LAWYERS FOR EDUCATIONAL AND INFORMATIONAL PURPOSES ONLY AND IS NOT INTENDED, AND SHOULD NOT BE CONSTRUED, AS LEGAL ADVICE.

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