RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

“Recent developments are just like ancient history, except they happened less long ago.”

By

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American Bar Association Tax Section
January 19, 2019

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This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted — unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide an opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to us, at least) — income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.

On December 22, 2017, the President signed legislation that makes significant amendments to the Internal Revenue Code of 1986. This legislation, which became Pub. L. No. 115-97, is colloquially referred to as the Tax Cuts and Jobs Act (“TCJA”). On February 9, 2018, the President signed the Bipartisan Budget Act of 2018, Pub. L. No. 115-123, which also amended certain provisions of the Code. On March 23, 2018, the President signed the Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, which provides technical corrections to the new centralized partnership audit regime. This outline summarizes the changes in these Acts that, in our judgment, are the most important. The outline does not attempt to list the provisions of these Acts comprehensively or to explain them in detail. Readers should note that many of the TCJA changes affecting individual taxpayers are temporary and sunset for taxable years beginning after December 31, 2025, and that many provisions of the Bipartisan Budget Act of 2018 apply retroactively to 2017.

I. ACCOUNTING ........................................................................................................................................................................3
   A. Accounting Methods ..................................................................................................................................................................3
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>B.</td>
<td>Inventories</td>
<td>3</td>
</tr>
<tr>
<td>C.</td>
<td>Installment Method</td>
<td>4</td>
</tr>
<tr>
<td>D.</td>
<td>Year of Inclusion or Deduction</td>
<td>5</td>
</tr>
<tr>
<td>II.</td>
<td><strong>BUSINESS INCOME AND DEDUCTIONS</strong></td>
<td>9</td>
</tr>
<tr>
<td>A.</td>
<td>Income</td>
<td>7</td>
</tr>
<tr>
<td>B.</td>
<td>Deductible Expenses versus Capitalization</td>
<td>7</td>
</tr>
<tr>
<td>C.</td>
<td>Reasonable Compensation</td>
<td>7</td>
</tr>
<tr>
<td>D.</td>
<td>Miscellaneous Deductions</td>
<td>7</td>
</tr>
<tr>
<td>E.</td>
<td>Depreciation &amp; Amortization</td>
<td>9</td>
</tr>
<tr>
<td>F.</td>
<td>Credits</td>
<td>20</td>
</tr>
<tr>
<td>G.</td>
<td>Natural Resources Deductions &amp; Credits</td>
<td>24</td>
</tr>
<tr>
<td>H.</td>
<td>Loss Transactions, Bad Debts, and NOLs</td>
<td>26</td>
</tr>
<tr>
<td>I.</td>
<td>At-Risk and Passive Activity Losses</td>
<td>26</td>
</tr>
<tr>
<td>III.</td>
<td><strong>INVESTMENT GAIN AND INCOME</strong></td>
<td>26</td>
</tr>
<tr>
<td>A.</td>
<td>Gains and Losses</td>
<td>27</td>
</tr>
<tr>
<td>B.</td>
<td>Interest, Dividends, and Other Current Income</td>
<td>28</td>
</tr>
<tr>
<td>C.</td>
<td>Profit-Seeking Individual Deductions</td>
<td>32</td>
</tr>
<tr>
<td>D.</td>
<td>Section 121</td>
<td>32</td>
</tr>
<tr>
<td>E.</td>
<td>Section 1031</td>
<td>32</td>
</tr>
<tr>
<td>F.</td>
<td>Section 1033</td>
<td>33</td>
</tr>
<tr>
<td>G.</td>
<td>Section 1035</td>
<td>33</td>
</tr>
<tr>
<td>H.</td>
<td>Miscellaneous</td>
<td>33</td>
</tr>
<tr>
<td>IV.</td>
<td><strong>COMPENSATION ISSUES</strong></td>
<td>33</td>
</tr>
<tr>
<td>A.</td>
<td>Fringe Benefits</td>
<td>33</td>
</tr>
<tr>
<td>B.</td>
<td>Qualified Deferred Compensation Plans</td>
<td>34</td>
</tr>
<tr>
<td>C.</td>
<td>Nonqualified Deferred Compensation, Section 83, and Stock Options</td>
<td>36</td>
</tr>
<tr>
<td>D.</td>
<td>Individual Retirement Accounts</td>
<td>39</td>
</tr>
<tr>
<td>V.</td>
<td><strong>PERSONAL INCOME AND DEDUCTIONS</strong></td>
<td>40</td>
</tr>
<tr>
<td>A.</td>
<td>Rates</td>
<td>40</td>
</tr>
<tr>
<td>B.</td>
<td>Miscellaneous Income</td>
<td>40</td>
</tr>
<tr>
<td>C.</td>
<td>Hobby Losses and § 280A Home Office and Vacation Homes</td>
<td>43</td>
</tr>
<tr>
<td>D.</td>
<td>Deductions and Credits for Personal Expenses</td>
<td>47</td>
</tr>
<tr>
<td>E.</td>
<td>Divorce Tax Issues</td>
<td>49</td>
</tr>
<tr>
<td>F.</td>
<td>Education</td>
<td>55</td>
</tr>
<tr>
<td>G.</td>
<td>Alternative Minimum Tax</td>
<td>55</td>
</tr>
<tr>
<td>VI.</td>
<td><strong>CORPORATIONS</strong></td>
<td>56</td>
</tr>
<tr>
<td>A.</td>
<td>Entity and Formation</td>
<td>57</td>
</tr>
<tr>
<td>B.</td>
<td>Distributions and Redemptions</td>
<td>57</td>
</tr>
<tr>
<td>C.</td>
<td>Liquidations</td>
<td>57</td>
</tr>
<tr>
<td>D.</td>
<td>S Corporations</td>
<td>57</td>
</tr>
<tr>
<td>E.</td>
<td>Mergers, Acquisitions and Reorganizations</td>
<td>57</td>
</tr>
<tr>
<td>F.</td>
<td>Corporate Divisions</td>
<td>58</td>
</tr>
<tr>
<td>G.</td>
<td>Affiliated Corporations and Consolidated Returns</td>
<td>58</td>
</tr>
<tr>
<td>H.</td>
<td>Miscellaneous Corporate Issues</td>
<td>58</td>
</tr>
<tr>
<td>VII.</td>
<td><strong>PARTNERSHIPS</strong></td>
<td>62</td>
</tr>
<tr>
<td>A.</td>
<td>Formation and Taxable Years</td>
<td>66</td>
</tr>
<tr>
<td>B.</td>
<td>Allocations of Distributive Share, Partnership Debt, and Outside Basis</td>
<td>66</td>
</tr>
<tr>
<td>C.</td>
<td>Distributions and Transactions Between the Partnership and Partners</td>
<td>66</td>
</tr>
<tr>
<td>D.</td>
<td>Sales of Partnership Interests, Liquidations and Mergers</td>
<td>70</td>
</tr>
<tr>
<td>E.</td>
<td>Inside Basis Adjustments</td>
<td>72</td>
</tr>
<tr>
<td>F.</td>
<td>Partnership Audit Rules</td>
<td>73</td>
</tr>
</tbody>
</table>
G. Miscellaneous

VIII. TAX SHELTERS
A. Tax Shelter Cases and Rulings
B. Identified “tax avoidance transactions”
C. Disclosure and Settlement
D. Tax Shelter Penalties

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING
A. Exempt Organizations
B. Charitable Giving

X. TAX PROCEDURE
A. Interest, Penalties, and Prosecutions
B. Discovery: Summons and FOIA
C. Litigation Costs
D. Statutory Notice of Deficiency
E. Statute of Limitations
F. Liens and Collections
G. Innocent Spouse
H. Miscellaneous

XI. WITHHOLDING AND EXCISE TAXES
A. Employment Taxes
B. Self-employment Taxes
C. Excise Taxes

XII. TAX LEGISLATION
A. Enacted

I. ACCOUNTING
A. Accounting Methods
1. Many more taxpayers now can use the cash method of accounting. The 2017 Tax Cuts and Jobs Act, § 13102, made several amendments to expand the universe of C corporations, partnerships, and businesses with inventory that can use the cash method of accounting. These amendments apply to taxable years beginning after 2017.

General Rules for C Corporations. Code § 448(a) provides as a general rule that a C corporation, or a partnership with a C corporation as a partner, cannot use the cash method of accounting. Prior to amendment by the 2017 Tax Cuts and Jobs Act, an exception in § 448(b)(3) provided that this prohibition did not apply to an entity that met the gross receipts test for all prior tax years, and § 448(c)(1) provided that an entity met the gross receipts test for a year if its average annual gross receipts (measured over the three preceding tax years) did not exceed $5 million. The legislation made two significant changes. First, the legislation removed the requirement that an entity must meet the gross receipts test for all prior tax years in order to use the cash method. Instead, under amended § 448(b)(3), the inquiry is simply whether the entity’s average annual gross receipts, measured over the three preceding tax years, were below a specified limit. Second, the legislation increased the $5 million limit to $25 million. Accordingly, a C corporation, or a partnership with a C corporation as a partner, can use the cash method of accounting for a year if its average annual gross receipts, measured over the three prior years, do not exceed $25 million.

Farming C Corporations. Under Code § 447(a), taxable income from farming of a C corporation (or a partnership with a C corporation as a partner) engaged in the trade or business of farming must be determined using the accrual method of accounting. Prior to amendment by the 2017 Tax Cuts and Jobs Act, § 447(c)(2) provided that that this requirement did not apply if the C corporation met the gross receipts test specified in § 447(d). This gross receipts test required that, for all prior tax years,
the C corporation’s gross receipts must not have exceeded $1 million ($25 million in the case of family corporations). The legislation amended § 447(c)(2) to apply the same gross receipts test (in § 448(c)) that applies to C corporations generally. Pursuant to this amendment, a C corporation (or a partnership with a C corporation as a partner) engaged in the trade or business of farming can use the cash method of accounting for a year if its average annual gross receipts, measured over the three prior years, do not exceed $25 million.

**Businesses with Inventory.** Under § 471(c)(1)(A) as amended by the 2017 Tax Cuts and Jobs Act, a business that meets the gross receipts test of § 448(c) (average annual gross receipts, measured over the three prior years, do not exceed $25 million) can use the cash method of accounting even if inventories are a material income-producing factor. Thus, even if a C corporation has inventory, as long as it meets the gross receipts test, it can use the cash method of accounting.

**Inflation Adjustment.** According to § 448(c)(4), as amended by the 2017 Tax Cuts and Jobs Act, the $25 million figure used for purposes of the average gross receipts test will be adjusted for inflation (rounded to the nearest million) for taxable years beginning after 2018.

**Change in Method of Accounting.** A business that changes from the accrual method to the cash method to take advantage of the new rules will have a change in method of accounting. According to §§ 447(d) and 448(d)(7), these changes in method of accounting are treated as made with the consent of the IRS. Presumably, the IRS will issue automatic change procedures to facilitate such changes.

- **Guidance on changing from accrual to cash method.** In Rev. Proc. 2018-40, 2018-34 I.R.B. 320 (08/06/18), the IRS provided the procedures by which eligible taxpayers (referred to as “small business taxpayers”) may obtain automatic consent to change their method of accounting from the accrual to the cash method pursuant to the changes enacted in the 2017 Tax Cuts and Jobs Act.

2. **Congress has expanded the small construction contract exception to the percentage-of-completion method of accounting.** Generally, § 460(a) requires taxpayers to account for long-term contracts using the percentage-of-completion method of accounting. An exception exists, commonly known as the “small construction contract” exception, pursuant to which a taxpayer need not use the percentage-of-completion method for construction contracts if (1) at the time the contract is entered into, the taxpayer expects the contract to be completed within the two-year period beginning on the contract commencement date, and (2) the taxpayer’s average annual gross receipts (measured over the three taxable years preceding the taxable year in which such contract is entered into) do not exceed a specified limit. Prior to amendment by the 2017 Tax Cuts and Jobs Act, § 460(e)(1)(B)(ii) provided that that this limit was $10 million. Section 13102 of the legislation amended Code § 460(e)(1)(B)(ii) to provide that the test used for purposes of the second part of the small construction contract exception is the gross receipts test of § 448(c) (average annual gross receipts, measured over the three prior years, do not exceed $25 million). This change applies to contracts entered into after December 31, 2017, in taxable years ending after that date. Any change in method of accounting that a taxpayer makes pursuant to this new rule is treated, according to § 460(e)(2)(B), as made with the consent of the IRS and must be effected on a cut-off basis for all similarly classified contracts entered into on or after the year of change.

- **Guidance on changing methods of accounting for long-term construction contracts and home construction contracts.** In Rev. Proc. 2018-40, 2018-34 I.R.B. 320 (08/06/18), the IRS provided the procedures by which eligible taxpayers (referred to as “small business taxpayers”) may obtain automatic consent to (1) change their method of accounting for exempt long-term construction contracts described in § 460(e)(1)(B) from the percentage-of-completion method of accounting described in Reg. § 1.460-4(b) to an exempt contract method of accounting described in Reg. § 1.460-4(c), or (2) stop capitalizing costs under § 263A for home construction contracts defined in § 460(e)(1)(A).

**B. Inventories**

1. **Simplified inventory accounting for small businesses.** Under § 471(a) and Reg. § 1.471-1, taxpayers for whom the production, purchase, or sale of merchandise is an income-producing factor must account for inventories. Generally, under Reg. § 1.446-1(c)(2), when the use of inventories is necessary to clearly reflect income, a taxpayer must use the accrual method for purchases and sales. The 2017 Tax Cuts and Jobs Act, § 13102, redesignated § 471(c) as § 471(d) and added new
§ 471(c). New § 471(c) provides that taxpayers meeting the gross receipts test of § 448(c) (average annual gross receipts, measured over the three prior years, do not exceed $25 million) are not required to account for inventories under § 471. Instead, such taxpayers can use a method of accounting for inventories that either (1) treats inventories as non-incidental materials and supplies, or (2) conforms to the taxpayer’s financial accounting treatment of inventories (either in an “applicable financial statement” as defined in § 451(b)(3) or in the taxpayer’s books and records). This rule applies to taxable years beginning after 2017. Any change in method of accounting that a taxpayer makes pursuant to this new rule is treated, according to § 471(c)(4), as made with the consent of the IRS. Presumably, the IRS will issue automatic change procedures to facilitate such changes.

- **Guidance on accounting method changes for inventory.** In Rev. Proc. 2018-40, 2018-34 I.R.B. 320 (08/06/18), the IRS provided the procedures by which eligible taxpayers (referred to as “small business taxpayers”) may obtain automatic consent to change their method of accounting to treat inventory as non-incidental materials and supplies under Reg. § 1.162-3 pursuant to the changes enacted in the 2017 Tax Cuts and Jobs Act.

**C. Installment Method**

**D. Year of Inclusion or Deduction**

1. An expanded exception to the uniform capitalization rules for small businesses. The 2017 Tax Cuts and Jobs Act, § 13102, redesignated Code § 263A(i) as § 263A(j) and added new § 263A(i). New § 263A(i) excludes from the uniform capitalization rules of § 263A any taxpayers meeting the gross receipts test of § 448(c) (average annual gross receipts, measured over the three prior years, do not exceed $25 million). In the case of a taxpayer other than a corporation or a partnership, the gross receipts test is applied as if each trade or business of the taxpayer were a corporation or partnership. This exclusion is broader than one that existed before this change. Prior to this amendment, taxpayers that produced property and those that acquired property for resale generally were subject to § 263A, but an exception existed for taxpayers acquiring property for resale with average annual gross receipts that did not exceed $10 million. Under new § 263A(i), all taxpayers (other than tax shelters), including those that produce property, with average annual gross receipts that do not exceed $25 million, are not subject to the uniform capitalization rules. This provision applies to taxable years beginning after 2017. Any change in method of accounting that a taxpayer makes pursuant to this new rule is treated, according to § 263A(i)(3), as made with the consent of the IRS. Presumably, the IRS will issue automatic change procedures to facilitate such changes.

- **Guidance on accounting method changes for exception from requirement to capitalize costs under § 263A.** In Rev. Proc. 2018-40, 2018-34 I.R.B. 320 (08/06/18), the IRS provided the procedures by which eligible taxpayers (referred to as “small business taxpayers”) may obtain automatic consent to change their method of accounting from capitalizing costs under § 263A to a method of accounting that no longer capitalizes costs under § 263A (including costs for self-constructed assets), pursuant to § 263A(i) as enacted by the 2017 Tax Cuts and Jobs Act.

2. Accrual-method taxpayers may have to recognize income sooner as a result of legislative changes. The 2017 Tax Cuts and Jobs Act, § 13221, amended Code § 451 to make two changes that affect the recognition of income and the treatment of advance payments by accrual method taxpayers. Both changes apply to taxable years beginning after 2017. Any change in method of accounting required by these amendments for taxable years beginning after 2017 is treated as initiated by the taxpayer and made with the consent of the IRS.

   All events test linked to revenue recognition on certain financial statements. The legislation amended Code § 451 by redesignating § 451(b) through (i) as § 451(d) through (k) and adding a new § 451(b). New § 451(b) provides that, for accrual-method taxpayers, “the all events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in” either (1) an applicable financial statement, or (2) another financial statement specified by the IRS. Thus, taxpayers subject to this rule must include an item in income for tax purposes upon the earlier of satisfaction of the all events test or recognition of the revenue in an applicable financial statement (or other specified financial statement). According to the Conference Report that accompanied the legislation, this means, for example, that
any unbilled receivables for partially performed services must be recognized to the extent the amounts are taken into income for financial statement purposes. Income from mortgage servicing contracts is not subject to the new rule. The new rule also does not apply to a taxpayer that does not have either an applicable financial statement or another specified financial statement. An “applicable financial statement” is defined as (1) a financial statement that is certified as being prepared in accordance with generally accepted accounting principles that is (a) a 10-K or annual statement to shareholders required to be filed with the Securities and Exchange Commission, (b) an audited financial statement used for credit purposes, reporting to shareholders, partners, other proprietors, or beneficiaries, or for any other substantial nontax purpose, or (c) filed with any other federal agency for purposes other than federal tax purposes; (2) certain financial statements made on the basis of international financial reporting standards and filed with certain agencies of a foreign government; or (3) a financial statement filed with any other regulatory or governmental body specified by IRS.

Advance payments for goods or services. The legislation amended Code § 451 by redesignating § 451(b) through (i) as § 451(d) through (k) and adding a new § 451(c). This provision essentially codifies the deferral method of accounting for advance payments reflected in Rev. Proc. 2004-34, 2004-22 I.R.B. 991. New § 451(c) provides that an accrual-method taxpayer who receives an advance payment can either (1) include the payment in gross income in the year of receipt, or (2) elect to defer the category of advance payments to which such advance payment belongs. If a taxpayer makes the deferral election, then the taxpayer must include in gross income any portion of the advance payment required to be included by the applicable financial statement rule described above, and include the balance of the payment in gross income in the taxable year following the year of receipt. An advance payment is any payment: (1) the full inclusion of which in gross income for the taxable year of receipt is a permissible method of accounting (determined without regard to this new rule), (2) any portion of which is included in revenue by the taxpayer for a subsequent taxable year in applicable financial statement (as previously defined) or other financial statement specified by the IRS, and (3) which is for goods, services, or such other items as the IRS may identify. The term “advance payment” does not include several categories of items, including rent, insurance premiums, and payments with respect to financial instruments.

3. Let’s hope this tax services firm has more success on behalf of its clients. Amounts received from customers had to be included in income despite a promise to return the funds if the taxpayer did not obtain a successful result, and costs incurred on behalf of clients were not deductible, RJ Channels, Inc. v. Commissioner, T.C. Memo. 2018-27 (3/14/18). The taxpayer, a subchapter C corporation that used the accrual method of accounting, provided return preparation and other tax services. The taxpayer received payments from two different clients. It received approximately $215,000 in its taxable year ending May 31, 2012, and $153,000 in its taxable year ending May 31, 2013. The taxpayer represented to each client that, if it were unable to obtain a favorable result for the client through its provision of tax services, it would return the payment to the client. The taxpayer deposited the payments in its bank account and was able to use the funds without restriction. The taxpayer did not return either payment to the client and did not include either payment in gross income for the years in which it had received them. During its taxable year ending May 31, 2012, the taxpayer deducted certain costs it had paid on behalf of clients. The taxpayer characterized these amounts as “Legal and Professional Fees” and as “Taxes.” The clients later reimbursed the taxpayer for these costs. The IRS issued a notice of deficiency with respect to the taxpayer’s 2012 and 2013 tax years in which it included in the taxpayer’s gross income the payments it had received from clients and disallowed the taxpayer’s deduction of the costs paid on behalf of clients. The Tax Court (Judge Chiechi) ruled in favor of the IRS on both issues. With respect to the issue whether the payments received from clients were includible in income, the court characterized the question not as whether the payments should be included in income, but when the payments should be included in income. The court cited Schlude v. Commissioner, 372 U.S. 128 (1963), and Charles Schwab Corp. v. Commissioner, 107 T.C. 282 (1996), for the proposition that

[the right of a taxpayer on the accrual method of accounting to receive income is fixed upon the earliest of (1) the taxpayer’s receipt of payment, (2) the contractual due date of the payment, or (3) the taxpayer’s performance.]
The court also referred to the claim of right doctrine, under which a taxpayer that receives funds under a claim of right must include them in gross income in the year of receipt, even though the taxpayer might not be entitled to retain the funds and might be liable to return them. See North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932). The court characterized the taxpayer’s obligation to return the payments to its clients as a condition subsequent (rather than a condition precedent). Under this view, the taxpayer did not have a current obligation to return the funds, and under Schlude and Charles Schwab, was required to include them in gross income in the year of receipt. With respect to the issue whether the taxpayer could deduct amounts it had paid on behalf of clients, the court cited relied on Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943), as well as other authorities, for the proposition that amounts a taxpayer pays for the obligations of another taxpayer are not ordinary and necessary expenses within the meaning of § 162(a).

- With respect to the issue whether the taxpayer had to include the payments from clients in its gross income, the court rejected the taxpayer’s reliance on Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990), as “inapposite.” In Indianapolis Power, the Court held that amounts a utility company had received from customers were deposits, rather than advance payments, and therefore were not included in the taxpayer’s income. The Court in Indianapolis Power emphasized that the utility had an obligation to return the amounts it had received, and that the timing and amount of any refund were within the customer’s control. The Tax Court characterized Indianapolis Power as inapposite because it addressed the question whether the amounts received by the taxpayer constituted income, rather than when the amounts received constituted income.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. When we said tangible personal property, we really meant tangible personal property, says Congress. Under § 74(c), an employee can exclude from gross income the value of an “employee achievement award,” and the employer’s deduction for such an award is limited by § 274(j)(1). An employee achievement award is defined in § 274(j)(3)(A)(i) as an item of tangible personal property transferred by an employer to an employee that is awarded as part of a meaningful presentation and under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation. The 2017 Tax Cuts and Jobs Act, § 13310, amended Code § 274(j) to add a definition of “tangible personal property” in new § 274(j)(3)(A)(ii). Under this definition, the term “tangible personal property” does not include either (1) cash, cash equivalents, gift cards, gift coupons, or gift certificates, or (2) vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items. Despite this definition, arrangements can qualify as an employee achievement award if they “confer only the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer.” This provision applies to amounts paid or incurred after 2017.

B. Deductible Expenses versus Capitalization

1. Required amortization of specified research or experimental expenditures incurred after 2021. The 2017 Tax Cuts and Jobs Act, § 13206, amended Code § 174 to require the capitalization and amortization of specified research or experimental expenditures. The amortization period is 5 years (15 years for expenditures attributable to foreign research), beginning at the midpoint of the year in which the expenditures are paid or incurred. The term “specified research or experimental expenditures” is defined as research or experimental expenditures paid or incurred by the taxpayer during a taxable year in connection with the taxpayer’s trade or business. The term includes expenditures for software development. This rule applies to amounts paid or incurred in taxable years beginning after 2021.

C. Reasonable Compensation

1. Could we see compensation levels of top corporate officers actually decline? Code § 162(m) limits to $1 million the deduction of publicly traded corporations for compensation to covered employees (generally, certain top corporate officers). Certain types of compensation are not subject to this limit and are not taken into account in determining whether compensation exceeds $1 million, including remuneration payable (1) on a commission basis, or (2) solely on account of
attainment of one or more performance-based goals if certain approval requirements are met (“performance-based compensation”). The 2017 Tax Cuts and Jobs Act, § 13601, amended Code § 162(m) to eliminate the exceptions for commissions and performance-based compensation. Accordingly, such compensation must be taken into account in determining the amount of compensation with respect to a covered employee for a taxable year that exceeds $1 million and therefore is not deductible. The legislation also amended the definition of “covered employee” in four ways: (1) the statutory definition now includes the principal executive officer and principal financial officer (whereas formerly the statutory definition referred only to the chief executive officer), (2) the definition includes persons who served as principal executive officer or principal financial officer at any time during the taxable year (rather than at the end of the year), (3) the definition includes officers whose compensation must be reported to shareholders under the Securities Exchange Act of 1934 by reason of their being among the three highest compensated officers (rather than four highest compensated officers), and (4) the definition now includes a person who was a covered employee for any preceding taxable year beginning after 2016 (which means the limit applies to compensation paid after termination of employment or after the employee’s death). Finally, the legislation expands the category of corporations subject to the § 162(m) limit by defining “publicly traded corporation” to include foreign corporations publicly traded through American depositary receipts (ADRs) and certain large private corporations and S corporations. These changes apply to taxable years beginning after 2017. A transition rule provides that the changes do not apply to remuneration provided pursuant to a written binding contract that was in effect on November 2, 2017 as long as the contract is not materially modified after that date. Compensation provided pursuant to a renewal of a grandfathered contract is subject to the new rules.

a. Initial guidance on amended § 162(m). Notice 2018-68, 2018-36 I.R.B. 418 (8/21/18). The IRS has provided guidance on certain aspects of the amendments made to § 162(m) by the 2017 Tax Cuts and Jobs Act. Very generally, the notice addresses the amended rules for identifying covered employees and the operation of the grandfather rule for remuneration provided pursuant to a written binding contract that was in effect on November 2, 2017, including when such a contract will be considered materially modified so that it is no longer grandfathered. Treasury and the IRS expect to issue proposed regulations under § 162(m) that will incorporate the guidance provided in this notice.

D. Miscellaneous Deductions

1. Standard mileage rates for 2018. Notice 2018-3, 2018-2 I.R.B. 285 (12/14/17). The standard mileage rate for business miles in 2018 goes up to 54.5 cents per mile (from 53.5 cents in 2017) and the medical/moving rate goes up to 18 cents per mile (from 17 cents in 2017). The charitable mileage rate remains fixed by § 170(i) at 14 cents. The portion of the business standard mileage rate treated as depreciation is 25 cents per mile for 2018 (unchanged from 2017).

a. Minor changes to reflect the 2017 Tax Cuts and Jobs Act. Notice 2018-42, 2018-24 I.R.B. 750 (5/25/18). This notice modifies Notice 2018-3, 2018-2 I.R.B. 285 (12/14/17) to reflect changes made by Congress in the 2017 Tax Cuts and Jobs Act. Specifically, the notice clarifies that (1) the business standard mileage rate listed in Notice 2018-3 cannot be used to claim an itemized deduction for unreimbursed employee travel expenses because Congress disallowed miscellaneous itemized deductions for 2018, and (2) the standard mileage rate for moving is not applicable for the use of an automobile as part of a move because Congress disallowed the deduction of moving expenses for 2018 (except for members of the military on active duty who move pursuant to military orders incident to a permanent change of station, who can still use the standard mileage rate for moving). The notice also modifies Notice 2018-3 to reflect the 2017 Tax Cuts and Jobs Act’s increase to the depreciation limitations for passenger automobiles placed in service after December 31, 2017. Notice 2018-3 had identified a maximum standard automobile cost of $27,300 for passenger automobiles and $31,000 for trucks and vans for purposes of computing the allowance under a fixed and variable rate (FAVR) plan. This notice provides that the maximum standard automobile cost may not exceed $50,000 for passenger automobiles (including trucks and vans) placed in service after December 31, 2017.

2018) and the medical/moving rate goes up to 20 cents per mile (from 18 cents in 2018). The charitable mileage rate remains fixed by § 170(i) at 14 cents. The portion of the business standard mileage rate treated as depreciation goes up to 26 cents per mile for 2019 (from 25 cents in 2018). The maximum standard automobile cost may not exceed $50,400 (up from $50,000 in 2018) for passenger automobiles (including trucks and vans) for trucks and vans for purposes of computing the allowance under a fixed and variable rate (FAVR) plan.

- The notice reminds taxpayers that (1) the business standard mileage rate cannot be used to claim an itemized deduction for unreimbursed employee travel expenses because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed miscellaneous itemized deductions for 2019, and (2) the standard mileage rate for moving has limited applicability for the use of an automobile as part of a move during 2019 because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed the deduction of moving expenses for 2019 (except for members of the military on active duty who move pursuant to military orders incident to a permanent change of station, who can still use the standard mileage rate for moving).

3. **Oh, come on! No more deductions for taking a client to a professional sports game?** The 2017 Tax Cuts and Jobs Act, § 13304, amended Code § 274(a) to disallow deductions for costs “[w]ith respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation.” Similarly, no deduction is allowed for membership dues with respect to any club organized for business, pleasure, recreation or other social purposes. This rule applies to taxable years beginning after 2017.

- **What is “entertainment”?** Regulations issued before the Tax Cuts and Jobs Act (Reg. § 1.274-2(b)(1)) provide that whether an activity constitutes entertainment is determined using an objective test and set forth the following definition of the term “entertainment”:

  [T]he term “entertainment” means any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family. The term “entertainment” may include an activity, the cost of which is claimed as a business expense by the taxpayer, which satisfies the personal, living, or family needs of any individual, such as providing food and beverages, a hotel suite, or an automobile to a business customer or his family. The term “entertainment” does not include activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as (a) supper money provided by an employer to his employee working overtime, (b) a hotel room maintained by an employer for lodging of his employees while in business travel status, or (c) an automobile used in the active conduct of trade or business even though used for routine personal purposes such as commuting to and from work. Reg. § 1.274-2(b)(1).

- The complete disallowance of deductions for costs of activities of a type generally considered to constitute entertainment will give rise to some difficult issues. Activities can be thought of as falling on a spectrum. At one end of the spectrum are activities that clearly are not entertainment. At the other end are activities that clearly are entertainment. The difficult issues will arise for the many activities that fall somewhere in the middle, as illustrated by the following examples.

**Example 1:** A self-employed CPA travels out of town to perform an audit. The CPA flies to the client’s location and stays at a hotel for several days. While there, the CPA buys breakfast, lunch, and dinner each day. The meals are not “entertainment” and therefore are not subject to disallowance under amended § 274(a). They are, however, subject to the 50 percent limitation of § 274(n)(1).

**Example 2:** A self-employed attorney invites a client to attend a professional sports game and pays the entire cost associated with attending. The cost of attending will be regarded as entertainment and therefore not deductible.

**Example 3:** The client of a self-employed attorney spends the day in the attorney’s office to review strategy for an upcoming IRS Appeals conference. They take a break
for lunch at a restaurant down the street. During lunch, they continue their discussion.
The attorney pays for the meal. Is the meal nondeductible “entertainment”? Or is it (at least in part) a deductible business expense subject to the 50 percent limitation of § 274(n)(1)?

a. Business meals are not “entertainment” and are still deductible subject to the normal 50 percent limitation, says the IRS. Notice 2018-76, 2018-42 I.R.B. 599 (10/3/18). In this notice, the IRS announced that Treasury and the IRS will issue proposed regulations under § 274 that will include guidance on the deductibility of expenses for certain business meals. According to the notice, the 2017 TCJA did not change the definition of “entertainment” under § 274(a)(1), and therefore the regulations under § 274(a)(1) that define entertainment continue to apply. Further, the notice states that, although the 2017 TCJA did not address the circumstances in which the provision of food and beverages might constitute entertainment, its legislative history “clarifies that taxpayers generally may continue to deduct 50 percent of the food and beverage expenses associated with operating their trade or business.” The notice provides that, until proposed regulations are issued, taxpayers can rely on this notice and can deduct 50 percent of an otherwise allowable business meal expense if five requirements are met: (1) the expense is an ordinary and necessary expense under § 162(a) paid or incurred during the taxable year in carrying on any trade or business; (2) the expense is not lavish or extravagant under the circumstances; (3) the taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages; (4) the food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact; and (5) in the case of food and beverages provided during or at an entertainment activity, the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The notice also provides that the entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages. The notice provides the following examples:

Example 1.

1. Taxpayer A invites B, a business contact, to a baseball game. A purchases tickets for A and B to attend the game. While at the game, A buys hot dogs and drinks for A and B.

   2. The baseball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets is an entertainment expense and is not deductible by A. The cost of the hot dogs and drinks, which are purchased separately from the game tickets, is not an entertainment expense and is not subject to the § 274(a)(1) disallowance. Therefore, A may deduct 50 percent of the expenses associated with the hot dogs and drinks purchased at the game.

Example 2.

1. Taxpayer C invites D, a business contact, to a basketball game. C purchases tickets for C and D to attend the game in a suite, where they have access to food and beverages. The cost of the basketball game tickets, as stated on the invoice, includes the food and beverages.

   2. The basketball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets is an entertainment expense and is not deductible by C. The cost of the food and beverages, which are not purchased separately from the game tickets, is not an entertainment expense and is not stated separately on the invoice. Thus, the cost of the food and beverages also is an entertainment expense that is subject to the § 274(a)(1) disallowance. Therefore, C may not deduct any of the expenses associated with the basketball game.

Example 3.

1. Assume the same facts as in Example 2, except that the invoice for the basketball game tickets separately states the cost of the food and beverages.

   2. As in Example 2, the basketball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expense and is not deductible by C. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets, is not an entertainment expense and is not subject to
the § 274(a)(1) disallowance. Therefore, C may deduct 50 percent of the expenses associated with the food and beverages provided at the game.

4. And no more deductions for employers for most qualified transportation fringe benefits such as employer-paid parking. The 2017 Tax Cuts and Jobs Act, § 13304(c), amended Code § 274(a) by adding § 274(a)(4), which provides that, for amounts paid or incurred after 2017, no deduction is allowed for any “qualified transportation fringe” (as defined in § 132(f)) provided to an employee of the taxpayer. A qualified transportation fringe is any of the following provided by an employer to an employee: (1) transportation in a commuter highway vehicle in connection with travel between the employee’s residence and place of employment, (2) any transit pass, (3) qualified parking, and (4) any qualified bicycle commuting reimbursement. Further, the legislation added new § 274(l), which provides:

1. General Rule. No deduction shall be allowed under this chapter for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee’s residence and place of employment, except as necessary for ensuring the safety of the employee.

2. Exception. In the case of any qualified bicycle commuting reimbursement (as described in section 132(f)(5)(F)), this subsection shall not apply for any amounts paid or incurred after December 31, 2017, and before January 1, 2026.

Effect on Employers. Under § 274 as amended, an employer cannot deduct the cost of transportation in a commuter highway vehicle, a transit pass, or qualified parking paid or incurred after 2017. However, the employer can deduct the cost of a qualified bicycle commuting reimbursement paid or incurred after 2017 and before 2026.

Effect on Employees. With one exception, the legislation did not change the tax treatment of employees with respect to qualified transportation fringes. Employees can still (as under prior law) exclude from gross income (subject to applicable limitations) any of the following provided by an employer: (1) transportation in a commuter highway vehicle in connection with travel between the employee’s residence and place of employment, (2) any transit pass, or (3) qualified parking. The exception is a qualified bicycle commuting reimbursement, which, under new § 132(f)(8), must be included in an employee’s gross income for taxable years beginning after 2017 and before 2026.

a. Guidance on determining the nondeductible portion of the cost of employer-provided parking. Notice 2018-99, 2018-52 I.R.B. 1067 (12/10/18). In this notice, the IRS announced that Treasury and the IRS will issue proposed regulations under § 274 that will include guidance on determining nondeductible parking expenses and other expenses for qualified transportation fringes (and also the calculation of increased unrelated business taxable income (UBTI) of tax-exempt organizations that provide qualified transportation fringes). Until further guidance is issued, employers that own or lease parking facilities where their employees park can rely on interim guidance provided in the notice to determine the nondeductible portion of parking expenses under § 274(a)(4) and the corresponding increase in the amount of UBTI under § 512(a)(7) attributable to nondeductible parking expenses.

Employer Pays a Third Party for Employee Parking Spots. According to the notice, in situations in which an employer pays a third party an amount so that employees may park at the third party’s parking lot or garage, the amount disallowed by § 274(a)(4) generally is the taxpayer’s total annual cost of employee parking paid to the third party. Nevertheless, if the amount paid by the employer exceeds the § 132(f)(2) monthly limitation on exclusion ($260 for 2018 and $265 for 2019), the employer must treat the excess amount as compensation and wages to the employee. Accordingly, the excess amount is not disallowed as a deduction pursuant to § 274(e)(2), which provides that § 274(a) does not disallow as a deduction expenses for goods, services, and facilities to the extent the taxpayer treats the expenses as wages to its employees. The result is that the employer can deduct the monthly cost of parking provided to an employee to the extent the cost exceeds the § 132(f)(2) monthly limitation. These rules are illustrated by examples 1 and 2 in the notice.
Taxpayer Owns or Leases All or a Portion of a Parking Facility. The notice provides that, until further guidance is issued, if a taxpayer owns or leases all or a portion of one or more parking facilities where employees park, the nondeductible portion of the cost of providing parking can be calculated using any reasonable method. The notice provides a four-step methodology that is deemed to be a reasonable method. The notice cautions that, because § 274(a)(4) disallows a deduction for the expense of providing a qualified transportation fringe, using the value of employee parking to determine expenses allocable to employee parking is not a reasonable method. For purposes of the notice, the term “total parking expenses,” a portion of which is disallowed, does not include a deduction for depreciation on a parking structure used for parking by the taxpayer’s employees, but does include, without limitation, “repairs, maintenance, utility costs, insurance, property taxes, interest, snow and ice removal, leaf removal, trash removal, cleaning, landscape costs, parking lot attendant expenses, security, and rent or lease payments or a portion of a rent or lease payment.” Under the four-step methodology provided in the notice, employers can determine the nondeductible portion of parking costs by: (1) determining the percentage of parking spots that are reserved employee spots and treating that percentage of total parking expenses as disallowed; (2) determining whether the primary use of the remaining spots (greater than 50 percent actual or estimated usage) is providing parking to the general public, in which case the remaining portion of total parking expenses is not disallowed by § 274(a)(4); (3) if the primary use of the remaining parking spots (from step 2) is not to provide parking to the general public, identifying the number of remaining spots exclusively reserved for nonemployees, including visitors, customers, partners, sole proprietors, and 2-percent shareholders of S Corporations and treating this percentage of total parking expenses as not disallowed by § 274(a)(4); and (4) if there are any remaining parking expenses not specifically categorized as deductible or nondeductible after completing steps 1-3, reasonably determining “the employee use of the remaining parking spots during normal business hours on a typical business day … and the related expenses allocable to employee parking spots.” This four-step methodology is illustrated by examples 3 through 8 in the notice.

5. Rats! We knew that we should have been architects or engineers instead of tax advisors. The 2017 Tax Cuts and Jobs Act, § 11011, added § 199A, thereby creating an unprecedented, new deduction for trade or business (and certain other) income earned by sole proprietors, partners of partnerships (including members of LLCs taxed as partnerships or as sole proprietorships), and shareholders of S corporations. The Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, Division T, § 101 (“CAA 2018”), signed by the President on March 23, 2018, amended § 199A principally to address issues related to agricultural or horticultural cooperatives. New § 199A is intended to put owners of flow-through entities (but also including sole proprietors) on par with C corporations that will benefit from the new reduced 21% corporate tax rate; however, in our view, the new provision actually makes many flow-through businesses even more tax-favored than they were under pre-TCJA law.

Big Picture. Oversimplifying a bit to preserve our readers’ (and the authors’) sanity, new § 199A essentially grants a special 20 percent deduction for “qualified business income” (principally, trade or business income, but not wages) of certain taxpayers (but not most personal service providers except those falling below an income threshold). In effect, then, new § 199A reduces the top marginal rate of certain taxpayers with respect to their trade or business income (but not wages) by 20 percent (i.e., the maximum 37 percent rate becomes 29.6 percent on qualifying business income assuming the taxpayer is not excluded from the benefits of the new statute). Most high-earning (over $415,000 taxable income if married filing jointly) professional service providers (including lawyers, accountants, investment advisors, physicians, etc., but not architects or engineers) are excluded from the benefits of new § 199A. Of course, the actual operation of new § 199A is considerably more complicated, but the highlights (lowlights?) are as summarized above.

Effective dates. Section 199A applies to taxable years beginning after 2017 and before 2026.

Initial Observations. Our initial, high-level observations of new § 199A are set forth below:

1. How § 199A applies. New § 199A is applied at the individual level of any qualifying taxpayer by first requiring a calculation of taxable income excluding the deduction allowed by § 199A and then allowing a special deduction of 20 percent of qualified business income against
taxable income to determine a taxpayer’s ultimate federal income tax liability. Thus, the deduction is not an above-the-line deduction allowed in determining adjusted gross income; it is a deduction that reduces taxable income. The deduction is available both to those who itemize deductions and those who take the standard deduction. The deduction cannot exceed the amount of the taxpayer’s taxable income reduced by net capital gain. The §199A deduction applies for income tax purposes; it does not reduce self-employment taxes. Query what states that piggyback off federal taxable income will do with respect to new §199A. Presumably, the deduction will be disallowed for state income tax purposes.

2. Eligible taxpayers. Section 199A(a) provides that the deduction is available to “a taxpayer other than a corporation.” The deduction of §199A is available to individuals, estates, and trusts. For S corporation shareholders and partners, the deduction applies at the shareholder or partner level. Section 199A(f)(4) directs Treasury to issue regulations that address the application of §199A to tiered entities.

3. Qualified trades or businesses (or, what’s so special about architect and engineers?)—§199A(d). One component of the §199A deduction is 20 percent of the taxpayer’s qualified business income. To have qualified business income, the taxpayer must be engaged in a qualified trade or business, which is defined as any trade or business other than (1) the trade or business of performing services as an employee, or (2) a specified service trade or business. A specified service trade or business is defined (by reference to Code §1202(e)(3)(A)) as “any trade or business involving the performance of services in the fields of health, … law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.” Architects and engineers must be special, because they are excluded from the definition of a specified service trade or business. There is no reasoned explanation for this exclusion in the 2017 TCJA Conference Report. Note: taxpayers whose taxable income, determined without regard to the §199A deduction, is below a specified threshold are not subject to the exclusion for specified service trades or businesses, i.e., these taxpayers can take the §199A deduction even if they are doctors, lawyers, accountants etc. The thresholds are $315,000 for married taxpayers filing jointly and $157,500 for all other taxpayers. (These figures will be adjusted for inflation in years beginning after 2018.) Taxpayers whose taxable income exceeds these thresholds are subject to a phased reduction of the benefit of the §199A deduction until taxable income reaches $415,000 for joint filers and $207,500 for all other taxpayers, at which point the service business cannot be treated as a qualified trade or business.

4. Qualified business income—§199A(c). One component of the §199A deduction is 20 percent of the taxpayer’s qualified business income, which is generally defined as the net amount from a qualified trade or business of items of income, gain, deduction, and loss included or allowed in determining taxable income. Excluded from the definition are: (1) income not effectively connected with the conduct of a trade or business in the United States, (2) specified investment-related items of income, gain, deduction, or loss, (3) amounts paid to an S corporation shareholder that are reasonable compensation, (4) guaranteed payments to a partner for services, (5) to the extent provided in regulations, payments to a partner for services rendered other than in the partner’s capacity as a partner, and (6) qualified REIT dividends or qualified publicly traded partnership income (because these two categories are separate components of the §199A deduction).

5. Determination of the amount of the §199A deduction—§199A(a)-(b). Given the much-touted simplification thrust of the 2017 Tax Cuts and Jobs Act, determining the amount of a taxpayer’s §199A deduction is surprisingly complex. One way to approach the calculation is to think of the §199A deduction as the sum of two buckets, subject to one limitation. Bucket 1 is the sum of the following from all of the taxpayer’s qualified trades or businesses, determined separately for each qualified trade or business: the lesser of (1) 20 percent of the qualified trade or business income with respect to the trade or business, or (2) the greater of (a) 50 percent of the W-2 wages with respect to the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted
basis immediately after acquisition of all qualified property. *(Note: this W-2 wages and capital limitation does not apply to taxpayers whose taxable income is below the $157,500/$315,000 thresholds mentioned earlier in connection with the definition of a qualified trade or business. For taxpayers below the thresholds, Bucket 1 is simply 20 percent of the qualified trade or business income. For taxpayers above the thresholds, the wage and capital limitation phases in and fully applies once taxable income reaches $207,500/$415,000.) Bucket 2 is 20 percent of the sum of the taxpayer’s qualified REIT dividends and qualified publicly traded partnership income. The limitation is that the sum of Buckets 1 and 2 cannot exceed the amount of the taxpayer’s taxable income reduced by the taxpayer’s net capital gain. Thus, a taxpayer’s §199A deduction is determined by adding together Buckets 1 and 2 and applying the limitation.

6. **Revised rules for cooperatives and their patrons.** The Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, Division T, §101, signed by the President on March 23, 2018, amended §199A to fix what was commonly referred to as the “grain glitch.” Under §199A as originally enacted, farmers selling goods to agricultural cooperatives were permitted to claim a deduction effectively equal to 20 percent of gross sales, while farmers selling goods to independent buyers effectively could claim a deduction equal to 20 percent of net income. Some independent buyers argued that this difference created an unintended market preference for producers to sell to agricultural cooperatives. Under the amended version of §199A, agricultural cooperatives would determine their deduction under rules set forth in §199A(g) that are similar to those in old (and now repealed) section §199. The §199A deduction of an agricultural cooperative is equal to 9 percent of the lesser of (1) the cooperative’s qualified production activities income, or (2) taxable income calculated without regard to specified items. The cooperative’s §199A deduction cannot exceed 50 percent of the W-2 wages paid of the cooperative. A cooperative can pass its §199A deduction through to their farmer patrons. In addition, the legislation modified the original version of §199A to eliminate the 20-percent deduction for qualified cooperative dividends received by a taxpayer other than a corporation. Instead, under the amended statute, taxpayers are entitled to a deduction equal to the lesser of 20 percent of net income recognized from agricultural and horticultural commodity sales or their overall taxable income, subject to a wage and capital limitation.

7. **An incentive for business profits rather than wages.** Given a choice, most taxpayers who qualify for the §199A deduction would prefer to be compensated as an independent contractor (i.e., 1099 contractor) rather than as an employee (i.e., W-2 wages), unless employer-provided benefits dictate otherwise because, to the extent such compensation is “qualified business income,” a taxpayer may benefit from the 20 percent deduction authorized by §199A.

8. **The “Edwards/Gingrich loophole” for S corporations becomes more attractive.** New §199A exacerbates the games currently played by S corporation shareholders regarding minimizing compensation income (salaries and bonuses) and maximizing residual income from the operations of the S corporation. For qualifying S corporation shareholders, minimizing compensation income not only will save on the Medicare portion of payroll taxes, but also will maximize any deduction available under new §199A.

    a. **Let the games begin!** Treasury and the IRS have issued proposed regulations under §199A. REG-107892-18. Qualified Business Income, 83 F.R. 40884 (8/16/18). The Treasury Department and the IRS have published proposed regulations under §199A. The proposed regulations address the following six general areas. In addition, Prop. Reg. §1.643(f)-1 provides anti-avoidance rules for multiple trusts.

    **Operational rules.** Prop. Reg. §1.199A-1 provides guidance on the determination of the §199A deduction. The operational rules define certain key terms, including qualified business income, qualified REIT dividends, qualified publicly traded partnership income, specified service trade or business, and W-2 wages. According to Prop. Reg. §1.199A-1(b)(13), a “trade or business” is “a section 162 trade or business other than performing services as an employee.” In addition, if tangible or intangible property is rented or licensed to a trade or business that is commonly controlled (within the meaning of Prop. Reg. §1.199A-1(b)(1)(i)), then the rental or licensing activity is treated as a trade
or business for purposes of § 199A even if the rental or licensing activity would not, on its own, rise to the level of a trade or business. The operational rules also provide guidance on computation of the § 199A deduction for those with taxable income below and above the $157,500/$315,000 thresholds mentioned earlier as well as rules for determining the carryover of negative amounts of qualified business income and negative amounts of combined qualified REIT dividends and qualified publicly traded partnership income. The proposed regulations clarify that, if a taxpayer has an overall loss from combined qualified REIT dividends and qualified publicly traded partnership income, the overall loss does not affect the amount of the taxpayer’s qualified business income and instead is carried forward separately to offset qualified REIT dividends and qualified publicly traded partnership income in the succeeding year. The operational rules also provide rules that apply in certain special situations, such as Prop. Reg. § 1.199A-1(e)(1), which clarifies that the § 199A deduction has no effect on the adjusted basis of a partner’s partnership interest or the adjusted basis of an S corporation shareholder’s stock basis.

Determination of W-2 Wages and the Unadjusted Basis of Property. Prop. Reg. § 1.199A-2 provides rules for determining the amount of W-2 wages and the unadjusted basis immediately after acquisition (UBIA) of qualified property. The amount of W-2 wages and the UBIA of qualified property are relevant to taxpayers whose taxable incomes exceed the $157,500/$315,000 thresholds mentioned earlier. For taxpayers with taxable income in excess of these limits, one component of their § 199A deduction (Bucket I described earlier) is the lesser of (1) 20 percent of the qualified trade or business income with respect to the trade or business, or (2) the greater of (a) 50 percent of the W-2 wages with respect to the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the UBIA of all qualified property. The rules of Prop. Reg. § 1.199A-2 regarding W-2 wages generally follow the rules under former § 199 (the now-repealed domestic production activities deduction) but, unlike the rules under former § 199, the W-2 wage limitation in § 199A applies separately for each trade or business. The amount of W-2 wages allocable to each trade or business generally is determined according to the amount of deductions for those wages allocated to each trade or business. Wages must be “properly allocable” to qualified business income to be taken into account for purposes of § 199A, which means that the associated wage expense must be taken into account in determining qualified business income. In the case of partnerships and S corporations, a partner or S corporation shareholder’s allocable share of wages must be determined in the same manner as that person’s share of wage expenses. The proposed regulations provide special rules for application of the W-2 wage limitation to situations in which a taxpayer acquires or disposes of a trade or business. Simultaneously with the issuance of these proposed regulations, the IRS issued Notice 2018-64, 2018-35 I.R.B. 347 (8/8/18), which contains a proposed revenue procedure that provides guidance on methods for calculating W-2 wages for purposes of § 199A. The proposed regulations also provide guidance on determining the UBIA of qualified property. Prop. Reg. § 1.199A-2(c)(1) restates the statutory definition of qualified property, which is depreciable tangible property that is (1) held by, and available for use in, a trade or business at the close of the taxable year, (2) used in the production of qualified business income, and (3) for which the depreciable period has not ended before the close of the taxable year. The proposed regulations clarify that UBIA is determined without regard to both depreciation and amounts that a taxpayer elects to treat as an expense (e.g., pursuant to § 179, 179B, or 179C) and that UBIA is determined as of the date the property is placed in service. Special rules address property transferred with a principal purpose of increasing the § 199A deduction, like-kind exchanges under § 1031, involuntary conversions under § 1033, subsequent improvements to qualified property, and allocation of UBIA among partners and S corporation shareholders.

Qualified Business Income, Qualified REIT Dividends, and Qualified Publicly Traded Partnership Income. Prop. Reg. § 1.199A-3 provides guidance on the determination of the components of the § 199A deduction: qualified business income (QBI), qualified REIT dividends, and qualified publicly traded partnership (PTP) income. The proposed regulations generally restate the statutory definitions of these terms. Among other significant rules, the proposed regulations clarify that (1) gain or loss treated as ordinary income under § 751 is considered attributable to the trade or business conducted by the partnership and therefore can be QBI if the other requirements of § 199A are satisfied, (2) §1231 gain or loss is not QBI if the § 1231 “hotchpot” analysis results in these items becoming long-term capital gains and losses, and that §1231 gain or loss is QBI if the § 1231 analysis results in these items
becoming ordinary (assuming all other requirements of § 199A are met), (3) losses previously suspended under §§ 465, 469, 704(d), or 1366(d) that are allowed in the current year are treated as items attributable to the trade or business in the current year, except that such losses carried over from taxable years ending before January 1, 2018, are not taken into account in a later year for purposes of computing QBI, and (4) net operating losses carried over from prior years are not taken into account in determining QBI for the current year, except that losses disallowed in a prior year by § 461(l) (the provision enacted by the 2017 TCJA that denies excess business losses for noncorporate taxpayers) are taken into account in determining QBI for the current year.

Aggregation Rules. Prop. Reg. § 1.199A-4 permits, but does not require, taxpayers to aggregate trades or businesses for purposes of determining the § 199A deduction if the requirements in Prop. Reg. § 1.199A-4(b)(1) are satisfied. Treasury and the IRS declined to adopt the existing aggregation rules in Reg. § 1.469-4 that apply for purposes of the passive activity loss rules on the basis that those rules, which apply to “activities” rather than trades or businesses and which serve purposes somewhat different from those of § 199A, are inappropriate. Instead, the proposed regulations permit aggregation if the following five requirements are met: (1) the same person, or group of persons, directly or indirectly owns a majority interest in each of the businesses to be aggregated, (2) the required level of ownership exists for the majority of the taxable year in which the items attributable to the trade or business are included in income, (3) all of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year (not taking into account short taxable years), (4) none of the aggregated businesses is a specified service trade or business, and (5) the trades or businesses to be aggregated meet at least two of three factors designed to demonstrate that the businesses really are part of a larger, integrated trade or business. The proposed regulations also impose a consistency rule under which an individual who aggregates trades or businesses must consistently report the aggregated trades or businesses in subsequent taxable years. In addition, the proposed regulations require that taxpayers attach to the relevant return a disclosure statement that identifies the trades or businesses that are aggregated.

Specified Service Trade or Business. Prop. Reg. § 1.199A-5 provides extensive guidance on the meaning of the term “specified service trade or business.” For purposes of § 199A, a qualified trade or business is any trade or business other than (1) the trade or business of performing services as an employee, or (2) a specified service trade or business. Code § 199A(d)(2) defines a specified service trade or business (by reference to Code § 1202(e)(3)(A)) as “any trade or business involving the performance of services in the fields of health, ... law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.” Architects and engineers are excluded. For taxpayers whose taxable incomes are below the $157,500/$315,000 thresholds mentioned earlier, a business is a qualified trade or business even if it is a specified service trade or business. The proposed regulations provide guidance on what is means to be considered providing services in each of these categories. Regarding the last category, the proposed regulations state that a trade or business in which the principal asset is the reputation or skill of one or more employees means any trade or business that consists of one or more of the following: (1) a trade or business in which a person receives fees, compensation, or other income for endorsing products or services, (2) a trade or business in which a person licenses or receives fees (or other income) for use of an individual’s image, likeness, name, signature, voice, trademark, or symbols associated with that person’s identity, or (3) receiving fees or other income for appearing at an event or on radio, television, or another media format. The proposed regulations set forth several examples. The proposed regulations also create a de minimis rule under which a trade or business (determined before application of the aggregation rules) is not a specified service trade or business if it has gross receipts of $25 million or less and less than 10 percent of its gross receipts is attributable the performance of services in a specified service trade or business, or if it has more than $25 million in gross receipts and less than 5 percent of its gross receipts is attributable the performance of services in a specified service trade or business.

Special Rules for Passsthrough Entities, Publicly Traded Partnerships, Trusts, and Estates. Prop. Reg. § 1.199-6 provides guidance for passthrough entities, publicly traded partnerships trusts, and estates may need to follow in determining the § 199A deduction of the entity or its owners. The
proposed regulations provide computational steps for passthrough entities and publicly traded partnerships, and special rules for applying § 199A to trusts and decedents’ estates.

**Effective Dates.** The proposed regulations generally are proposed to apply to taxable years ending after the date of publication of final regulations in the Federal Register. Nevertheless, taxpayers can rely on the proposed regulations in their entirety until final regulations are published. However, to prevent abuse, certain provisions of the proposed regulations are proposed to apply to taxable years ending after December 17, 2017, the date of enactment of the 2017 TCJA. In addition, Prop. Reg. § 1.643(f)-1, which provides anti-avoidance rules for multiple trusts, is proposed to apply to taxable years ending after August 16, 2018.

b. **The IRS has issued a proposed revenue procedure that provides guidance on methods for calculating W-2 wages for purposes of § 199A.** Notice 2018-64, 2018-35 I.R.B. 347 (8/8/18). This proposed revenue procedure provides three methods for calculating “W-2 wages” as that term is defined in § 199A(b)(4) and Reg. § 1.199A-2. The first method (the unmodified Box method) allows for a simplified calculation while the second and third methods (the modified Box 1 method and the tracking wages method) provide greater accuracy. The methods are substantially similar to the methods provided in Rev. Proc. 2006-47, 2006-2 C.B. 869, which applied for purposes of former Code § 199A. The IRS has requested comments on the proposed revenue procedure. The proposed revenue procedure is proposed to apply generally to taxable years ending after December 31, 2017.

6. **Unless you fit in one of the exceptions, Congress just increased the interest rate on all your business loans.** The 2017 Tax Cuts and Jobs Act, § 13301, amended § 163(j) to limit the deduction for business interest expense. Consequently, if your business is impacted by amended § 163(j), you will pay more for the use of borrowed funds, which is a de facto interest increase. Basically, the deduction for business interest expense under amended § 163(j) will be limited to the sum of: (1) business interest income, (2) 30 percent of “adjusted taxable income,” and (3) floor plan financing interest. The term “adjusted taxable income” is defined essentially as earnings before interest, tax, depreciation and amortization (EBITDA) for 2018 through 2022, and then earnings before interest and taxes (EBIT) for subsequent years. Businesses with average annual gross receipts (computed over 3 years) of $25 million or less and businesses in certain industries (notably real estate if a proper election is made, but also floor plan financing of auto dealers and regulated utilities) are exempted from the limitations of amended §163(j). Real estate businesses must accept slightly longer recovery periods by using the alternative depreciation system for certain depreciable property if they elect out of the § 163(j) limitation. Because real estate businesses making the election out must use the alternative depreciation system for so-called qualified improvement property (among other categories), electing out of the § 163(j) limitation would seem to have the effect of making qualified improvement property ineligible for bonus depreciation under § 168(k).

a. **Treasury and the IRS have provided interim guidance by giving insight on forthcoming proposed regulations regarding the § 163(j) limitation on deduction of business interest.** Notice 2018-28, 2018-16 I.R.B. 492 (4/2/18). In this notice, the Treasury Department and the IRS have announced that they intend to issue proposed regulations providing guidance on several issues related to the limitation of § 163(j) on the deduction of business interest. The notice describes some of the rules that will be included in the proposed regulations in order to provide taxpayers with interim guidance. These rules fall into the following five broad categories.

**Treatment of Interest Disallowed by Former § 163(j) in Tax Years Beginning Before 2018.** The version of § 163(j) in effect before the amendments made by the Tax Cuts and Jobs Act applied only to corporations. Under the pre-TCJA version of § 163(j), interest disallowed as a deduction was treated as interest paid or accrued in the succeeding taxable year and could be carried forward indefinitely. In addition, under the prior version of § 163(j), a corporation could carry forward for three years any “excess limitation” (the amount by which 50 percent of the corporation’s adjusted taxable income exceeded its net interest expense), which made it less likely that the corporation would be subject to § 163(j) in those subsequent years. The notice provides that the proposed regulations will (1) clarify that taxpayers with interest disallowed under the prior version of § 163(j) for the last taxable year beginning before January 1, 2018, may carry such interest forward as business interest to the taxpayer’s first taxable year beginning after December 31, 2017, and that the rules of new § 163(j) then will apply
to the interest carried forward, and (2) provide that, because new § 163(j) does not have a mechanism for carrying forward any excess limitation, no amount previously treated as an excess limitation carryforward may be carried to taxable years beginning after December 31, 2017. The proposed regulations also will address the interaction of § 163(j) (including the rules for amounts carried forward from taxable years beginning before 2018) with new § 59A, commonly referred to as the base erosion and anti-abuse tax (BEAT) provision, which imposes a minimum tax on certain large corporations that make deductible payments to related foreign parties.

Business Interest Expense and Income of C Corporations. The notice provides that the proposed regulations will take the position that (1) all interest paid or accrued by a C corporation on indebtedness of the C corporation will be business interest within the meaning of § 163(j)(5), and (2) with respect to indebtedness held by a C corporation, all interest that is includible in the C corporation’s gross income will be business interest income within the meaning of § 163(j)(6). In other words, a C corporation is not treated as having investment interest or investment income; instead, all interest paid or accrued by a C corporation and all interest included in income of a C corporation is treated as business interest and business interest income. The notice provides that this rule will not apply to subchapter S corporations. According to the notice, the proposed regulations also will address whether and to what extent interest is properly characterized as business interest or business interest income when it is paid or accrued by, or includible in the gross income of, a non-corporate entity such as a partnership in which a C corporation holds an interest.

Application of § 163(j) to Consolidated Groups. With respect to a corporate consolidated group, the notice provides that the proposed regulations will apply the § 163(j) limitation at the consolidated group level. Accordingly, the limitation of 30 percent of adjusted taxable income will be determined with reference to consolidated taxable income, which necessarily means that intercompany obligations will be disregarded for purposes of the § 163(j) limitation. The proposed regulations also will address other issues, such as the allocation of the § 163(j) limitation among consolidated group members. The notice indicates, however, that Treasury and the IRS anticipate that the proposed regulations will not treat as a single taxpayer for purposes of § 163(j) an affiliated group of corporations that does not file a consolidated return.

Impact of § 163(j) on Earnings and Profits. According to the notice, the proposed regulations will clarify that the limitation of § 163(j) does not affect whether or when business interest expense of a C corporation reduces the corporation’s earnings and profits.

Application of § 163(j) to Partnerships and S Corporations. With respect to partnerships, § 163(j)(4) provides that the limitation on business interest applies at the partnership level. Partners, however, also are subject to § 163(j) in determining their taxable income. The notice indicates that the proposed regulations will provide that, in determining a partner’s annual limitation under § 163(j), a partner can include the partner’s share of the partnership’s business interest income for the taxable year only to the extent of the partner’s share of the excess of (1) the partnership’s business interest income over (2) the partnership’s business interest expense (not including floor plan financing). In addition, the proposed regulations will provide that a partner cannot include the partner’s share of the partnership’s floor plan financing interest in determining the partner’s annual limitation under § 163(j).

b. Proposed regulations provide guidance on the 163(j) limitation on the deduction of business interest. REG-106089-18, Limitation on Deduction for Business Interest Expense, 83 F.R. 67490 (12/28/18). Treasury and the IRS have issued lengthy proposed regulations regarding the limitation of § 163(j) on the deduction of business interest. The proposed regulations provide general rules and definitions and rules for calculating the limitation in consolidated group, partnership, and international contexts.

7. To make room for § 199A, Congress repealed the § 199 domestic production activities deduction. We will remember fondly some of the issues it generated, such as whether assembling items into gift baskets constituted “manufacturing.” The 2017 Tax Cuts and Jobs Act, § 13305, repealed Code § 199, which granted a special deduction to taxpayers with domestic production activities. The repeal is effective for taxable years beginning after 2017.
8. Violations of law just became a little more expensive. The 2017 Tax Cuts and Jobs Act, § 13306, amended Code § 162(f) to disallow deductions:

for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law.

Prior to amendment, § 162(f) stated simply that “[n]o deduction shall be allowed … for any fine or similar penalty paid to a government for the violation of any law.” The intent of this provision appears to be to broaden the category of nondeductible items beyond those that might technically constitute a fine or penalty. The amended statute contains exceptions for (1) certain amounts for restitution or remediation (including remediation of property) or to come into compliance with law that are identified as such in a court order or settlement agreement, (2) amounts paid or incurred pursuant to a court order in a suit in which no government or governmental entity is a party, and (3) any amount paid or incurred as taxes due. Payments of restitution for failure to pay taxes that are assessed as restitution in the same manner as a tax qualify for the first exception just listed only if the amounts “would have been allowed as a deduction under this chapter if it had been timely paid.” This rule appears to mean that a payment of restitution in a tax case qualifies for the exception only if the taxes would have been deductible if timely paid. The legislation also adds to the Code § 6050X, which requires government agencies to report to the IRS and the taxpayer the amount of each settlement agreement or order entered into where the aggregate amount required to be paid or incurred to or at the direction of the government is at least $600 (or such other amount as may be specified by Treasury). These reports will separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance. The disallowance of deductions and the new reporting requirement apply to amounts paid or incurred on or after December 22, 2017, the date of enactment, but do not apply to amounts paid or incurred under any binding order or agreement entered into before that date.

a. Guidance on amended § 162(f). Notice 2018-23, 2018-15 I.R.B. 474 (3/27/18). Section 162(f), as amended by the Tax Cuts and Jobs Act, is effective for amounts paid or incurred on or after December 22, 2017, the date of enactment. Nevertheless, Notice 2018-23 delays the information reporting requirement otherwise imposed upon officials of government and governmental entities under § 6050X until a date specified in to-be-proposed regulations (but not earlier than January 1, 2019). Notice 2018-23 also requests comments addressing the development of regulations under amended § 162(f) and new § 6050X. In addition, Notice 2018-23 provides transitional guidance regarding one of the exceptions to the disallowance rule of § 162(f)(1). One exception, set forth in § 162(f)(2), provides that an amount otherwise deductible under the Code is not disallowed if the taxpayer satisfies the requirements of § 162(f)(2)(A)(i), (ii), and (iii). Section 162(f)(2)(A)(i) requires a taxpayer to establish that the amount paid or incurred (1) constitutes restitution (including remediation of property) for damage or harm that was or may be caused by violation of any law or the potential violation of any law; or (2) is paid to come into compliance with any law that was violated or otherwise involved in the investigation or inquiry into the potential violation of any law (the “establishment requirement”). Section 162(f)(2)(A)(ii) further requires that the amount paid or incurred be identified as restitution or as an amount paid to come into compliance with such law in the court order or settlement agreement (the “identification requirement”). Finally, § 162(f)(2)(A)(iii) provides that in the case of any amount of restitution for failure to pay any tax imposed under the Code, the amount is treated as if it were a payment of tax if it would have been allowed as a deduction had it been timely paid. Section 162(f)(2)(A) further provides that meeting the identification requirement of § 162(f)(2)(A)(ii) alone is not sufficient to meet the establishment requirement under § 162(f)(2)(A)(i). Until proposed regulations are issued, the identification requirement in § 162(f)(2)(A)(ii) is treated as satisfied for an amount if the settlement agreement or court order specifically states on its face that the amount is restitution, remediation, or for coming into compliance with the law. Notice 2018-23 reiterates that even if the identification requirement is treated as satisfied under the Notice, taxpayers must meet the establishment requirement as well in order to qualify for the § 162(f)(2) exception.

9. Professional gamblers have a new incentive to fly coach when traveling to a casino: otherwise deductible expenses of a professional gambler are now deductible only to the
extents of gains from wagering transactions. Under Code § 165(d), losses from wagering transactions are deductible only to the extent of gains from wagering transactions. Thus, the cost of wagers incurred by an individual are deductible (on Schedule A as an itemized deduction) only to the extent of gambling winnings (reported on the “other income” line of Form 1040). The 2017 Tax Cuts and Jobs Act, § 11050, amended Code § 165(d) by adding a new sentence that reads: “the term ‘losses from wagering transactions’ includes any deduction otherwise allowable under this chapter incurred in carrying on any wagering transaction.” The effect of this amendment is to change the result in Mayo v. Commissioner, 136 T.C. 81 (2001), in which the Tax Court held that expenses other than the cost of wagers incurred by a taxpayer engaged in the trade or business of gambling are not subject to the limitation of § 165(d) and instead are deductible as business expenses under § 162(a). Under § 165(d) as amended, costs of a professional gambler, including both the cost of wagers and other costs such as the cost of traveling to a casino, are deductible only to the extent of gambling winnings. This change applies to taxable years beginning after 2017 and before 2026.

- The legislation did not change the deductibility of losses from wagering transactions for non-professional gamblers. Code § 67(g), as amended by the Tax Cuts and Jobs Act, disallowed the deduction of all miscellaneous itemized deductions for taxable years beginning after 2017 and before 2026. Under Code § 67(b)(3), however, the deduction for losses from wagering transactions described in § 165(d) is not a miscellaneous itemized deduction.

10. Businesses will have to allow survivors of sexual harassment and sexual abuse to dish the dirt or else forgo a deduction. The 2017 Tax Cuts and Jobs Act, § 13307, amended Code § 162 by redesignating § 162(q) as § 162(r) and adding new § 162(q), which provides that no deduction is allowed for any settlement, payment, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement. The provision applies to amounts paid or incurred after the date of enactment, December 22, 2017.

11. Glad-handing local officials is now more expensive: deductions for local lobbying expenses are disallowed. The 2017 Tax Cuts and Jobs Act, § 13308, amended Code § 162(e) by striking § 162(e)(2) and (7) and redesignating the remaining paragraphs accordingly. Prior to their repeal, § 162(e)(2) and (7) allowed as a deduction costs incurred in carrying on a trade or business to lobby local councils or similar governing bodies, including Indian tribal governments. This change applies to amounts paid or incurred after the date of enactment, December 22, 2017.

12. A retroactive incentive to make commercial buildings energy efficient. The Bipartisan Budget Act of 2018, § 40413, retroactively extended the § 179D deduction for the cost of energy efficient commercial building property. Generally, these are improvements designed to reduce energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of a commercial building by 50 percent or more in comparison to certain standards. The lifetime limit on deductions under § 179D is $1.80 per square foot. As extended, the deduction is available for property placed in service before January 1, 2018.

E. Depreciation & Amortization

1. Certain depreciation and amortization provisions of the 2017 Tax Cuts and Jobs Act:

a. Increased limits and expansion of eligible property under § 179.

Increased § 179 Limits. The 2017 Tax Cuts and Jobs Act, § 13101, increased the maximum amount a taxpayer can deduct under § 179 to $1 million (increased from $520,000). This limit is reduced dollar-for-dollar to the extent the taxpayer puts an amount of § 179 property in service that exceeds a specified threshold. The legislation increased this threshold to $2.5 million (increased from $2,070,000). These changes apply to property placed in service in taxable years beginning after 2017. The legislation did not change the limit on a taxpayer’s § 179 deduction for a sport utility vehicle, which remains at $25,000. The basic limit of $1 million, the phase-out threshold of $2.5 million, and the sport utility vehicle limitation of $25,000 all will be adjusted for inflation for taxable years beginning after 2018.

Revised and expanded definition of qualified real property. The 2017 Tax Cuts and Jobs Act, § 13101, also simplified and expanded the definition of “qualified real property,” the cost of which can
be deducted under § 179 (subject to the applicable limits just discussed). Prior to amendment by the 2017 Tax Cuts and Jobs Act, § 179(f) defined qualified real property as including “qualified leasehold improvement property,” “qualified restaurant property,” and “qualified retail improvement property.” The legislation revised the definition of qualified real property by replacing these three specific categories with a single category, “qualified improvement property” as defined in § 168(e)(6). Section 168(e)(6) defines qualified improvement property (subject to certain exceptions) as “any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service.” In addition, the legislation expands the category of qualified real property by defining it to include the following improvements to nonresidential real property placed in service after the date the property was first placed in service: (1) roofs, (2) heating, ventilation, and air-conditioning property, (3) fire protection and alarm systems, and (4) security systems. These changes apply to property placed in service in taxable years beginning after 2017.

Section 179 property expanded to include certain personal property used to furnish lodging. The 2017 Tax Cuts and Jobs Act, § 13101, also amended Code § 179(d)(1). The effect of this amendment is to include within the definition of § 179 property certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging (such as beds or other furniture, refrigerators, ranges, and other equipment).

- Guidance on the procedure for electing to treat qualified real property as § 179 property. In Rev. Proc. 2019-8, 2019-3 I.R.B. 347 (12/21/18), the IRS provided the procedure by which taxpayers can elect to deduct the cost of qualified real property under § 179(a). According to the notice, for qualified real property placed in service in taxable years beginning after 2017, taxpayers make the election “by filing an original or amended Federal tax return for that taxable year in accordance with procedures similar to those in § 1.179-5(c)(2) and section 3.02 of Rev. Proc. 2017–33.” Taxpayers that have filed an original return can elect to increase the portion of the cost of qualified real property deducted under § 179(a) by filing an amended return and will not be treated as having revoked a prior election under § 179 for that year.

b. Goodbye, basis; hello 100 percent § 168(k) bonus first-year depreciation!

100 percent bonus depreciation for certain property. The 2017 Tax Cuts and Jobs Act, § 13201, amended Code § 168(k)(1) and 168(k)(6) to permit taxpayers to deduct 100 percent of the cost of qualified real property for the year in which the property is placed in service. This change applies to property acquired and placed in service after September 27, 2017, and before 2023. The percentage of the property’s adjusted basis that can be deducted is reduced from 100 percent to 80 percent in 2023, 60 percent in 2024, 40 percent in 2025, and 20 percent in 2026. (These periods are extended by one year for certain aircraft and certain property with longer production periods). Property acquired on or before September 27, 2017 and placed in service after that date is eligible for bonus depreciation of 50 percent if placed in service before 2018, 40 percent if placed in service in 2018, 30 percent if placed in service in 2019, and is ineligible for bonus depreciation if placed in service after 2019.

Used property eligible for bonus depreciation. The legislation also amended Code § 168(k)(2)(A) and (E) to make used property eligible for bonus depreciation under § 168(k). Prior to this change, property was eligible for bonus depreciation only if the original use of the property commenced with the taxpayer. This rule applies to property acquired and placed in service after September 27, 2017. Note, however, that used property is eligible for bonus depreciation only if it is acquired “by purchase” as defined in § 179(d)(2). This means that used property is not eligible for bonus depreciation if the property (1) is acquired from certain related parties (within the meaning of §§ 267 or 707(b)), (2) is acquired by one component member of a controlled group from another component member of the same controlled group, (3) is property the basis of which is determined by reference to the basis of the same property in the hands of the person from whom it was acquired (such as a gift), or (4) is determined under § 1014 (relating to property acquired from a decedent). In addition, property acquired in a like-kind exchange is not eligible for bonus depreciation.

Qualified property. The definition of “qualified property” eligible for bonus depreciation continues to include certain trees, vines, and plants that bear fruits or nuts (deductible at a 100 percent level for items planted or grafted after September 27, 2017, and before 2023, and at reduced percentages for
items planted or grafted after 2022 and before 2027). The definition also includes a qualified film or television production. Excluded from the definition is any property used in a trade or business that has had floor plan financing indebtedness (unless the business is exempted from the § 163(j) interest limitation because its average annual gross receipts over a three-year period do not exceed $25 million).

Section 280F $8,000 increase in first-year depreciation. For passenger automobiles that qualify, § 168(k)(2)(F) increases by $8,000 in the first year the § 280F limitation on the amount of depreciation deductions allowed. The legislation continues this $8,000 increase for passenger automobiles acquired and placed in service after 2017 and before 2023. For passenger automobiles acquired on or before September 27, 2017, and placed in service after that date, the previously scheduled phase-down of the $8,000 increase applies as follows: $6,400 if placed in service in 2018, $4,800 if placed in service in 2019, and $0 after 2019.

- The IRS has issued proposed regulations that provide guidance on § 168(k) first-year depreciation. REG-104397-18, Additional First-Year Depreciation Deduction, 83 F.R. 39292 (8/8/18). These proposed regulations provide guidance regarding the additional first year depreciation deduction under § 168(k) as amended by the 2017 Tax Cuts and Jobs Act. They affect taxpayers who deduct depreciation for qualified property acquired and placed in service after September 27, 2017. Generally, the proposed regulations describe and clarify the statutory requirements that must be met for depreciable property to qualify for the additional first year depreciation deduction provided by § 168(k). These regulations are proposed to apply to qualified property placed in service (or planted or grafted) during or after the taxpayer’s taxable year that includes the date of publication of final regulations in the Federal Register. Until final regulations are issued, taxpayers can choose to apply the proposed regulations to qualified property acquired and placed in service (or planted or grafted) after September 27, 2017, during taxable years ending on or after September 28, 2017.

c. Changes to the 280F depreciation limits on passenger automobiles and removal of computer and peripheral equipment from the definition of listed property. The 2017 Tax Cuts and Jobs Act, § 13202, amended Code § 280F(a)(1)(A) to increase the maximum amount of allowable depreciation for passenger automobiles and for which bonus depreciation under § 168(k) is not claimed. The maximum amount of allowable depreciation is $10,000 for the year in which the vehicle is placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years in the recovery period. The legislation also amended § 280F(d)(4) to remove computer or peripheral equipment from the definition of listed property. Both changes apply to property placed in service after 2017 in taxable years ending after 2017.

d. Changes to the depreciation of certain property used in a farming business.

Modifications to the depreciation of farm machinery and equipment. The 2017 Tax Cuts and Jobs Act, § 13203, made two changes with respect to the depreciation of any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) that is used in a farming business. (For this purpose, the term “farming business” is defined in Code § 263A(e)(4).) The legislation amended Code § 168(b)(2) and (e)(3)(B) to repeal the required use of the 150 percent declining balance method and to reduce the recovery period from 7 years to 5 years. Accordingly, such machinery and equipment should be depreciable over 5 years using the double declining balance method and the half-year convention. This change applies to property placed in service after 2017 in taxable years ending after 2017.

Mandatory use of ADS for farming businesses that elect out of the new interest limitation. The 2017 Tax Cuts and Jobs Act, § 13205, amended Code § 168 to add new § 168(g)(1)(G), which requires a farming business that elects out of the newly-enacted interest limitation of § 163(j) to use the alternative depreciation system for any property with a recovery period of 10 years or more. This change applies to taxable years beginning after 2017. Note: aside from longer recovery periods, the requirement to use the alternative depreciation system for property with a recovery period of 10 years or more would seem to have the effect of making such property ineligible for bonus depreciation under § 168(k) even if it normally would be eligible for bonus depreciation.

- For guidance on the application of the alternative depreciation system in this

e. Revised definitions and minor adjustments to recovery periods for real property. With respect to real property, the 2017 Tax Cuts and Jobs Act, § 13204, amended Code § 168 to simplify certain definitions and make minor adjustments for purposes of the alternative depreciation system.

Three categories consolidated into one. The legislation replaced the categories of “qualified leasehold improvement property,” “qualified restaurant property,” and “qualified retail improvement property” with a single category, “qualified improvement property.” Code § 168(e)(6) defines qualified improvement property (subject to certain exceptions) as “any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service.” Qualified improvement property is depreciable over 15 years using the straight-line method and is subject to the half-year convention. This change applies to property placed in service after 2017. Note: the Conference Agreement indicates that the normal recovery period for qualified improvement property is 15 years, but § 168 as amended does not reflect this change. This should be addressed in technical corrections.

Residential rental property has a 30-year ADS recovery period. The legislation reduced the recovery period for residential rental property for purposes of the alternative depreciation system from 40 years to 30 years. The general recovery period for such property remains at 27.5 years. This change applies to property placed in service after 2017. An optional depreciation table for residential rental property with a 30-year ADS recovery period appears in Rev. Proc. 2019-8, 2019-3 I.R.B. 347 (12/21/18).

Mandatory use of ADS for real property trades or businesses electing out of the new interest limitation. The legislation amended Code § 168 to add new § 168(g)(1)(F) and (g)(8), which require a real property trade or business that elects out of the newly-enacted interest limitation of § 163(j) to use the alternative depreciation system for nonresidential real property, residential rental property, and qualified improvement property. This change applies to taxable years beginning after 2017. Note: aside from longer recovery periods, the requirement to use the alternative depreciation system for qualified improvement property would seem to have the effect of making qualified improvement property ineligible for bonus depreciation under § 168(k).


a. We suppose it makes sense that racehorses have a swift recovery period. The Bipartisan Budget Act of 2018, § 40304, retroactively extended the classification of racehorses as 3-year MACRS property so that the classification applies to racehorses placed in service before 2018. A racehorse placed in service after 2017 qualifies for the 3-year recovery period only if it is more than two years old when placed in service.


c. A portion of the cost of certain mine safety equipment can be treated as a current deduction through 2017. The Bipartisan Budget Act of 2018, § 40307, retroactively extended the election under § 179E to treat 50 percent of the cost of any qualified advanced mine safety equipment property as an expense in the tax year in which the equipment is placed in service. The election is available for qualifying property placed in service before January 1, 2018.
F. Credits

1. Employers who retained employees despite becoming inoperable in areas affected by Hurricanes Harvey, Irma, or Maria are eligible for a 40 percent employee retention credit. The Disaster Relief and Airport and Airway Extension Act of 2017 (“2017 Disaster Relief Act”), Pub. L. No. 115-63, was signed by the President on September 29, 2017. Section 503 of the 2017 Disaster Relief Act provides that an “eligible employer” can include the “Hurricane Harvey employee retention credit” among the credits that are components of the general business credit under § 38(b). The credit is equal to 40 percent of “qualified wages” for each “eligible employee.” The cap on the amount of qualified wages that can be taken into account is $6,000. Thus, the maximum credit per employee is $2,400. An eligible employer is an employer that conducted an active trade or business on a specified date in the Hurricane Harvey disaster zone, Hurricane Irma disaster zone, or Hurricane Maria disaster zone, if the trade or business became inoperable on any day after the specified date and before January 1, 2018, as a result of damage sustained by the relevant hurricane. The specified dates are August 23, 2017 (Harvey), September 4, 2017 (Irma), and September 16, 2017 (Maria). The term eligible employee is defined as an employee whose principal place of employment with an eligible employer was in the relevant disaster zone on the relevant specified date. The term qualified wages means wages (as defined in § 51(c)(1), but without regard to § 3306(b)(2)(B)) paid or incurred by an eligible employer with respect to an eligible employee on any day after the relevant specified date and before January 1, 2018, during the period beginning on the date the trade or business first became inoperable at the employee’s principal place of employment and ending on the date on which the trade or business resumed significant operations at the principal place of employment. Wages can be qualified wages regardless of whether the employee performed no services, performed services at a different location, or performed services at the employee’s principal place of employment before significant operations resumed. An employee is not considered an eligible employee if the employer is allowed a credit with respect to the employee under § 51(a), i.e., an eligible employer cannot claim the 40 percent credit with respect to an employee for any period if the employer is allowed a Work Opportunity Tax Credit with respect to the employee under § 51 for that period.

- Section 501 of the 2017 Disaster Relief Act defines the terms Hurricane Harvey disaster area, Hurricane Irma disaster area, and Hurricane Maria disaster area as an area with respect to which the President has declared a major disaster by reason of the relevant hurricane before October 17, 2017. (Note: the date originally in the 2017 Disaster Relief Act was September 21, 2017. This date was changed to October 17, 2017, by the Bipartisan Budget Act of 2018, Division B, § 20201, Pub. L. No. 115-123, which was signed by the President on February 9, 2018.) The terms Hurricane Harvey disaster zone, Hurricane Irma disaster zone, and Hurricane Maria disaster zone are defined as the portion of the relevant disaster area determined by the President to warrant individual or individual and public assistance from the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of the relevant hurricane.

a. Congress has provided a similar credit to employers who retained employees despite becoming inoperable in areas affected by California wildfires. The Bipartisan Budget Act of 2018, § 20103 of Division B, provides that an “eligible employer” can include the “California wildfire employee retention credit” among the credits that are components of the general business credit under § 38(b). This credit is essentially the same as the “Hurricane Harvey employee retention credit” enacted as part of the 2017 Disaster Relief Act, except that it applies to a different category of employers. For purposes of the California wildfire employee retention credit, an eligible employer is one that conducted an active trade or business on October 8, 2017, in the California wildfire disaster zone whose trade or business was inoperable on any day after October 8, 2017, and before January 1, 2018, as a result of damage sustained by reason of wildfires with respect to which the President declared a major disaster under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. Like the Hurricane Harvey employee retention credit, the California wildfire employee retention credit is a credit equal to 40 percent of “qualified wages” (up to $6,000) for each “eligible employee,” so that the maximum credit per employee is $2,400.

- The Bipartisan Budget Act of 2018 defines the term “California wildfire disaster zone” as the portion of the California wildfire disaster area determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert
T. Stafford Disaster Relief and Emergency Assistance Act by reason of wildfires in California. The term “California wildfire disaster area” is defined as an area with respect to which the President declared a major disaster from January 1, 2017, through January 18, 2018, under section 401 of the Stafford Act by reason of wildfires in California.

2. A new credit for employers that pay wages to certain employees during periods of family and medical leave. The 2017 Tax Cuts and Jobs Act, § 13403, adds to the Code new § 45S, which provides that an “eligible employer” can include the “paid family and medical leave credit” among the credits that are components of the general business credit under § 38(b). The credit is equal to a percentage of the amount of wages paid to “qualifying employees” during periods in which the employees are on family and medical leave. The credit is available against both the regular tax and the alternative minimum tax.

Amount of the credit. To be eligible for the credit, the employer must pay during the period of leave at a rate that is at least 50 percent of the wages normally paid to the employee. The credit is 12.5 percent of the wages paid, increased by 0.25 percentage points for each percentage point by which the rate of payment exceeds 50 percent. The maximum credit is 25 percent of wages. Thus, if an employer pays an employee at a rate that is 60 percent of the employee’s normal wages, the credit is 15 percent of wages paid (12.5 percent plus 2.5 percentage points). The credit reaches 25 percent when the employer pays at a rate that is 100 percent of employee’s normal wages. The credit cannot exceed the amount derived from multiplying the employee’s normal hourly rate by the number of hours for which the employee takes leave. The compensation of salaried employees is to be prorated to an hourly wage under regulations to be issued by the Treasury Department. The maximum amount of leave for any employee that can be taken into account for purposes of the credit is twelve weeks per taxable year.

Eligible employer. An eligible employer is defined as one who has in place a written policy that (1) allows all full-time “qualifying employees” not less than two weeks of annual paid family and medical leave, and that allows all part-time qualifying employees a commensurate amount of leave on a pro rata basis, and (2) requires that the rate of payment under the program is not less than 50 percent of the wages normally paid to the employee.

Eligible employee. An eligible employee is defined as any employee as defined in section 3(e) of the Fair Labor Standards Act of 1938 who has been employed by the employer for one year or more and who, for the preceding year, had compensation not in excess of 60 percent of the compensation threshold for highly compensated employees. For 2017, the threshold for highly compensated employees (see § 414(q)(1)(B)) was $120,000. Thus, for purposes of determining the credit in 2018, an employee is an eligible employee only if his or her compensation for 2017 did not exceed $72,000 ($120,000 * 60 percent).

Family and medical leave. The term “family and medical leave” is defined as leave described under sections 102(a)(1)(a)-(e) or 102(a)(3) of the Family and Medical Leave Act of 1993. (Generally, these provisions describe leave provided because of the birth or adoption of a child, because of a serious health condition of the employee or certain family members, or because of the need to care for a service member with a serious injury or illness.) If an employer provides paid leave as vacation leave, personal leave, or other medical or sick leave, this paid leave is not considered to be family and medical leave.

No double benefit. The legislation amends Code § 280C(a) to provide that no deduction is allowed for the portion of wages paid to an employee for which this new credit is taken. Thus, if an employer pays $10,000 to an employee and takes a credit for 25 percent, or $2,500, the employer could deduct as a business expense only $7,500 of the wages.

Effective date. The credit is available for wages paid in taxable years beginning after 2017.

3. Congress gives a “thumbs up” to new energy efficient homes. The Bipartisan Budget Act of 2018 § 40410, retroactively extended the § 45L credit of $2,000 or $1,000 (depending on the projected level of fuel consumption) an eligible contractor can claim for each qualified new energy efficient home constructed by the contractor and acquired by a person from the contractor for use as a residence during the tax year. As extended, the credit is available for homes acquired before January 1, 2018.
G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

1. Those NOLs are not worth what they used to be (at least until 2026). The 2017 Tax Cuts and Jobs Act, § 11012, amended § 461 by adding § 461(l), which disallows “excess business losses” for noncorporate taxpayers for taxable years beginning in 2018. Such “excess business losses” are determined after application of the passive loss rules of § 469. Essentially, as the authors read the statute, losses disallowed for a taxable year under § 461(l) are carried over to the next taxable year and become NOL carryforwards subject to revised § 172(a) (discussed below). Thus, the practical effect of § 461(l) appears to be a one-year deferral of “excess business losses.” An “excess business loss” is defined as the amount by which a noncorporate taxpayer’s aggregate trade or business deductions exceed aggregate gross income from those trades or businesses, plus $250,000 ($500,000 for joint filers). The term “aggregate trade or business deductions” apparently does not include § 172 carryforwards, so NOLs carried forward from 2017 and prior taxable years are not limited by new § 461(l). Such carryforwards are, however, limited by the changes made to § 172(a) (as discussed below). For partnerships and S corporations, new § 461(l) applies at the partner or shareholder level, and for farmers, the prior limitation on “excess farm losses” under § 461(j) is suspended so that only § 461(l) applies to limit such losses. After 2018, the cap on “excess business losses” is adjusted annually for inflation. Mercifully, new § 461(l) sunsets for taxable years beginning on or after January 1, 2026.

a. Surely you jest . . . there’s even more bad news for NOLs? The 2017 Tax Cuts and Jobs Act, § 13302(a), amended § 172(a) such that, for taxable years beginning in 2018, NOLs (except “farming losses” and NOLs of non-life insurance companies) no longer may be carried back two years, and any carried forward NOLs are capped at 80 percent of taxable income (computed without regard to NOLs). This change to § 172(a) is permanent.

b. The good news: NOLs now are like BFFs; they stick with you until you die! The 2017 Tax Cuts and Jobs Act, § 13302(b), amended § 172(b)(1)(A)(ii) so that NOLs may be carried forward indefinitely (except by non-life insurance companies) rather than being limited to 20 years as under pre-TCJA law. This change to § 172(b) is permanent.

I. At-Risk and Passive Activity Losses

1. California taxpayer with “trashy” tenants qualifies as real estate professional, but another with a bogus calendar that conflicted with bank statements does not. Franco v. Commissioner, T.C. Summary Op. 2018-9 (03/06/18); and Pourmirzaie v. Commissioner, T.C. Memo 2018-26 (03/08/18). These two recent cases issued just days apart somewhat humorously demonstrate what it takes to avoid the passive loss rules by establishing real estate professional status under § 469(c)(7). Rental activity is per se passive under § 469(c)(2); however, pursuant to § 469(c)(7), certain taxpayers may qualify for the so-called “real estate professional” exception to the passive loss rules. A taxpayer qualifies as a real estate professional if the taxpayer adequately establishes that (i) more than half of the personal services the taxpayer performed in trades or businesses during the year were performed in real property trades or businesses, and (ii) the taxpayer performed more than 750 hours of services in real property trades or businesses in which the taxpayer materially participated during the year. Contemporaneous daily time reports, logs, or similar documents are the best way to prove hours worked and material participation, but Reg. § 1.469-5T(f)(4) also provides that hours worked and material participation may be established by any “reasonable means.” In Franco v. Commissioner, Special Trial Judge Guy ruled that a California taxpayer who testified that his tenants “were not attentive to trash disposal matters” and that he therefore had made weekly trips to his rental properties to ensure that “trash bins were set out for collection” and who could produce an activity log, numerous emails, and home improvement store receipts relating to his rental properties qualified under § 469(c)(7). On the other hand, in Pourmirzaie v. Commissioner, a California couple who attempted to establish material participation through testimony and by producing a calendar that was reconstructed from memory during the course of the audit did not qualify as a real estate professional. Although the couple’s testimony and reconstructed calendar in Pourmirzaie would have established material participation, the IRS pointed the Tax Court to the couple’s bank statements. The bank
statements showed purchases in London, Dallas, Philadelphia, Boca Raton, and New York on the same dates that the couple’s reconstructed calendar showed work at their rental properties. Judge Halpern held the couple did not qualify for the § 469(c)(7) exception because “[s]imply stated, we do not believe” their testimony or the reconstructed calendar.

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. The Tax Court emphasizes that the alchemy of transforming § 1231 gain into capital gain does not render § 1231 assets to be capital assets. CRI-Leslie, LLC v. Commissioner, 147 T.C. 217 (9/7/16). The taxpayer, an LLC treated as a TEFRA partnership, entered into a contract to sell a hotel property that it owned and received a deposit of $9.7 million. The buyer under the contract defaulted and forfeited the $9.7 million deposit, which was retained by the taxpayer. The hotel property was a § 1231 asset, not a capital asset. The taxpayer reported the $9.7 million forfeited deposit as net long-term capital gain, and the IRS asserted a deficiency based on treating the forfeited deposit as ordinary income. The taxpayer argued that its characterization of the forfeited deposit as long-term capital gain was supported by § 1234A, which provides that:

Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—

(1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or

(2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,

shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation arrangement).

The taxpayer’s position was that “Congress clearly intended for section 1234A to apply not only to payments received from contract terminations relating to capital assets but also to payments from terminations relating to section 1231 property.” The IRS argued that the “plain and unambiguous wording” of § 1234A requires a narrow interpretation limited to a “capital asset in the hands of the taxpayer.” The Tax Court (Judge Laro) agreed with the IRS’s position. The court rejected the taxpayer’s argument that the legislative history of § 1234A, see S. Rept. No. 105-33, at 134 (1997), 1997-4 C.B. (Vol. 2) 1067, 1214, warranted extending § 1234A to § 1231 assets because it demonstrated that Congress enacted § 1234A to “ensure that taxpayers received the same tax characterization of gain or loss whether the property is sold or the contract to which the property is subject is terminated.” The court reasoned that “[s]ince section 1234A expressly refers to property that is ‘a capital asset in the hands of the taxpayer’ and no other type of property, and since property described in section 1231 is excluded explicitly from the definition of ‘capital asset’ in section 1221, we must conclude that the plain meaning of ‘capital asset’ as used in section 1234A does not extend to section 1231 property.” The court was “unable find anything in the legislative history of section 1234A to support [the taxpayer’s] assertion that Congress intended to include section 1231 property within its ambit.”

a. “The problem with the view that Section 1234A should be understood to reach Section 1231 property is that the Code’s plain language flatly forecloses it,” says the Eleventh Circuit. CRI-Leslie, LLC v. Commissioner, 882 F.3d 1026 (11th Cir. 2/15/18), aff’g 147 T.C. 217 (9/7/16). In a relatively brief but well written and even entertaining opinion by Judge Newsom, the U.S. Court of Appeals for the Eleventh Circuit affirmed the Tax Court’s decision. The court recognized that, had the sale of the hotel gone through as planned, the taxpayer’s gain from the sale would have been a § 1231 gain and therefore eligible to be classified as long-term capital gain. Because the sale did not go through, however, the characterization of the taxpayer’s gain was governed by § 1234A. Pursuant to § 1221(a)(2), the court reasoned, assets that are “property used in the trade or business” and therefore subject to § 1231 are expressly excluded from the category of capital assets. The plain language of § 1234A, the court emphasized, makes clear that it applies only
to termination of rights with respect to a capital asset. “If, as CRI-Leslie acknowledges, the hotel isn’t a ‘capital asset’ within the meaning of Section 1221, then Section 1234A’s special rule … simply doesn’t apply. That’s it. End of case.” The court rejected the taxpayer’s argument that, although the language of § 1234A refers only to capital assets, Congress intended that § 1234A provide taxpayers with the same tax treatment whether the underlying property is sold or the contract to which the property is subject is terminated. The taxpayer emphasized portions of the legislative history of § 1234A in which Congress cited cases the result of which would be changed by § 1234A. These cases involved property subject to § 1231. The court acknowledged that the taxpayer’s argument was “not without foundation” and seemed “to have attracted some scholarly supporters. See, e.g., Boris I. Bittker, Martin J. McMahon & Lawrence Zelenak, Federal Income Taxation of Individuals ¶ 32.01[4][b] ….” But the court ultimately declined to adopt this view. “In a contest such as we have here, between clear statutory text and (even compelling) evidence of sub- or extra-textual ‘intent,’ the former must prevail.”

2. Pyrrhotite cracking the foundation of your house? IRS to the rescue! Rev. Proc. 2017-60, 2017-50 I.R.B. 559 (11/23/17). Pyrrhotite is a naturally occurring mineral in stone aggregate used to produce concrete. Pyrrhotite oxidizes in the presence of water and oxygen, leading to expansion that cracks and deteriorates concrete foundations prematurely. As discovered and reported by the Connecticut Department of Consumer Protection, some homeowners in New England have suffered premature deterioration in their concrete foundations due to pyrrhotite. This had led taxpayers to inquire of the IRS whether the damage to their concrete foundations caused by pyrrhotite may be claimed as a personal casualty loss under § 165. Normally, a § 165 casualty loss is limited to an identifiable event that is sudden, unexpected, or unusual and that causes damage to property. The amount of a taxpayer’s casualty loss ordinarily is the decrease in the fair market value of the property (less any insurance reimbursement) as a result of the casualty, not to exceed the taxpayer’s adjusted basis in the damaged property. On the other hand, damage or loss resulting from progressive deterioration of property through a steadily operating cause generally is not considered a casualty loss within the meaning of § 165. Matheson v. Commissioner, 54 F.2d 537 (2d Cir. 1931). If a § 165 casualty loss is sustained for personal use property, a deduction is allowable only for (i) the amount of the loss that exceeds $100 per casualty and (ii) the net amount of all of the taxpayer’s personal casualty losses (in excess of personal casualty gains, if any) that exceeds 10 percent of the taxpayer’s adjusted gross income for the year. In Rev. Proc. 2017-60, the IRS concludes that damage to concrete foundations caused by pyrrhotite may qualify as a § 165 casualty loss if the loss is determined and reported in compliance with the guidance provided by the revenue procedure. Specifically, the revenue procedure creates a safe harbor under which a taxpayer who pays to repair damage to the taxpayer’s personal residence caused by pyrrhotite may treat the amount paid as a casualty loss in the year of payment. To qualify for the safe harbor, an affected taxpayer must obtain either (1) a written evaluation from a licensed engineer indicating that the foundation was made with defective concrete and obtain a reassessment report that shows the reduced value of the property based on the written evaluation from the engineer and an inspection pursuant to Connecticut Public Act No. 16-45, or (2) a written evaluation from a licensed engineer indicating that the foundation was made with defective concrete containing the mineral pyrrhotite. The amount of the casualty loss is the amount paid by the taxpayer to repair the damage (limited by the taxpayer’s basis in the property and reduced by any insurance proceeds received for the damage). The revenue procedure also specifies other guidelines for claiming a pyrrhotite casualty loss, including reporting the loss on IRS Form 4684 with “Revenue Procedure 2017-60” typed at the top of the form. The revenue procedure is effective for federal income tax returns (including amended returns) filed after November 21, 2017.

a. Thanks again to the IRS, you have until October 15, 2018, to address those pesky pyrrhotite problems. Rev. Proc. 2018-14, 2018-9 I.R.B. 378 (2/7/18). As noted above, Rev. Proc. 2017-60 allowed qualifying taxpayers to claim a casualty loss attributable to pyrrhotite damage in the year the taxpayer paid to repair the damage. For taxable years beginning after 2017 and before 2026, however, new Code § 165(h)(5) (added by § 11044 of the 2017 Tax Cuts and Jobs Act) eliminates the deduction for personal casualty losses (other than those attributable to a federally declared disaster). As a result, the victims of pyrrhotite damage, who otherwise were granted relief under Rev. Proc. 2017-60 above, are denied relief unless they made repair payments before January 1, 2018. This revenue procedure mercifully amends Rev. Proc. 2017-60 to extend the time for taxpayers
to pay for pyrrhotite damage and claim a casualty loss deduction on their 2017 or earlier tax returns. Essentially, taxpayers may pay for pyrrhotite damage (as long as the offending concrete was poured before January 1, 2018) up until October 15, 2018, and if they otherwise qualify for relief under pre-TCJA § 165 and Rev. Proc. 2017-60, they may claim a casualty loss deduction for the payment on their original or amended tax return for 2017. Specifically, the revenue procedure provides:

If a taxpayer pays to repair damage to that taxpayer’s personal residence caused by a deteriorating concrete foundation during the taxpayer’s 2016 taxable year or earlier, the taxpayer may treat the amount paid as a casualty loss on a timely Amended U.S. Individual Income Tax Return (Form 1040X) for the taxable year of payment. If a taxpayer pays to repair the damage during the taxpayer’s 2017 taxable year or prior to a timely filed (including extensions) original U.S. Individual Income Tax Return (Form 1040, 1040A or 1040EZ) for the 2017 taxable year, the taxpayer may treat the amount paid as a casualty loss on the taxpayer’s original 2017 income tax return (or a timely filed Form 1040X for the 2017 taxable year). If a taxpayer pays to repair the damage after filing an original 2017 income tax return and prior to the last day for filing a timely Form 1040X for the 2017 taxable year, the taxpayer may treat the amount paid as a casualty loss on a timely filed Form 1040X for the 2017 taxable year. For purposes of this revenue procedure, the term “deteriorating concrete foundation” means a concrete foundation that is damaged as a result of the presence of the mineral pyrrhotite in the concrete mixture used before January 1, 2018.

3. **Unlike most taxpayers in similar situations, these taxpayers were able to show that their initial purpose of developing the property for sale to customers changed to holding the property as an investment.** Sugar Land Ranch Development, LLC v. Commissioner, T.C. Memo. 2018-21 (2/22/18). The petitioner in this case, Sugar Land Ranch Development, LLC (SLRD), a TEFRA partnership, was organized under Texas law in 1998 “principally to acquire contiguous tracts of land in Sugar Land, Texas, just southwest of Houston, and to develop that land into single-family residential building lots and commercial tracts.” Between 1998 and 2008, SLRD took certain actions with respect to the land, which formerly had been an oil field. These actions included capping oil wells and some environmental cleanup. Because of the effects of the subprime mortgage crisis, in 2008, SLRD’s managers decided that SLRD would not subdivide or otherwise develop the property and instead would hold it as an investment and sell it once the market had recovered. Their decision was memorialized in a contemporaneous unanimous written consent document as well as in a resolution adopted by SLRD’s members in November 2009. In 2011, a major homebuilder, Taylor Morrison of Texas, Inc., approached SLRD about buying two parcels of land and later decided to acquire a third parcel as well. In total, these three parcels were approximately 580 acres in size. Taylor Morrison acquired two of the parcels by paying SLRD a lump sum in 2012, the year in issue. (Taylor Morrison also was obligated to pay SLRD a percentage of the final sale price of each future home developed and sold on one of the properties, as well as a fixed amount for each plat recorded on both parcels, but none of these amounts were paid in 2012). On its partnership return on Form 1065 for 2012, SLRD reported an $11 million capital gain with respect to the sale of one parcel and a $1.6 million capital loss with respect to the other. The IRS issued a notice of final partnership administrative adjustment in which it asserted that the aggregate net income from the two sales was ordinary income. The Tax Court (Judge Thornton) held that SLRD properly characterized the gain and loss from the sales of the two properties as capital gain and loss. To determine whether the parcels were held for investment and therefore capital assets or instead property held primarily for sale to customers in the ordinary course of business, the court applied a multi-factor test derived from the decision of the U.S. Court of Appeals for the Fifth Circuit (to which this case is appealable) in Suburban Realty Co. v. United States, 615 F.2d 171 (5th Cir. 1980). These factors include:

- the frequency and substantiality of sales of property; the taxpayer’s purposes in acquiring the property and the duration of ownership; the purpose for which the property was subsequently held; the extent of developing and improving the property to increase sales revenue; the use of a business office for the sale of property; the extent to which the taxpayer used advertising, promotion, or other activities to increase sales;
and the time and effort the taxpayer habitually devoted to the sales. … Frequency and substantiality of sales is the most important factor.

In this case, the court explained, SLRD never subdivided the property and never developed or sold lots from the parcels in question. It also did not undertake marketing or promotional activities. Instead, SLRD received an unsolicited offer from Taylor Morrison to purchase the parcels. For at least three years before SLRD sold the parcels, there was no development activity on them. The court also rejected the IRS’s arguments that SLRD’s sales of these parcels should be viewed as part of development activity undertaken by related parties on adjacent land. The court concluded that the evidence, including “the highly credible testimony” of SLRD’s managers, showed “that in 2008 SLRD ceased to hold its property primarily for sale in that business [of selling residential and commercial lots to customers] and began to hold it only for investment.”

4. Warning: This case hot out of La La Land involving the short sale of a personal residence converted to rental property may short circuit your brain! Simonsen v. Commissioner, 150 T.C. No. 8 (3/14/18). In a one-of-a-kind case of first impression interpreting an almost one-of-a-kind regulation, the Tax Court (Judge Holmes) ruled that both the IRS and the taxpayer got it wrong, so neither won. The case involved (1) a short sale of a principal residence converted to rental property, (2) satisfaction of a recourse mortgage that is treated as nonrecourse debt for federal income tax purposes due to a unique provision of California law, and (3) arcane tax regulations that result in neither gain nor loss being recognized upon a disposition of property. In other words, this is the kind of case that only pointed-headed tax professors like us can love!

The facts. The taxpayers in this case, husband and wife, purchased their principal residence in California in 2005 for $695,000. Their five-year, interest-only mortgage on the home was approximately $566,000. In 2008, when the great recession hit, the value of the taxpayers’ home plummeted, wiping out their equity. In September of 2010, the taxpayers converted their principal residence to a rental property, and the taxpayers moved elsewhere in California. After renting the property for about one year, and with home values still being depressed, the taxpayers grew tired of using good money to chase bad, and they entered into a short sale transaction with an unrelated buyer and their lender, Wells Fargo. The closing occurred in November 2011. (In a typical short sale, a buyer purchases property for a price that is below the amount of debt encumbering the property, so the sales proceeds (net of expenses of sale) are paid entirely to the lender in exchange for the lender releasing the mortgage and releasing the seller from any deficiency.) The taxpayers’ short sale resulted in approximately $363,000 of gross sales proceeds and approximately $346,000 of net sales proceeds after expenses. All $346,000 of net sales proceeds was paid at the closing to Wells Fargo, and Wells Fargo released its mortgage on the property and discharged the taxpayers from the remaining $220,000 (approximately) principal balance of their loan. For their tax year 2011, the taxpayers received a Form 1099-S (Proceeds from Real Estate Transactions) for $363,000 from the title company, and a Form 1099-C (Cancellation of Debt) for approximately $220,000 from Wells Fargo. For reasons explained below, these Forms 1099 were misleading as to the actual tax treatment of the taxpayers’ short sale, so the title company and Wells Fargo bear some responsibility for the taxpayers’ (and the IRS’s) confusion in this case, as detailed below.

The taxpayers’ mistakes. For reasons that do not require elaboration, but in part due to the Forms 1099 received, the taxpayers mistakenly, but honestly, reported the short sale and the discharge of indebtedness on their 2011 federal income tax return as two separate transactions. This in turn led to the taxpayers erroneously reporting a $216,000 (approximately) loss deduction under § 165 and $219,000 (approximately) of excludible cancellation of indebtedness income under § 108(a)(1)(E) (qualified principal residence indebtedness). The taxpayers also made another mistake concerning the tax treatment of the short sale. California has an anti-deficiency statute applicable to certain owner-occupied residential real property. Thus, a lender may be able to foreclose on protected residential real property, but the lender cannot pursue a deficiency judgment if the value of the property is less than the principal amount of the debt. Therefore, due to California law, certain home mortgage indebtedness is treated as nonrecourse debt for federal income tax purposes even though it is treated as recourse debt for all other purposes.
The IRS’s mistake. After auditing the taxpayers’ 2011 federal income tax return, the IRS combined the short sale and discharge of indebtedness into one transaction, which is the correct approach under 2925 Briarpark, Ltd. v. Commissioner, 163 F.3d 313 (5th Cir. 1999), aff’g T.C. Memo 1997-298. Accordingly, the IRS treated the taxpayers as having an amount realized on the short sale of approximately $566,000, but no discharge of indebtedness income. If the mortgage was nonrecourse indebtedness for federal income tax purposes, treating the entire principal amount of the debt as the amount realized is the correct approach under Crane v. Commissioner, 331 U.S. 1 (1947). At this point, though, the IRS’s analysis went awry. The IRS, citing Reg. § 1.165-9(b)(2) (adjusted basis for loss purposes with respect to personal use property converted to rental property), treated the taxpayers’ adjusted basis in the property at the time of sale as being only $495,000, the property’s fair market at the time it was converted to rental property less allowable depreciation. Hence, the IRS’s view was that the taxpayers actually had gain from the short sale (amount realized of $566,000 less adjusted basis of $495,000). This analysis (after denying the § 165 loss and taking into account the gain) led to a deficiency assessment against the taxpayers of $70,000 for 2011, which prompted the taxpayers to file a petition in Tax Court. The IRS’s mistake was that it failed to consider the difference between the taxpayers’ adjusted basis for determining gain and their adjusted basis for determining loss under Reg. § 165-9(b)(2), as Judge Holmes explained in his opinion.

Judge Holmes’s opinion. After recounting the facts as well as the taxpayers’ and the IRS’s mutual mistakes in their approaches as summarized above, Judge Holmes focused upon Reg. § 1.165-9(b)(2). Judge Holmes determined that neither the taxpayer nor the IRS had properly applied the regulation. As the IRS asserted, the regulation does indeed require a taxpayer converting personal use property to determine the basis of a personal residence converted to rental property by subtracting appropriate depreciation from the lower of adjusted basis or fair market, but the regulation expressly states that the result is the taxpayer’s adjusted basis for determining loss. Thus, a proper application of the regulation results in one adjusted basis (after taking into account depreciation) for gain purposes, and another adjusted basis (after taking into account depreciation) for loss purposes. See, e.g., Reg. § 1.1015-1(a)(1) (which does the same thing in the context of a gift of property when the fair market value of the property at the time of the gift is lower than its adjusted basis). Therefore, although the taxpayers’ amount realized was approximately $566,000 as the IRS determined, the taxpayers’ adjusted basis in the property differed depending upon whether gain or loss was being determined. The amount realized of $566,000 did not exceed their adjusted basis for determining gain and was not less than their adjusted basis for determining loss. Because the amount realized of $566,000 was between the taxpayers’ loss basis of $495,000 and the taxpayers’ gain basis of $695,000 (or thereabouts, as the exact amount was unnecessary to determine), the taxpayers realized neither a gain nor a loss upon the sale. The taxpayers’ still had a tax deficiency for 2011 unrelated to the short sale, so technically the IRS “won” the case, but it was a Pyrrhic victory for the IRS, and Judge Holmes declined to impose penalties.

5. Taxpayer restores money-pit mansion to its former glory, but due to taxpayer’s failure to rent or hold out for rental, gets “hammered” by capital loss. Keefe v. Commissioner, T.C. Memo. 2018-28 (03/15/18). These married taxpayers, neither of whom was an architect or contractor, acquired and restored Wrentham House, a historic mansion in Newport, Rhode Island. From May of 2000 until May of 2008 the taxpayers spent approximately $10 million repairing and restoring the mansion with the ultimate goal of turning it into a luxury vacation rental property. Notwithstanding taxpayers’ $10 million investment in the mansion, structural and other problems prevented the property from being marketable as a rental property until June of 2008. At that time, of course, the “Great Recession” was in full swing, and there was virtually no market and no prospect for luxury rentals. Consequently, the mansion was never rented or even seriously marketed for rental, and in August of 2009, the mansion was sold in a short sale for approximately $6 million. The taxpayer’s claimed that the mansion was § 1231 property used in a trade or business thereby entitling them to ordinary loss treatment. The IRS contended that the mansion was not used in a trade or business but instead was a capital asset, so the loss on the short sale was a capital loss subject to the $3,000 per year limitation of § 1211(b). The Tax Court (Chief Judge Marvel) held for the IRS. Citing Gilford v. Commissioner, 201 F.2d 735 (2d Cir. 1953) because the case would be appealable to the Second Circuit Court of Appeals, Judge Marvel explained that the taxpayers failed to show that their alleged rental activities were “sufficient, continuous, and substantial enough to constitute a trade or business with respect to rental of the property.” Accordingly, § 1231 did not apply to the mansion, so the mansion
was a capital asset subject to the capital loss limitation of § 1211(b). The court also upheld the IRS’s imposition of accuracy-related penalties.

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

1. Say it isn’t so! Miscellaneous itemized deductions are no longer deductible beginning in 2018. The 2017 Tax Cuts and Jobs Act, § 11045, amended Code § 67 by adding § 67(g), which disallows as deductions all miscellaneous itemized deductions for taxable years beginning after 2017 and before 2026. Miscellaneous itemized deductions are defined in § 67(b) and, prior to the Tax Cuts and Jobs Act, were deductible to the extent that, in the aggregate, they exceeded 2 percent of the taxpayer’s adjusted gross income. The largest categories of miscellaneous itemized deductions are: (1) investment-related expenses such as fees paid for investment advice or for a safe deposit box used to store investment-related items, (2) unreimbursed employee business expenses, and (3) tax preparation fees.

a. But estates and non-grantor trusts can breathe a sigh of relief. Notice 2018-61, 2018-31 I.R.B. 278 (07/13/18). Under § 67(e), the adjusted gross income of an estate or trust generally is computed in the same manner as that of an individual. Furthermore, prior to the Tax Cut and Jobs Act, estates and non-grantor trusts were subject to the 2 percent floor on miscellaneous itemized deductions like individuals unless a cost paid or incurred by the estate or non-grantor trust “would not have been incurred if the property were not held in such estate or trust.” Put differently, estates and non-grantor trusts avoided the 2 percent floor on miscellaneous itemized deductions if they paid or incurred a cost that “commonly or customarily” would not have been paid or incurred by a hypothetical individual holding the same property as the estate or non-grantor trust. For example, Reg. § 1.67-4(b)(3) provides as follows:

Tax preparation fees. Costs relating to all estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent’s final individual income tax returns are not subject to the 2-percent floor. The costs of preparing all other tax returns (for example, gift tax returns) are costs commonly and customarily incurred by individuals and thus are subject to the 2-percent floor.

If a fee (such as a tax preparation fee) paid or incurred by an estate or non-grantor trust was bundled so that it included costs that were both subject to the 2 percent floor (e.g., gifts tax return) and not subject to the 2 percent floor (e.g., fiduciary income tax return), then the estate or non-grantor trust must allocate the bundled fee appropriately.

The enactment of new § 67(g), which states that “no miscellaneous itemized deduction” is allowed until 2026, left many estates and trusts wondering whether their investment-related and tax-related expenses (e.g., return preparation fees, trustee fees, financial advisor fees, etc.) peculiar to the administration of an estate or trust remain deductible either in whole or in part. Notice 2018-61 announces that Treasury and the IRS do not read new § 67(g) to disallow all investment- and tax-related expenses of estates and non-grantor trusts. Thus, the Treasury Department and the IRS intend to issue regulations clarifying that estates and non-grantor trusts may continue to deduct investment- and tax-related expenses just as they could prior to the enactment of new § 67(g). Notice 2018-61 also announces that Treasury and the IRS are aware of concerns surrounding whether new § 67(g) impacts a beneficiary’s ability to deduct investment- and tax-related expenses pursuant to § 642(h) (unused loss carryovers and excess deductions) upon termination of an estate or non-grantor trust. Treasury and the IRS intend to issue regulations addressing these concerns as well.

D. Section 121

E. Section 1031

1. When it comes to like-kind exchanges, President Trump, qualified exchange intermediaries, and non-dealers in real estate are winners, but those exchanging airplanes, earth movers, and other large equipment are “losers.” The 2017 Tax Cuts and Jobs Act, § 13303, amended § 1031(a)(1) so that the term “real property” is substituted for “property” for taxable years beginning after 2017. Pre-TCJA § 1031(e) (livestock of different sexes), (i) (mutual ditch, reservoir,
or irrigation company stock), and (h)(2) (U.S. and non-U.S. personal property) are repealed. In effect, then, like-kind exchanges under § 1031 for 2018 and future years are limited to real property. New § 1031(e) provides that if under § 761(a) a partnership elects out of subchapter K, then an interest in such a partnership is treated for purposes of § 1031 as “an interest in each of the assets of such partnership and not as an interest in a partnership.” The changes to § 1031 are permanent. Nevertheless, a transition rule (TCJA § 13303(c)) allows any forward or reverse exchange that began under § 1031 before 2018 to qualify for nonrecognition if completed after December 31, 2017 (assuming, of course, that all other requirements of § 1031 are met).

F. Section 1033

G. Section 1035

H. Miscellaneous

1. A self-created patent, invention, model or design, secret formula or process is excluded from the definition of a capital asset. The 2017 Tax Cuts and Jobs Act, § 13314, amended Code § 1221(a)(3) to expand the types of self-created property that are excluded from the definition of a capital asset. Prior to amendment by the Tax Cuts and Jobs Act, Code § 1221(a)(3) excluded from the definition of a capital asset “a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by...” a taxpayer whose personal efforts created the property or (in the case of a letter, memorandum, or similar property) a taxpayer for whom the property was produced. This same property is excluded from the capital asset category if it is held by a taxpayer whose basis in the property is determined by reference to the basis of the person who created it or for whom it was created (e.g., a taxpayer who acquired the property from the creator as a gift). The legislation adds to the list of property subject to this rule “a patent, invention, model or design (whether or not patented), a secret formula or process.” A conforming amendment to Code § 1231(b)(1)(C) excludes this same property from the definition of “property used in a trade or business” for purposes of § 1231. Thus, a self-created patent, model or design, secret formula or process is not a capital asset and is not subject to § 1231. The effect of this provision is to treat gain or loss from the sale or disposition of these assets as ordinary. This rule applies to dispositions after 2017.

- The legislation creates an unresolved conflict between amended § 1221(a)(3), on the one hand, and § 1235, on the other. Section 1235(a) provides that a transfer (other than by gift, inheritance, or devise) by a “holder” of property consisting of all substantial rights to a patent or an undivided interest in a patent is treated as the sale or exchange of a capital asset held for more than one year. This is true regardless of whether payments received by the transferee are payable periodically as the transferee uses the patent or are contingent on the productivity, use, or disposition of the property transferred. The term “holder” includes an individual whose efforts created the property. Thus, if an individual whose personal efforts created a patent sells the patent, § 1235 dictates that the gain is long-term capital gain and § 1221(a)(3) dictates that the patent is not a capital asset. In our view, § 1235 should take priority because it essentially says that gain from the sale of a self-created patent is long-term capital gain and does not make this result contingent on the patent’s status as a capital asset. This conflict is likely the result of a legislative oversight. The House version of the legislation would have amended § 1221(a)(3) and would have repealed § 1235. The final version of the legislation amended § 1221(a)(3) but left § 1235 in place.

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. The Tax Court ices the IRS by allowing the Boston Bruins’ 100% deduction for away-game meals as a de minimis fringe, while the winning slap shot may be that hotel and banquet facilities can be “leased.” Jacobs v. Commissioner, 148 T.C. No. 24 (6/26/17). The taxpayers, a married couple, own the S corporation that operates the Boston Bruins professional hockey team. When the Bruins travel to away games, the team provides the coaches, players, and other team personnel with hotel lodging as well as pre-game meals in private banquet rooms. Game preparation (e.g., strategy meetings, viewing films, discussions among coaches and players) also takes place during these team meals. The Bruins enter into extensive contracts with away-game hotels, including terms specifying the food to be served and how the banquet rooms should be set up. The taxpayers’ S
corporation spent approximately $540,000 on away-game meals at hotels over the years 2009 and 2010, deducting the full amount thereof pursuant to §§ 162, 274(n)(2)(B), and 132(e). Section 274(n) generally disallows 50 percent of meal and entertainment expenses, but § 274(n)(2)(B) provides an exception if the expense qualifies as a de minimis fringe benefit under § 132(e). Under Reg. § 1.132–7, employee meals provided on a nondiscriminatory basis qualify under § 132(e) if (1) the eating facility is owned or leased by the employer; (2) the facility is operated by the employer; (3) the facility is located on or near the business premises of the employer; (4) the meals furnished at the facility are provided during, or immediately before or after, the employee’s workday; and (5) the annual revenue derived from the facility normally equals or exceeds the direct operating costs of the facility. The IRS argued that the Bruins’ expenses do not qualify under § 132(e) and thus should be limited to 50 percent under § 274(n) because meals at away-game hotels are neither at facilities “operated by the employer,” nor “owned or leased by the employer,” nor “on or near the business premises of the employer.” After easily determining that the other requirements for de minimis fringe benefit treatment were met, the Tax Court (Judge Ruwe) focused upon whether, for purposes of § 132(e) and Reg. § 1.132–7, the Bruins’ away-game hotels can be considered facilities that are “operated by the employer,” “leased by the employer,” and “on or near the business premises of the employer.” Judge Ruwe held that because away-game travel and lodging are indispensable to professional hockey and because the Bruins’ contracts with the hotels specify many of the details regarding lodging, meals, and banquet rooms, the meal expenses are 100 percent deductible as a de minimis fringe. The hotel facilities are “operated by the employer” because the regulations expressly construe that term to include being operated under contract with the employer. The hotel facilities also should be considered “leased” by the employer, the court concluded, due to the extensive contracts and the team’s exclusive use and occupancy of designated hotel space. Further, the court concluded that, because away-game travel and lodging is an indispensable part of professional hockey, the hotel facilities should be considered the business premises of the employer.

- The slap shot to the IRS: The Tax Court’s holding that the Bruins’ “lease” the hotel facilities is somewhat at odds with regulations under § 512. Reg. § 1.512(b)-(1)c(5) provides that amounts received for the use or occupancy of space where personal services are rendered to the occupant (e.g., hotel services) does not constitute rent for purposes of the § 512 exclusion from unrelated business taxable income. See also Rev. Rul. 80-298, 1980-2 C.B.197 (amounts received by tax-exempt university for professional football team’s use of playing field and dressing room along with maintenance, linen, and security services is not rental income for purposes of § 512 exclusion from UBTI). Judge Ruwe’s decision may embolden tax-exempt organizations seeking to exclude so-called “facility use fees” (e.g., payments made to an aquarium for exclusive use of its space for corporate events) from UBTI.

  a. But wait, upon further consultation with the replay center, the call is reversed! The 2017 Tax Cuts and Jobs Act, § 13304, amends Code § 274(n) to remove the exception to the 50 percent limitation for meal expenses that qualify as a de minimis fringe benefit. Accordingly, employers can deduct only 50 percent of the cost of employee meals provided at an employer-operated eating facility. This rule applies to amounts paid or incurred after 2017 and before 2026. Beginning in 2026, such costs are entirely disallowed as deductions pursuant to new Code § 274(o).

  2. Meals provided for the convenience of the employer will not be deductible beginning in 2026. The 2017 Tax Cuts and Jobs Act, § 13304, amended Code § 274 by adding § 274(o), which disallows as deductions meals provided for the convenience of the employer (within the meaning of § 119), which otherwise would be deductible by the employer. This rule applies to amounts paid or incurred after 2025.

  3. Are we really so strapped for cash that we have to tax people who ride their bicycles to work? The 2017 Tax Cuts and Jobs Act, § 11047, amends Code § 132(f) by adding § 132(f)(8), which provides that the exclusion from gross income provided by § 132(f)(1)(D) for qualified bicycle commuting reimbursements provided by employers shall not apply to any taxable year beginning after 2017 and before 2026.

  4. Those who move for work-related reasons now have a higher tax bill. Is this really good for the economy? Provided that certain requirements are met, Code § 217 allows a taxpayer to deduct moving expenses paid or incurred in connection with the taxpayer’s commencement
of work (either as an employee or as a self-employed individual) at a new principal place of work. Section 132(g) of the Code excludes from an employee’s gross income a “qualified moving expense reimbursement,” defined as an employer’s reimbursement of moving expenses that, if paid by the employee, would be deductible under § 217. The 2017 Tax Cuts and Jobs Act amended both provisions. Section 11049 of the TCJA amended Code § 217 by adding § 217(k), which provides that the deduction for moving expenses shall not apply to any taxable year beginning after 2017 and before 2026. Section 11048 of the TCJA amended Code § 132(g) by adding § 132(g)(2), which provides that the exclusion from gross income for a qualified moving expense reimbursement shall not apply to any taxable year beginning after 2017 and before 2026. Both amendments contain an exception for members of the armed forces on active duty who move pursuant to a military order and incident to a permanent change of station, i.e., such individuals can still deduct moving expenses and exclude moving expense reimbursements.

a. Individuals can exclude from gross income reimbursements received from employers in 2018 for expenses incurred in connection with moves that occurred before 2018.

Notice 2018-75, 2018-41 I.R.B. 556 (9/21/18). Prior to the 2017 Tax Cuts and Jobs Act, § 132(a)(6) permitted individuals to exclude from gross income a “qualified moving expense reimbursement,” defined in § 132(g) as an employer’s reimbursement of moving expenses that, if paid by the individual, would be deductible under § 217. In the Tax Cuts and Jobs Act, Congress suspended this exclusion (except with respect to members of the armed forces on active duty who move pursuant to military orders) for taxable years beginning after 2017 and before 2026. This notice provides that the suspension of the exclusion does not apply to individuals who receive reimbursements from employers in 2018 for expenses incurred in connection with moves that occurred before 2018. The notice provides as follows:

Thus, if an individual moved in 2017 and the expenses for the move would have been deductible by the individual under section 217 as in effect prior to the amendments made by the Act if they had been paid directly by the individual in 2017, and the individual did not deduct the moving expenses, then the amount received (directly or indirectly) in 2018 by the individual from an employer as payment for or reimbursement of the expenses will be a qualified moving expense reimbursement under section 132(g)(1).

An individual therefore can exclude such payments by employers from gross income regardless of whether the employer paid the moving expense directly or instead reimbursed the individual. The notice provides that employers who have included such amounts in an individual’s wages or compensation for purposes of federal employment taxes (and therefore have withheld and paid federal employment taxes on these amounts) can use the adjustment process under § 6413 or the refund claim process under § 6402 to correct the overpayment of federal employment taxes.

B. Qualified Deferred Compensation Plans

1. Relief for certain closed defined benefit pension plans. Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13). This notice provides temporary nondiscrimination relief for certain “closed” defined benefit pension plans (i.e., those that provide ongoing accruals but that have been amended to limit those accruals to some or all of the employees who participated in the plan on a specified date). Typically, new hires are offered only a defined contribution plan, and the closed defined benefit plan has an increased proportion of highly compensated employees.

a. The relief is extended to plan years beginning before 2017. Notice 2015-28, 2015-14 I.R.B. 848 (3/19/15). This notice extends for an additional year the temporary nondiscrimination relief originally provided in Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13), by applying that relief to plan years beginning before 2017. The notice cautions that all remaining provisions of the nondiscrimination regulations under § 401(a)(4) (including the rules relating to the timing of plan amendments under Reg. § 1.401(a)(4)-5) continue to apply. Treasury and the IRS anticipate issuing proposed amendments to the § 401(a)(4) regulations that would be finalized and apply after the relief under Notice 2014-5 and this notice expires.
b. Proposed regulations provide nondiscrimination relief for certain closed plans and formulas and make other changes. REG-125761-14, Nondiscrimination Relief for Closed Defined Benefit Pension Plans and Additional Changes to the Retirement Plan Nondiscrimination Requirements, 81 F.R. 4976 (1/29/16). The Treasury Department and the IRS have published proposed amendments to the regulations under § 401(a)(4), which provides generally that a plan is a qualified plan only if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees. The proposed regulations modify a number of provisions in the existing regulations under § 401(a)(4) to address situations and plan designs that were not contemplated in the development of the existing regulations. Many of the changes in the proposed regulations provide nondiscrimination relief for certain closed plans and formulas, but the proposed regulations also include other changes that are not limited to closed plans and formulas. The proposed amendments generally would apply to plan years beginning on or after the date of publication of final regulations and, subject to some significant exceptions, taxpayers are permitted to apply the provisions of the proposed regulations for plan years beginning on or after 1/1/14.

c. The relief is extended to plan years beginning before 2018. Notice 2016-57, 2016-40 I.R.B. 432 (9/19/16). This notice extends for an additional year the temporary nondiscrimination relief originally provided in Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13), by applying that relief to plan years beginning before 2018. The IRS has done so because it anticipates that the proposed regulations (REG-125761-14, Nondiscrimination Relief for Closed Defined Benefit Pension Plans and Additional Changes to the Retirement Plan Nondiscrimination Requirements, 81 F.R. 4976 (1/29/16)) will not be published as final regulations in time for plan sponsors to make plan design decisions based on the final regulations before expiration of the relief provided under Notice 2014-5 (as extended by Notice 2015-28). Therefore, the IRS has extended the relief for an additional year.

d. The relief is extended to plan years beginning before 2019. Notice 2017-45, 2017-38 I.R.B. 232 (8/31/17). This notice extends for an additional year the temporary nondiscrimination relief originally provided in Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13), by applying that relief to plan years beginning before 2019. The IRS has done so because it anticipates that the proposed regulations (REG-125761-14, Nondiscrimination Relief for Closed Defined Benefit Pension Plans and Additional Changes to the Retirement Plan Nondiscrimination Requirements, 81 F.R. 4976 (1/29/16)) will not be published as final regulations in time for plan sponsors to make plan design decisions based on the final regulations before expiration of the relief provided under Notice 2014-5 (as last extended by Notice 2016-57). Therefore, the IRS has extended the relief for an additional year.

e. The relief is extended to plan years beginning before 2020. Notice 2018-69, 2018-37 I.R.B. 426 (8/24/18). This notice extends for an additional year the temporary nondiscrimination relief originally provided in Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13), by applying that relief to plan years beginning before 2020. The IRS has done so because it anticipates that the proposed regulations (REG-125761-14, Nondiscrimination Relief for Closed Defined Benefit Pension Plans and Additional Changes to the Retirement Plan Nondiscrimination Requirements, 81 F.R. 4976 (1/29/16)) will not be published as final regulations in time for plan sponsors to make plan design decisions based on the final regulations before expiration of the relief provided under Notice 2014-5 (as last extended by Notice 2017-45). Therefore, the IRS has extended the relief for an additional year.

2. Congress makes access to retirement plan funds even easier for victims of Hurricanes Harvey, Irma, and Maria. The Disaster Relief and Airport and Airway Extension Act of 2017 (“2017 Disaster Relief Act”), Pub. L. No. 115-102, was signed by the President on September 29, 2017. Section 502 of the 2017 Disaster Relief Act provides special rules that apply to distributions from qualified employer plans and IRAs and to loans from qualified employer plans for victims of Hurricanes Harvey, Irma, and Maria. To a large extent, these rules supersede those in Announcement 2017-11, 2017-39 I.R.B. 255 (8/30/17), and Announcement 2017-13, 2017-40 I.R.B. 271 (9/12/17).

Qualified Hurricane Distributions. Section 502(a) of the 2017 Disaster Relief Act provides four special rules for “qualified hurricane distributions.” First, the legislation provides that qualified
hurricane distributions up to an aggregate amount of $100,000 are not subject to the normal 10-percent additional tax of § 72(t) that applies to distributions to a taxpayer who has not reached age 59-1/2. **Second,** the legislation provides that, unless the taxpayer elects otherwise, any income resulting from a qualified hurricane distribution is reported ratably over the three-year period beginning with the year of the distribution. **Third,** the legislation permits the recipient of a qualified hurricane distribution to contribute up to the amount of the distribution to a qualified employer plan or IRA that would be eligible to receive a rollover contribution of the distribution. The contribution need not be made to the same plan from which the distribution was received, and must be made during the three-year period beginning on the date of the distribution. If contributed within the required three-year period, the distribution and contribution are treated as made in a direct trustee-to-trustee transfer within 60 days of the distribution. The apparent intent of this rule is to permit the taxpayer to exclude the distribution from gross income to the extent it is reconstituted within the required period. Because the reconstituted contribution may take place in a later tax year than the distribution, presumably a taxpayer would include the distribution in gross income in the year received and then file an amended return for the distribution year upon making the reconstituted. **Fourth,** qualified hurricane distributions are not treated as eligible rollover distributions for purposes of the withholding rules, and therefore are not subject to the normal 20 percent withholding that applies to eligible rollover distributions under § 3405(c). A qualified hurricane distribution is defined as any distribution from an eligible retirement plan as defined in § 402(c)(8)(B) (which includes qualified employer plans and IRAs) made before January 1, 2019, and (1) on or after August 23, 2017, to an individual whose principal place of abode on that date was located in the Hurricane Harvey disaster area and who sustained an economic loss by reason of Hurricane Harvey, (2) on or after September 4, 2017, to an individual whose principal place of abode on that date was located in the Hurricane Irma disaster area and who sustained an economic loss by reason of Hurricane Irma, or (3) on or after September 16, 2017, to an individual whose principal place of abode on that date was located in the Hurricane Maria disaster area and who sustained an economic loss by reason of Hurricane Maria.

**Recontributions of Withdrawals Made for Home Purchases.** Section 502(b) of the 2017 Disaster Relief Act permits an individual who received a “qualified distribution” to contribute up to the amount of the distribution to a qualified employer plan or IRA that would be eligible to receive a rollover contribution of the distribution. A qualified distribution is a hardship distribution that an individual received from a qualified employer plan or IRA after February 28, 2017, and before September 21, 2017, that was to be used to purchase or construct a principal residence in the Hurricane Harvey, Irma, or Maria disaster areas that was not purchased or constructed on account of the hurricanes. The contribution need not be made to the same plan from which the distribution was received, and must be made during the period beginning on August 23, 2017, and ending on February 28, 2018. The distribution and contribution are treated as made in a direct trustee-to-trustee transfer within 60 days of the distribution. The apparent intent of this rule is to permit the taxpayer to exclude the distribution from gross income to the extent it is reconstituted within the required period.

**Loans.** For victims of Hurricanes Harvey, Irma, or Maria, section 502(c) of the 2017 Disaster Relief Act increases the limit on loans from qualified employer plans and permits repayment over a longer period of time. Normally, under § 72(p), a loan from a qualified employer plan is treated as a distribution unless it meets certain requirements. One requirement is that the loan must not exceed the lesser of (1) $50,000 or (2) the greater of one-half of the present value of the employee’s nonforfeitable accrued benefit or $10,000. A second requirement is that the loan must be repaid within five years. In the case of a loan made to a “qualified individual” during the period from September 29, 2017 (the date of enactment) through December 31, 2018, the legislation increases the limit on loans to the lesser of (1) $100,000 or (2) the greater of all of the present value of the employee’s nonforfeitable accrued benefit or $10,000. The legislation also provides that, if a qualified individual has an outstanding plan loan on August 23, 2017 (for Harvey victims), September 4, 2017 (for Irma victims), or September 16, 2017 (for Maria victims) with a due date for any repayment on or before December 31, 2018, the due date is delayed for one year. If an individual takes advantage of this delay, then any subsequent repayments are adjusted to reflect the delay in payment and interest accruing during the delay. This appears to require reamortization of the loan. A qualified individual is defined as an individual whose principal place of abode (1) was located in the Hurricane Harvey disaster area on August 23, 2017, and who sustained an economic loss by reason of Hurricane Harvey, (2) was located in the Hurricane Irma disaster area on August 23, 2017, and who sustained an economic loss by reason of Hurricane Irma, or (3) was located in the Hurricane Maria disaster area on September 16, 2017, and who sustained an economic loss by reason of Hurricane Maria.
disaster area on September 4, 2017, and who sustained an economic loss by reason of Hurricane Irma, or (3) was located in the Hurricane Maria disaster area on September 16, 2017, and who sustained an economic loss by reason of Hurricane Maria.

**Hurricane Harvey, Irma, and Maria Disaster Areas.** Section 501 of the 2017 Disaster Relief Act defines the Hurricane Harvey disaster area, Hurricane Irma disaster area, and Hurricane Maria disaster area as an area with respect to which the President has declared a major disaster by reason of the relevant hurricane before October 17, 2017. (Note: the date originally in the 2017 Disaster Relief Act was September 21, 2017. This date was changed to October 17, 2017, by the Bipartisan Budget Act of 2018, Division B, § 20201, Pub. L. No. 115-123, which was signed by the President on February 9, 2018.)

a. **Congress has enacted similar rules to allow easier access to retirement funds for those affected by California wildfires.** The Bipartisan Budget Act of 2018, Pub. L. No. 115-123, § 20102 of Division B provides those affected by California wildfires with the same special rules for distributions from qualified employer plans and IRAs and for loans from qualified employer plans that Congress previously enacted as part of the 2017 Disaster Relief Act for those affected by Hurricanes Harvey, Irma, and Maria.

**Qualified Wildfire Distributions.** The legislation provides that “qualified wildfire distributions” up to an aggregate limit of $100,000 are not subject to the normal 10-percent additional tax of § 72(t), are to be included in gross income over a three-year period unless the recipient elects otherwise, can be recontributed to an eligible plan within three years and thereby treated as tax-free rollovers, and are not subject to the normal 20 percent withholding that applies to eligible rollover distributions under § 3405(c). A qualified wildfire distribution is defined as any distribution from an eligible retirement plan as defined in § 402(c)(8)(B) (which includes qualified employer plans and IRAs) made on or after October 8, 2017, and before January 1, 2019, to an individual whose principal place of abode during any portion of the period from October 8, 2017, to December 31, 2017, was located in the California wildfire disaster area and who sustained an economic loss by reason of the wildfires.

**Recontributions of Withdrawals Made for Home Purchases.** The legislation permits an individual who received a “qualified distribution” to contribute up to the amount of the distribution to a qualified employer plan or IRA that would be eligible to receive a rollover contribution of the distribution. A qualified distribution is a hardship distribution that an individual received from a qualified employer plan or IRA after March 31, 2017, and before January 15, 2018, that was to be used to purchase or construct a principal residence in the California wildfire disaster area that was not purchased or constructed on account of the wildfires. The contribution need not be made to the same plan from which the distribution was received, and must be made during the period beginning on October 8, 2017, and ending on June 30, 2018. The distribution and contribution are treated as made in a direct trustee-to-trustee transfer within 60 days of the distribution. This special rule permits the taxpayer to exclude the distribution from gross income to the extent it is recontributed within the required period.

**Loans.** The legislation provides those affected by California wildfires the same increased loan limit and extended repayment period that Congress previously provided in the 2017 Disaster Relief Act to those affected by Hurricanes Harvey, Irma, and Maria. In the case of a loan made to a “qualified individual” during the period from February 9, 2018 (the date of enactment) through December 31, 2018, the legislation increases the limit on loans to the lesser of (1) $100,000 or (2) the greater of all of the present value of the employee’s nonforfeitable accrued benefit or $10,000. The legislation also provides that, if a qualified individual has an outstanding plan loan on or after October 8, 2017, with a due date for any repayment on or before December 31, 2018, the due date is delayed for one year. A qualified individual is any individual whose principal place of abode during any portion of the period from October 8, 2017, to December 31, 2017, was located in the California wildfire disaster area and who sustained an economic loss by reason of the wildfires.

**California Wildfire Disaster Area.** The Bipartisan Budget Act of 2018 defines the term “California wildfire disaster area” as an area with respect to which the President declared a major disaster from January 1, 2017, through January 18, 2018, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of wildfires in California.

- Elective deferral in §§ 401(k), 403(b), and 457 plans are increased from $18,500 to $19,000 with a catch up provision for employees aged 50 or older that remains unchanged at $6,000.

- The limit on contributions to an IRA is increased to $6,000 (from $5,500). The AGI phase out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to $64,000 to $74,000 (from $63,000-$73,000) for single filers and heads of household, increased to $103,000-$123,000 (from $101,000-$121,000) for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, and increased to $189,000-$199,000 (from $193,000-$203,000) for an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered. The phase-out range for contributions to a Roth IRA is increased to $193,000-$203,000 (from $189,000-$199,000) for married couples filing jointly, and increased to $122,000-$175,000 (from $120,000-$135,00) for singles and heads of household.

- The annual benefit from a defined benefit plan under § 415 is increased to $225,000 (from $220,000).

- The limit for defined contribution plans is increased to $56,000 (from $55,000).

- The amount of compensation that may be taken into account for various plans is increased to $280,000 (from $275,000), and is increased to $415,000 (from $405,000) for government plans.

- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to $64,000 (from $63,000) for married couples filing jointly, increased to $48,000 (from $47,250) for heads of household, and increased to $32,000 (from $31,500) for singles and married individuals filing separately.

C. Nonqualified Deferred Compensation, Section 83, and Stock Options

1. Employees of privately owned corporations can elect to defer income from “qualified equity grants” for up to five years. The 2017 Tax Cuts and Jobs Act, § 13603, amended Code § 83 by adding § 83(i), which allows a “qualified employee” to elect to defer income attributable to “qualified stock” transferred to the employee by the employer. The election must be made no later than 30 days after the first time the employee has substantially vested in the stock. Generally, the effect of this provision is to allow the employee to defer including in income the amount that the employee normally would be required to include under the rules of § 83(a). Under the rules of § 83(h), the employer’s deduction for the value of the stock should be deferred until the employee includes the value in gross income. If the employee does not make the § 83(i) election, then the normal rules of § 83 apply. If the employee does make the § 83(i) election, then the employee must include in gross income the amount determined under § 83(a) (normally the fair market value of the stock less whatever the employee paid for it, determined when the rights of the employee in the stock first become transferable or not subject to substantial risk of forfeiture) upon the first to occur of the following: (1) the first date the qualified stock becomes transferable (including transferable to the employer); (2) the date the employee first becomes an “excluded employee”; (3) the first date on which any stock of the employer becomes readily tradable on an established securities market; (4) the date five years after the first date the employee’s right to the stock becomes substantially vested; or (5) the date on which the employee revokes his or her election. The statute contains many definitions. A “qualified employee” generally is any employee other than an “excluded employee.” Excluded employees are defined as a 1 percent owners (currently or during the ten preceding calendar years), those who have been at any prior time the Chief Executive Officer or the Chief Financial Officer, and those who are one of the four highest compensated officers (currently or during any of the ten preceding taxable years) determined on the basis of the shareholder disclosure rules for compensation under the Securities Exchange Act of 1934. “Qualified stock” is generally defined as stock transferred by an “eligible corporation” that is an employer of an employee.
in connection with the employee’s performance of services if the employee receives the stock either in connection with the exercise of an option or in settlement of a restricted stock unit. A corporation is an “eligible corporation” if (1) no stock of the corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year, and (2) the corporation has a written plan under which not less than 80 percent of all employees who provide services to the corporation in the United States (or any U.S. possession) are granted stock options, or are granted restricted stock units, with the same rights and privileges to receive qualified stock. A corporation that transfers qualified stock to an employee must provide notice to the employee that the stock is qualified stock and that the employee may be eligible to elect to defer income on such stock. This provision applies to options exercised, or restricted stock units settled, after 2017.

a. Initial guidance on the income deferral of § 83(i). Notice 2018-97, 2018-52 IRB 1052 (12/7/18). The IRS has provided initial guidance on the application of § 83(i). According to the notice, Treasury and the IRS anticipate that further guidance on § 83(i) will be issued in the form of proposed regulations that will incorporate the guidance provided in the notice and will apply to any taxable year ending on or after December 7, 2018. Generally, the notice addresses the following issues: (1) application of the requirement in § 83(i)(2)(C)(i)(II) that grants be made to not less than 80 percent of all employees who provide services to the corporation in the United States, (2) application of federal income tax withholding to the deferred income related to the qualified stock, and (3) the ability of an employer to opt out of permitting employees to elect the deferred tax treatment even if the requirements under § 83(i) are otherwise met.

D. Individual Retirement Accounts

1. We can no longer unwind Roth conversions if the market goes down. The 2017 Tax Cuts and Jobs Act, § 13611, amended Code § 408A(d)(6)(B) by adding § 408A(d)(6)(B)(iii), which prohibits recharacterizing conversion contributions to a Roth IRA as made to a traditional IRA. This change still permits conversions of a traditional IRA to a Roth IRA (and therefore still permits so-called back-door Roth IRAs), but prohibits recharacterizing the conversion by the October 15 extended due date for individual returns. This change therefore precludes an individual from deciding to unwind a Roth conversion by the extended due date of the individual’s return based on market performance. The provision applies to taxable years beginning after 2017.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

1. Under the new, simplified rate structure of the 2017 Tax Cuts and Jobs Act, the number of individual rate brackets has been reduced from seven to seven. The 2017 Tax Cuts and Jobs Act, § 11001(a), added Code § 1(j), which replaces the existing rate structure for ordinary income of individuals with a new rate structure for taxable years beginning after 2017 and before 2026. Unless Congress takes further action, the existing rate structure, as adjusted for inflation, will apply once more for taxable years beginning after 2025. The following tables show the rate structure for individuals that had been scheduled to take effect for taxable years beginning in 2018 and the rate structure that will apply by virtue of the 2017 Tax Cuts and Jobs Act. The brackets established by the 2017 Tax Cuts and Jobs Act will be adjusted for inflation for tax years beginning after 2018.

<table>
<thead>
<tr>
<th>2018 Rates for Single Individuals</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>If taxable income is:</strong></td>
</tr>
<tr>
<td><strong>1</strong></td>
</tr>
<tr>
<td><strong>After TCJA</strong></td>
</tr>
<tr>
<td><strong>2</strong></td>
</tr>
<tr>
<td><strong>After TCJA</strong></td>
</tr>
<tr>
<td><strong>3</strong></td>
</tr>
</tbody>
</table>
### 2018 Rates for Married Individuals Filing Joint Returns and Surviving Spouses

<table>
<thead>
<tr>
<th>If taxable income is:</th>
<th>Then income tax equals:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1</strong></td>
<td><strong>Before TCJA</strong> Not over $19,050</td>
</tr>
<tr>
<td><strong>After TCJA</strong> Not over $19,050</td>
<td>10% of taxable income</td>
</tr>
<tr>
<td><strong>2</strong></td>
<td><strong>Before TCJA</strong> Over $19,050 but not over $77,400</td>
</tr>
<tr>
<td><strong>After TCJA</strong> Over $19,050 but not over $77,400</td>
<td>$1,905, plus 12% of the excess over $19,050</td>
</tr>
<tr>
<td><strong>3</strong></td>
<td><strong>Before TCJA</strong> Over $77,400 but not over $156,150</td>
</tr>
<tr>
<td><strong>After TCJA</strong> Over $77,400 but not over $165,000</td>
<td>$8,907, plus 22% of the excess over $77,400</td>
</tr>
<tr>
<td><strong>4</strong></td>
<td><strong>Before TCJA</strong> Over $156,150 but not over $237,950</td>
</tr>
<tr>
<td><strong>After TCJA</strong> Over $165,000 but not over $315,000</td>
<td>$28,179, plus 24% of the excess over $165,000</td>
</tr>
<tr>
<td><strong>5</strong></td>
<td><strong>Before TCJA</strong> Over $237,950 but not over $424,950</td>
</tr>
<tr>
<td><strong>After TCJA</strong> Over $315,000 but not over $400,000</td>
<td>$64,179, plus 32% of the excess over $315,000</td>
</tr>
<tr>
<td><strong>6</strong></td>
<td><strong>Before TCJA</strong> Over $424,950 but not over $480,050</td>
</tr>
<tr>
<td><strong>After TCJA</strong> Over $400,000 but not over $600,000</td>
<td>$91,379, plus 35% of the excess over $400,000</td>
</tr>
<tr>
<td><strong>7</strong></td>
<td><strong>Before TCJA</strong> Over $480,050</td>
</tr>
<tr>
<td><strong>After TCJA</strong> Over $600,000</td>
<td>$161,379, plus 37% of the excess over $600,000</td>
</tr>
</tbody>
</table>

2. The rates of tax on net capital gains and qualified dividends remain essentially the same under the 2017 Tax Cuts and Jobs Act. The 2017 Tax Cuts and Jobs Act, § 11001(a), added Code § 1(j). For taxable years beginning after 2017, and before 2026, § 1(j)(5) retains the
existing maximum rates of tax on net capital gains and qualified dividends. Thus, the maximum rates of tax on adjusted net capital gain remain at 0 percent, 15 percent, or 20 percent. The maximum rate of tax on unrecaptured section 1250 gain remains at 25 percent, and the maximum rate on 28-percent rate gain remains at 28 percent. Further, the 3.8 percent tax on net investment income remains in place. However, unlike current law, which determines the rate of tax on adjusted net capital gain by reference to the rate of tax that otherwise would be imposed on the taxpayer’s taxable income (including the adjusted net capital gain), new § 1(j)(5) defines “breakpoints” that are used for this purpose. The breakpoints are those under the current rate structure (before amendment by the 2017 Tax Cuts and Jobs Act) but are adjusted for inflation for taxable years beginning after 2017. For taxable years beginning in 2018, the following table shows the breakpoints that establish the rate of tax on adjusted net capital gain.

<table>
<thead>
<tr>
<th>2018 Rates of Tax on Adjusted Net Capital Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Rate</td>
</tr>
<tr>
<td>----------</td>
</tr>
<tr>
<td>0% if taxable income does not exceed</td>
</tr>
<tr>
<td>15% if taxable income does not exceed</td>
</tr>
<tr>
<td>20% if taxable income exceeds</td>
</tr>
</tbody>
</table>

3. An incentive for kids to be entrepreneurial? The Tax Cuts and Jobs Act modified the kiddie tax by applying the rates of tax applicable to trusts and estates to the unearned income of children. The 2017 Tax Cuts and Jobs Act, § 11001(a), added Code § 1(j). For taxable years beginning after 2017 and before 2026, § 1(j)(4) modifies the so-called “kiddie tax” by taxing the unearned income of children under the rate schedule that applies to trusts and estates. (The earned income of children continues to be taxed at the rates that normally apply to a single individual.) This changes the approach of current law, under which the tax on unearned income of children is determined by adding it to the income of the child’s parents and calculating a hypothetical increase in tax for the parents. Under the new approach, the child’s tax on unearned income is unaffected by the parents’ tax situation. The 2017 Tax Cuts and Jobs Act does not change the categories of children subject to the kiddie tax.

B. Miscellaneous Income

1. An exclusion from gross income for wrongfully incarcerated individuals. The 2015 PATH Act, § 304, added to the Code § 139F, which excludes from the gross income of an individual who is convicted of a criminal offense under federal or state law and wrongfully incarcerated any civil damages, restitution, or other monetary award relating to the individual’s incarceration. An individual was wrongfully incarcerated if the individual is pardoned, granted clemency, or granted amnesty for the offense because the individual was innocent, or if the conviction is reversed or vacated and the charging instrument is then dismissed or the individual is found not guilty at a new trial. The new provision applies to taxable years beginning before, on, or after December 18, 2015, the date of enactment. A special rule allows individuals to make a claim for credit or refund of any overpayment of tax resulting from the exclusion, even if the claim would normally be barred by operation of any law or rule of law (including res judicata), if the claim for credit or refund is filed before the close of the one-year period beginning on December 18, 2015.

   a. Congress has extended to December 18, 2018, the time within which individuals can file claims for refund based on the § 139F exclusion. The Bipartisan Budget Act of 2018, § 41103 of the legislation extends the time within which individuals who are eligible for the
Code § 139F exclusion can file a claim for credit or refund of any overpayment of tax resulting from the exclusion. Pursuant to this amendment, even if an individual’s claim was barred as of December 18, 2015, by operation of any law or rule of law (including res judicata), the individual can make a claim for credit or refund based on the § 139F exclusion if the claim is filed before the close of the three-year period beginning on December 18, 2015. Thus, individuals have until December 18, 2018, to file such claims.


a. Designated beneficiaries of ABLE accounts can contribute an additional amount and are eligible for the saver’s credit. Code § 529A, enacted by the Stephen Beck, Jr., Achieving a Better Life Experience (ABLE) Act of 2014 (which became Division A of the Tax Increase Prevention Act of 2014), provides a tax-favored savings account for certain individuals with disabilities—the ABLE account. ABLE accounts permit certain individuals who became disabled before reaching age 26 and their families to contribute amounts to meet expenses related to the designated beneficiary’s disability without affecting the beneficiary’s eligibility for Supplemental Security Income, Medicaid, and other public benefits. ABLE accounts are modeled on § 529 accounts that are used to save for college education. Like § 529 accounts, ABLE accounts must be established pursuant to a state program, contributions to ABLE accounts are not tax deductible, the earnings of the ABLE account are not subject to taxation, and distributions from ABLE accounts are not included in the designated beneficiary’s income to the extent they are used for qualified expenses related to the disability. Aggregate contributions to an ABLE account from all contributors cannot exceed the annual per-donee gift tax exclusion ($15,000 in 2018). The 2017 Tax Cuts and Jobs Act, § 11024, amended Code § 529A to increase this contribution limit for contributions made before 2026. Under the increased limit, once the overall limitation on contributions is reached, an ABLE account’s designated beneficiary who is an employee (as defined) can contribute an additional amount equal to the lesser of: (1) the compensation includible in the beneficiary’s income for the year, or (2) the federal poverty line for a one-person household as determined for the immediately preceding year ($12,486 for a single individual under age 65 in 2016). A designated beneficiary is considered to be an employee for this purpose only if the person is an employee with respect to whom no contribution is made to a defined contribution plan, an annuity contract described in § 403(b), or an eligible deferred compensation plan described in § 527. The legislation also makes designated beneficiaries of ABLE accounts who contribute eligible for the saver’s credit of § 25B for contributions made before 2026. Both amendments are effective for taxable years beginning after December 22, 2017, the date of enactment.

b. Tax-free rollovers are permitted from a § 529 college savings account to an ABLE account. The 2017 Tax Cuts and Jobs Act, § 11025, amends Code § 529 to permit amounts in a § 529 account to be rolled over without penalty to an ABLE account if the owner of the ABLE account is the designated beneficiary of the § 529 account or a member of the designated beneficiary’s family. Amounts rolled over pursuant to this provision, together with any other contributions to the ABLE account, are taken into account for purposes of the limit on aggregate contributions to the ABLE account. Any amount rolled over that exceeds this limitation is included in the gross income of the distributee in the manner provided by § 72. This provision applies to distributions from a § 529 account after December 22, 2017 (the date of enactment) that are transferred within 60 days and before 2026 to an ABLE account.

c. Guidance is forthcoming on tax-free rollovers from a § 529 college savings account to an ABLE account. Notice 2018-58, 2018-33 I.R.B. 305 (07/30/18). In this notice, the IRS has announced that Treasury and the IRS intend to issue proposed regulations that will provide, pursuant to the 2017 amendment of § 529, that distributions from a § 529 account made after December 22, 2017, and before January 1, 2026, to the ABLE account of the designated beneficiary of that § 529 account (or family member of that designated beneficiary) are not subject to income tax if two requirements are met. First, the distributed funds must be contributed to the ABLE account within 60 days after their withdrawal from the § 529 account. Second, the distributed funds, when added to all other contributions made to the ABLE account for the taxable year that are subject to the limitation under § 529A(b)(2)(B) must not exceed that limitation. Generally, the limitation under § 529A(b)(2)(B) is the annual gift tax exclusion under § 2503(b) plus, for beneficiaries who are employed, the lower of the beneficiary’s taxable compensation or the federal poverty line for a one-
person household as determined for the immediately preceding year. The notice provides that taxpayers, beneficiaries, and administrators of § 529 accounts and ABLE accounts can rely on this guidance before the proposed regulations are issued.

d. More guidance is forthcoming on the increased contribution limits for beneficiaries of ABLE accounts who are employed or self-employed. Notice 2018-62, 2018-34 I.R.B. 316 (08/03/18). The 2017 Tax Cuts and Jobs Act, § 11024, amended Code § 529A to increase the contribution limit under § 529A(b)(2)(B) for contributions made to an ABLE account before 2026. Under the increased limit, once the overall limitation on contributions is reached, an ABLE account’s designated beneficiary who is an employee (as defined) can contribute an additional amount equal to the lesser of: (1) the compensation includible in the beneficiary’s income for the year, or (2) the federal poverty line for a one-person household as determined for the immediately preceding year ($12,486 for a single individual under age 65 in 2016). In this notice, the IRS has announced that Treasury and the IRS intend to issue proposed regulations that will (1) confirm that the employed designated beneficiary, acting on his or her behalf, is solely responsible for ensuring that the requirements for additional contributions are met and for maintaining adequate records for that purpose; (2) provide that ABLE programs may allow a designated beneficiary to certify under penalties of perjury that he or she is a designated beneficiary described in § 529A(b)(7) and that his or her contributions do not exceed the increased limit set forth in § 529A(b)(2)(B)(ii); (3) clarify that the relevant federal poverty guidelines for purposes of the increased contribution limit are those updated periodically in the Federal Register by the U.S. Department of Health and Human Services for the state in which the beneficiary resides, and (4) provide that a program will not be treated as a qualified ABLE program if it accepts contributions that are not in cash or that exceed the contribution limits in § 529A(b)(2)(B). Because ABLE programs may need to adjust their systems and account documents to be in compliance with regulatory requirements, and because some necessary changes might require state legislative action, Treasury and the IRS anticipate that final regulations will provide transition relief to allow adequate time for any necessary changes.

3. A new exclusion for cancellation of student loans on account of the death or permanent disability of the student. The 2017 Tax Cuts and Jobs Act, § 11031, amended Code § 108(f) by adding § 108(f)(5), which excludes from a taxpayer’s gross income any amount which would be included in gross income by reason of the discharge of a student loan if the loan is discharged on account of the death or total and permanent disability of the student. For this purpose, the term “student loan” has the meaning set forth in § 108(f)(2) (which describes loans made by the federal or a state government or any political subdivision as well as loans made by certain public benefit corporations and educational organizations), and also includes private educational loans as defined in Consumer Credit Protection Act § 140(7). This exclusion applies to discharges of indebtedness occurring after 2016 and before 2026.

4. What’s $19 million among friends? A taxpayer who received funds to invest but who used them for personal purposes had gross income. Sun v. Commissioner, 880 F.3d 173 (5th Cir. 1/18/18), aff’g T.C. Memo. 2015-56 (3/24/15). The taxpayer controlled and served as Chief Executive Officer of a corporation whose primary business was importing and distributing minerals. He also devoted a significant amount of time to investment activities, both through an LLC that he controlled and through his personal online brokerage account. The taxpayer and his business acquaintance and friend, a Chinese citizen and resident of Hong Kong, orally agreed that the taxpayer would invest his friend’s funds. Over a period of two years, the friend sent $19 million to be invested. Of this amount, approximately $15 million was sent to the corporation the taxpayer controlled, where it was held in an officer loan account solely for the taxpayer’s benefit. The corporation treated the balance in the account as funds the taxpayer had loaned to the corporation that eventually would be repaid to him. The remaining $4 million was sent either to the taxpayer’s personal brokerage account or to the LLC through which he conducted investment activities. Although the taxpayer did invest these latter funds, they were commingled with the taxpayer’s own funds and the taxpayer did not maintain a separate accounting of their performance. The taxpayer used several million of the funds in the officer loan account for personal purposes, including the purchase of a Mercedes Benz automobile and for gambling. The taxpayer informed his friend that he had lost approximately $2 million of the friend’s funds through gambling. In notices of deficiency issued both to the corporation and to the taxpayer,
the IRS asserted the following alternative theories: (1) the corporation must include in gross income the amounts received from the taxpayer’s friend and must be treated as making dividend distributions to the taxpayer that resulted in gross income for the taxpayer, and the taxpayer also must include in gross income all fund he received directly from his friend, or (2) the corporation acted merely as a conduit and the taxpayer must include in gross income all amounts received by him and by the corporation. The taxpayer argued that none of the amounts received from his friend were included in the corporation’s or his gross income because they were either loans or funds entrusted to the taxpayer for investment. The Tax Court (Judge Paris) held that the funds in question were neither gifts nor loans but were amounts entrusted to the taxpayer for investment; nevertheless, the Tax Court held that the taxpayer had to include in gross income all of the amounts sent by the taxpayer’s friend because the taxpayer had misappropriated them. In an opinion by Judge Costa, the U.S. Court of Appeals for the Fifth Circuit affirmed the Tax Court’s decision. The court acknowledged that, although the nature of the oral agreement between the taxpayer and his friend was not entirely clear, his friend expected to receive back some funds at some point. Nevertheless, the court relied on James v. United States, 366 U.S. 213 (1961), for the proposition that misappropriated funds are included in gross income:

An obligation to “return some money at some point” is not, however, inconsistent with misappropriation. … For all but the riskiest of investments, an investor with a diversified portfolio expects to get some money back even if the investments do not turn out well. But that does not mean the recipient of the funds is allowed to make personal use of the money. And when the holder of the funds uses the money to enrich himself, he has received “economic value,” which is the defining characteristic of income. …

A vague understanding that some money will be returned at some undefined time is not the mutual recognition of an agreement to repay in full that James contemplates.

The court also affirmed the Tax Court’s imposition of the 20 percent accuracy-related penalty of § 6662(a) and (b)(1) for negligence or disregard of rules or regulations in omitting the income in question.

5. Congress has extended through 2017 the exclusion for discharge of qualified principal residence indebtedness. The Bipartisan Budget Act of 2018, § 40201, retroactively extended through December 31, 2017 the § 108(a)(1)(E) exclusion for up to $2 million ($1 million for married individuals filing separately) of income from the cancellation of qualified principal residence indebtedness.

6. Who would have thought that selling your life insurance policy to a stranger was a good idea anyway? Notice 2018-41, 2018-20 I.R.B. 584 (04/26/18) The 2017 Tax Cuts and Jobs Act, §§ 13520-13522, has modified the rules concerning the exclusion of life insurance proceeds upon the death of the insured as well as the determination of basis in a life insurance contract. The modified rules primarily impact the tax treatment of so-called life settlements (where a stranger purchases a life insurance policy on a healthy insured) and viatical settlements (where a stranger purchases a life insurance policy on a terminally-ill insured). Particularly, as explained in detail below, amended § 101 now contains a special carve out to the normal life insurance policy transfer-for-value rules. See § 101(a)(3). This special carve out applies to “reportable policy sales,” which generally will include life settlement and viatical settlement transactions. Furthermore, § 13520 adds new § 6050Y to impose unique reporting requirements on the transferor and the insurer with respect to “reportable policy sales.” In part, new § 6050Y will require disclosure of “reportable death benefits,” as defined, but essentially meaning death benefits paid on an insurance policy that has been transferred in a “reportable policy sale.” Finally, § 13521 adds a new subsection “(B)” to § 1016(a)(1) to clarify (and reverse the IRS’s position in Rev. Rul. 2009-13, 2009-1 C.B. 1029 (05/01/09)) that basis in an annuity or life insurance contract includes premiums and other costs paid without reduction for for mortality expenses or other reasonable charges incurred under the contract (also known as “cost of insurance”). Notice 2018-41 states that the IRS will issue proposed regulations providing guidance concerning the new rules and that otherwise required reporting under § 6050Y will be delayed until after final regulations are published. We commend Notice 2018-41 for careful study by those readers advising clients on life settlement and viatical settlement transactions. The changes made by TCJA to § 101
and the addition of § 6050Y (which are the focus of the Notice) apply to taxable years beginning after 2017. The amendment adding new § 1016(a)(1)(B) applies retroactively to transactions entered into after August 25, 2009. For additional background, see below.

Some background. Section 101 generally excludes from gross income the proceeds of a life insurance policy payable by reason of the death of the insured. If, however, a life insurance policy is transferred for valuable consideration prior to the death of the insured (i.e., “a transfer for value”), then death benefit proceeds (to the extent they exceed the transferee-owner’s basis in the policy) are includable in gross income by the transferee-owner of the policy upon the insured’s death unless an exception applies. These exceptions provide that, notwithstanding a transfer for value, death benefit proceeds remain excludable if (i) the transferee-owner’s basis in the policy is determined in whole or in part by reference to the transferor’s basis (e.g., a carryover basis transaction) or (ii) the transferee-owner is the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation of which the insured is a shareholder or officer. If a transfer-for-value exception does not apply, then Rev. Rul. 2009-14, 2009-1 C.B. 1031 (05/02/09) sets out the IRS’s position that any death benefit payable to the transferee-owner is ordinary income (to the extent it exceeds the transferee-owner’s basis in the policy) while a subsequent sale of the policy by the transferee-owner before the death of the insured can produce capital gain.

Why new rules? Life settlement and viatical settlement transactions have increased over the last several years. The increase in the estate and gift tax exemption has contributed in part to this market because some previously purchased life insurance policies are no longer to pay anticipated estate taxes. Changes to restrictive state laws concerning so-called “stranger owned” life insurance also have contributed to an increase in these transactions. In a typical life settlement transaction, the policyholder, often the individual insured under the life insurance contract, sells his or her life insurance contract to an unrelated person. The consideration paid generally is a lump-sum cash payment that is less than the death benefit on the policy, but more than the amount that would be received by the policyholder upon surrender of the life insurance contract. The IRS previously announced its position regarding the tax treatment of life settlement transactions in Rev. Rul. 2009-13, 2009-1 C.B. 1029 (05/01/09). Oversimplifying somewhat, Revenue Ruling 2009-13 provides that the seller of a policy in a life settlement transaction recognizes capital gain except with respect to the “inside buildup” in the policy (e.g., growth in cash surrender value of whole life insurance) over prior premium payments. This latter amount attributable to the inside buildup is the policy is characterized as ordinary income. The IRS also took the position in Rev. Rul. 2009-13 that the seller’s basis in a transferred policy must be adjusted downward by the cost of insurance separate from the investment in the contract. As discussed above, TCJA’s addition of new § 1016(a)(1)(B) reverses the IRS’s position in this regard. A viatical settlement, a special type of life settlement transaction, may involve the sale of a life insurance contract by the owner, but under § 101(g) may not necessarily be taxed like a life settlement transaction. Under a viatical settlement, a policyholder may sell or assign a life insurance contract after the insured has become terminally ill or chronically ill. If any portion of the death benefit under a life insurance contract on the life of an insured who is terminally ill or chronically ill (within the meaning of § 101(g)) is sold (through the sale of the life insurance contract) or assigned in a viatical settlement to a “viatical settlement provider” (as defined), the amount paid for the sale or assignment of that portion is treated as an amount paid under the life insurance contract by reason of the death of the insured (which may be excludable under § 101), rather than gain from the sale or assignment (which generally would not be excludable under § 101 unless a transfer-for-value exception applied). A viatical settlement provider for purposes of these rules is a person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts insuring the lives of terminally ill or chronically ill individuals (provided certain requirements are met). See Rev. Rul. 2002-82, 2002-2 C.B. 978 (12.23/02).

So, what’s in the new rules? Under new § 101(a)(3), the longstanding transfer-for-value exceptions described above do not apply if the transfer of the life insurance policy is a “reportable policy sale.” A reportable policy sale is defined as “the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer’s interest in such life insurance contract.” Pursuant to § 101(a)(3)(B), the term “indirectly” as used in this context applies to the acquisition of an interest in a life insurance
contract via a partnership, trust, or other entity. Beyond the above statutory language, however, new § 101(a)(3) provides no further guidance as to specifics, such as the “substantial family, business, or financial relationships” (including ownership via partnerships, trusts, or other entities) that exempt an otherwise reportable policy sale from the special inclusion rule of new §103(a)(3). In effect, then, Notice 2018-41 is the IRS’s means of telling insurers and those engaged in life settlement and viatical settlement transactions that the IRS knows the statutes are unclear and that the necessary guidance to comply with the new rules is forthcoming.

7. Church’s blue-envelope system for collecting pastor’s “shake-hand” money nevertheless results in green gross income, not excludable gifts. Felton v. Commissioner, T.C. Memo. 2018-168 (10/10/18). The taxpayer was the pastor of a sizeable church in Minnesota. The church had an envelope system for collecting offerings. White, gold, and blue envelopes where used. White envelopes were for tax-deductible contributions to the operating funds of the church. White envelopes included a line-item entry (“pastoral donations”) for a congregant to indicate the portion of any contribution which the congregant desired to be paid by the church to the taxpayer-pastor. Under this system, the taxpayer-pastor was paid by the church and reported as gross income approximately $40,000 annually in compensation for the years 2008 and 2009. Gold envelopes were for tax-deductible contributions to special programs and retreats conducted by the church. Blue envelopes ostensibly were for nondeductible “gifts” made by congregants to the taxpayer-pastor. After the end of each church service, the blue envelopes were delivered directly to the taxpayer-pastor. The church did not collect or account for blue envelope monies. [In some churches, these “gifts” to pastors are known as “shake-hand” contributions because they are often given to the pastor upon shaking his or her hand while leaving church. The taxpayer objected to this (underhanded?) method of collecting “gifts” for pastors, so the taxpayer caused the church to institute the blue-envelope system.] The taxpayer-pastor as well as the church had announced during a business meeting that blue-envelope contributions were not tax deductible and were solely for the pastor’s benefit; however, the distinction between blue-envelope and other contributions was not emphasized during church services. Upon audit, the IRS determined that the blue envelope monies provided to the taxpayer for the years 2008 ($258,001) and 2009 ($234,826) was gross income under § 61(a)(1) (“compensation for services”). The taxpayer-pastor argued that the blue envelope funds were excludable gifts under § 102(a). Essentially, the taxpayer’s position was that the $40,000 paid by the church annually to the taxpayer in “pastoral donations” was his salary, while the blue-envelope monies were excludible gifts because congregants knew those amounts were not tax deductible. The IRS argued, of course, that the blue-envelope monies were not gifts but disguised compensation. To support this argument, the IRS emphasized that the taxpayer had reported zero taxable income for 2008 or 2009, yet had claimed for each year a parsonage allowance of $80,000, mortgage interest deductions of more than $50,000, and charitable contribution deductions of $50,000. The Tax Court (Judge Holmes) held that the blue-envelope monies were not excludible gifts but instead were gross income to the taxpayer for his services as pastor. Judge Holmes pointed to four factors supporting the court’s conclusion: (1) the average congregant made blue-envelope donations in large part to keep the taxpayer-pastor preaching at the church; (2) the lack of emphasis in church services that blue-envelope monies were “gifts” to the pastor; (3) the routinized structure of the blue-envelope system for the taxpayer’s benefit; and (4) the ratio of the taxpayer’s salary to the purported blue-envelope “gifts.” Judge Holmes also upheld the IRS’s assertion of accuracy-related penalties under § 6662(a).

C. Hobby Losses and § 280A Home Office and Vacation Homes

D. Deductions and Credits for Personal Expenses

1. Deducting casualty losses in areas affected by Hurricanes Harvey, Irma, and Maria just got easier. The Disaster Relief and Airport and Airway Extension Act of 2017 (“2017 Disaster Relief Act”), Pub. L. No. 115-59, was signed by the President on September 29, 2017. Section 504(b) of the 2017 Disaster Relief Act provides special rules for disaster losses in specified areas that are attributable to Hurricanes Harvey, Irma, or Maria. Normally, a personal casualty loss is deductible only to the extent that it exceeds $100 and only to the extent the sum of all personal casualty losses exceeds 10 percent of adjusted gross income. The 2017 Disaster Relief Act provides that a “net disaster loss” is deductible only to the extent it exceeds $500 (rather than $100) and is deductible without regard to the normal 10-percent-of-AGI threshold. An individual with a net disaster loss can deduct the sum
of any non-disaster personal casualty losses, which remain subject to the $100 and 10 percent thresholds, and the net disaster loss. For example, if an individual has AGI of $90,000, a non-disaster-related casualty loss of $10,000 from the theft of a personal car, and a net disaster loss from Hurricane Harvey of $50,000, then the individual can deduct $900 of the theft loss ($10,000 reduced by $100 reduced by 10 percent of AGI) and can deduct $49,500 of the net disaster loss ($10,000 reduced by $500). The deduction for the net disaster loss is available both to those who itemize their deductions and those who do not. For those who do not itemize, the standard deduction is increased by the amount of the net disaster loss. The disallowance of the standard deduction for purposes of determining alternative minimum taxable income does not apply to this increased portion of the standard deduction.

A net disaster loss is defined as the amount by which “qualified disaster-related personal casualty losses” exceed personal casualty gains. A qualified disaster-related personal casualty loss is a loss described in § 165(c)(3) (which generally defines casualty losses) that is attributable to Hurricanes Harvey, Irma, or Maria and that arises: (1) in the Hurricane Harvey disaster area on or after August 23, 2017, (2) in the Hurricane Irma disaster area on or after September 4, 2017, or (3) in the Hurricane Maria disaster area on or after September 16, 2017. Section 501 of the 2017 Disaster Relief Act defines each of these areas as an area with respect to which the President has declared a major disaster by reason of the relevant hurricane before October 17, 2017. (Note: the date originally in the 2017 Disaster Relief Act was September 21, 2017. This date was changed to October 17, 2017, by the Bipartisan Budget Act of 2018, Division B, § 20201, Pub. L. No. 115-123, which was signed by the President on February 9, 2018.)

a. The IRS has provided safe harbor methods for determining casualty and theft losses for personal-use residential real property and personal belongings. Rev. Proc. 2018-8, 2018-2 I.R.B. 286 (12/13/17). This revenue procedure provides safe harbor methods that individual taxpayers can use in determining the amount of their casualty and theft losses for their personal-use residential real property and personal belongings. Additional safe harbor methods are available in the case of casualty and theft losses occurring as a result of any federally declared disaster. The IRS will not challenge an individual’s determination of the decrease in fair market value of personal-use residential real property or personal belongings if the individual qualifies for and uses one of the safe harbor methods described in the revenue procedure. The revenue procedure is effective December 13, 2017.

b. An additional safe harbor for personal-use residential real property affected by Hurricanes Harvey, Irma, or Maria. Rev. Proc. 2018-9, 2018-2 I.R.B. 290 (12/13/17). This revenue procedure provides the Cost Indexes Safe Harbor Method that individual taxpayers may use in determining the amount of their casualty losses pursuant to Code § 165 for their personal-use residential real property damaged or destroyed as a result of Hurricane and Tropical Storm Harvey, Hurricane Irma, and Hurricane Maria (the “2017 Hurricanes”). Specifically, this revenue procedure provides a safe harbor method that individuals may use to determine the decrease in fair market value of their personal-use residential real property on their U.S. income tax returns filed with the IRS. The IRS will not challenge an individual’s determination of the decrease in fair market value of personal-use residential real property attributable to one of the 2017 Hurricanes if the individual qualifies for and uses the safe harbor method described in the revenue procedure. The revenue procedure is effective for losses that are attributable to the 2017 Hurricanes and that arose after August 22, 2017 in specified areas.

c. Congress has enacted legislation to make deducting casualty losses easier in areas affected by California wildfires. The Bipartisan Budget Act of 2018, § 20104(b) of Division B, provides the same special rules for disaster losses that are attributable to California wildfires as it previously provided for disaster losses attributable to Hurricanes Harvey, Irma, and Maria. Specifically, the legislation provides that a “net disaster loss” is deductible only to the extent it exceeds $500 (rather than $100) and is deductible without regard to the normal 10-percent-of-AGI threshold. The deduction for the net disaster loss is available both to those who itemize their deductions and those who do not. For those who do not itemize, the standard deduction is increased by the amount of the net disaster loss. The disallowance of the standard deduction for purposes of determining alternative minimum taxable income does not apply to this increased portion of the standard deduction. A net disaster loss is defined as the amount by which “qualified disaster-related personal casualty losses”
exceed personal casualty gains. A qualified disaster-related personal casualty loss is a loss described in § 165(c)(3) (which generally defines casualty losses) that arises in the California wildfire disaster area on or after October 8, 2017, that is attributable to the wildfires.

2. Those affected by Hurricanes Harvey, Irma, or Maria can use prior-year earned income to determine their earned income tax credit and child tax credit. The Disaster Relief and Airport and Airway Extension Act of 2017 (“2017 Disaster Relief Act”), Pub. L. No. 115-63, was signed by the President on September 29, 2017. Section 504(c) of the 2017 Disaster Relief Act provides that a “qualified individual” can elect to use prior-year earned income for purposes of determining the individual’s earned income tax credit under § 32 and child tax credit under § 24. The election is available for qualified individuals whose earned income for the tax year that includes the “applicable date” is lower than their earned income for the preceding tax year. The applicable date is August 23, 2017, for Hurricane Harvey, September 4, 2017, for Hurricane Irma, and September 16 for Hurricane Maria. If a qualified individual makes this election, it applies for purpose of both the earned income tax credit and the child tax credit. For married couples filing a joint return, the election is available if either spouse is a qualified individual, and the earned income for the preceding year is the sum of the earned income in the preceding year of both spouses. A qualified individual is defined as a “qualified Hurricane Harvey individual,” a “qualified Hurricane Irma individual,” or a “qualified Hurricane Maria individual.” A qualified Hurricane Harvey individual is defined as an individual whose principal place of abode on August 23, 2017 was located (1) in the Hurricane Harvey disaster zone, or (2) outside the Hurricane Harvey disaster zone, but within the Hurricane Harvey disaster area if the individual was displaced from his or her principal place of abode by reason of Hurricane Harvey. The terms “qualified Hurricane Irma individual” and “qualified Hurricane Maria individual” are defined in a similar manner but with dates of September 4, 2017, and September 16, 2017, respectively.

- Section 501 of the 2017 Disaster Relief Act defines the terms Hurricane Harvey disaster area, Hurricane Irma disaster area, and Hurricane Maria disaster area as an area with respect to which the President has declared a major disaster by reason of the relevant hurricane before October 17, 2017. (Note: the date originally in the 2017 Disaster Relief Act was September 21, 2017. This date was changed to October 17, 2017, by the Bipartisan Budget Act of 2018, Division B, § 20201, Pub. L. No. 115-123, which was signed by the President on February 9, 2018.) The terms Hurricane Harvey disaster zone, Hurricane Irma disaster zone, and Hurricane Maria disaster zone are defined as the portion of the relevant disaster area to warrant individual or individual and public assistance from the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of the relevant hurricane.

a. Those affected by California wildfires also can use prior year earned income to determine their earned income tax credit and child tax credit. The Bipartisan Budget Act of 2018, § 20104(c) of Division B, provides that a “qualified individual” can elect to use prior-year earned income for purposes of determining the individual’s earned income tax credit under § 32 and child tax credit under § 24. The election is available for qualified individuals whose earned income for the tax year that includes any portion of the period from October 8, 2017, to December 31, 2017, is lower than their earned income for the preceding tax year. A qualified individual is defined as an individual whose principal place of abode during any portion of the period from October 8, 2017, to December 31, 2017, was located (1) in the California wildfire disaster zone, or (2) outside the California wildfire disaster zone, but within the California wildfire disaster area if the individual was displaced from his or her principal place of abode by reason of the wildfires.

- The Bipartisan Budget Act of 2018 defines the term “California wildfire disaster zone” as the portion of the California wildfire disaster area determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of wildfires in California. The term “California wildfire disaster area” is defined as an area with respect to which the President declared a major disaster from January 1, 2017, through January 18, 2018, under section 401 of the Stafford Act by reason of wildfires in California.

3. Standard deduction for 2018. The 2017 Tax Cuts and Jobs Act, § 11021, added Code § 63(c)(7), which significantly increases the standard deduction for taxable years beginning after
2017 and before 2026. This change, combined with the legislation’s limitation or elimination of many itemized deductions, is expected to cause a large number of taxpayers who have itemized deductions in prior years to take the standard deduction beginning in 2018. The standard deduction for 2018 will be $24,000 for joint returns and surviving spouses (increased from $13,000), $12,000 for unmarried individuals and married individuals filing separately (increased from $6,500), and $18,000 for heads of households (increased from $9,550). These figures will be adjusted for inflation for tax years beginning after 2018.

4. Let’s hope new withholding tables are issued soon. The deduction for personal exemptions has disappeared. The 2017 Tax Cuts and Jobs Act, § 11041, amended Code § 151(d) by adding § 151(d)(5), which reduces the exemption amount to zero for taxable years beginning after 2017 and before 2026. The effect of this amendment is to eliminate the deduction for personal exemptions. The reduction of the exemption amount to zero required conforming amendments to other Code provisions that make use of the exemption amount. For example, under § 6012, an individual taxpayer generally does not need to file a return if the taxpayer’s gross income does not exceed the sum of the basic standard deduction plus the exemption amount under § 151(d). The legislation addresses this by amending § 6012 to provide that an individual need not file a return if the taxpayer’s gross income does not exceed the standard deduction. Similarly, § 642(b)(2)(C) allows a qualified disability trust to deduct an amount equal to the exemption amount under § 151(d), and § 6334(d) exempts from levy an amount of weekly wages equal to 1/52 of the sum of the standard deduction and the aggregate amount of the taxpayer’s deductions for personal exemptions under § 151. The legislation addresses this issue by amending those provisions to refer to § 4,105 (to be adjusted for inflation), the exemption amount that had been scheduled to take effect in 2018 before the Tax Cuts and Jobs Act. The legislation also directs Treasury to develop rules to determine the amount of tax that employers are required to withhold from an employee’s wages but gives Treasury the discretion to apply current wage withholding rules for 2018.

a. Now that the exemption amount in § 151(d) is zero, how do we determine who is a qualifying relative? Notice 2018-70, 2018-38 I.R.B. 441 (8/28/18). The 2017 Tax Cuts and Jobs Act, § 11041, amended Code § 151(d) by adding § 151(d)(5), which reduces the exemption amount to zero for taxable years beginning after 2017 and before 2026. The intended effect of this amendment is to eliminate the deduction for personal exemptions authorized by § 151(a). Nevertheless, it is still necessary to determine for various purposes whether an individual is a “dependent” within the meaning of § 152. These purposes include determining eligibility for the earned income tax credit and for head-of-household filing status. The two basic categories of dependents under § 152 are a (1) qualifying child, and (2) qualifying relative. To be a qualifying relative, one of the requirements, set forth in § 152(d)(1)(B), is that the individual’s gross income for the calendar year must be less than the exemption amount as defined in § 151(d). By virtue of the Tax Cuts and Jobs Act, the exemption amount in § 151(d) is now zero. This notice addresses this conundrum. According to the notice, “because it would be highly unusual for an individual to have gross income less than zero, virtually no individuals would be eligible as qualifying relatives.” The notice provides that Treasury and the IRS intend to issue proposed regulations that will clarify that the zero exemption amount of § 151(d)(5)(A) for taxable years 2018-2025 does not apply to the gross income limitation in the definition of a qualifying relative in § 152(d)(1)(B). Instead, the proposed regulations will provide that,

in defining a qualifying relative for purposes of various provisions of the Code that refer to the definition of dependent in § 152, including, without limitation, for purposes of the new credit under § 24(h)(4) and head of household filing status under § 2(b), the § 151(d) exemption amount referenced in § 152(d)(1)(B) will be treated as $4,150 (adjusted for inflation), for taxable years in which the § 151(d)(5)(A) exemption amount is zero.

Thus, in determining eligibility for head-of-household filing status and for the new $500 credit authorized by § 24(h)(4) for dependents other than a qualifying child, an individual can be treated as a qualifying relative in 2018 if the individual’s gross income does not exceed $4,150. The notice provides that taxpayers can rely on the notice before the issuance of the proposed regulations.
5. Has the federal deduction for your high property or state income taxes made them easier to bear? Brace yourself! The deduction for state and local taxes not paid or accrued in carrying on a trade or business or an income-producing activity is limited to $10,000. The 2017 Tax Cuts and Jobs Act, § 11042, amended Code § 164(b) by adding § 164(b)(6). For individual taxpayers, this provision generally (1) eliminates the deduction for foreign real property taxes, and (2) limits to $10,000 ($5,000 for married individuals filing separately) a taxpayer’s itemized deductions on Schedule A for the aggregate of state or local property taxes, income taxes, and sales taxes deducted in lieu of income taxes. This provision applies to taxable years beginning after 2017 and before 2026. The provision does not affect the deduction of state or local property taxes or sales taxes that are paid or accrued in carrying on a trade or business or an income-producing activity (i.e., an activity described in § 212) that are properly deductible on Schedules C, E, or F. For example, property taxes imposed on residential rental property will continue to be deductible. With respect to income taxes, an individual can deduct only foreign income taxes paid or accrued in carrying on a trade or business or an income-producing activity. As under current law, an individual cannot deduct state or local income taxes as a business expense even if the individual is engaged in a trade or business as a sole proprietor. See Reg. § 1.62-1T(d).

   a. The IRS is not going to give blue states a pass on creative workarounds to the new $10,000 limitation on the personal deduction for state and local taxes. Notice 2018-54, 2018-24 I.R.B. 750 (05/23/18). In response to new § 164(b)(6), many states—including Connecticut, New Jersey, and New York—have enacted workarounds to the $10,000 limitation. For instance, New Jersey reportedly has enacted legislation giving property owners a special tax credit against otherwise assessable property taxes if the owner makes a contribution to charitable funds designated by local governments. Connecticut reportedly has enacted a new provision that taxes the income of pass-through entities such as S corporations and partnerships, but allows the shareholders or members a corresponding tax credit against certain state and local taxes assessed against them individually. Notice 2018-54 announces that the IRS and Treasury are aware of these workarounds and that proposed regulations will be issued to “make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers.” In other words, blue states, don’t bank on a charitable contribution or a flow-through income tax substituting for otherwise assessable state and local taxes to avoid new § 164(b)(6). The authors predict that this will be an interesting subject to watch over the coming months.

   b. And like Rameses II in The Ten Commandments, Treasury says, “So let it be written; so let it (finally!) be done.” REG-112176-18, Contributions in Exchange for State and Local Tax Credits, 83 F.R. 43563 (8/27/18). Moving swiftly, Treasury has published proposed regulations under § 170 that purport to close the door on any state-enacted workarounds to new § 164(b)(6). Prop. Reg. § 1.170A-1(h)(3) generally requires taxpayers to reduce the amount of any federal income tax charitable contribution deduction by the amount of any corresponding state or local tax credit the taxpayer receives or expects to receive. The proposed regulations further provide that a corresponding state or local tax deduction normally will not reduce the taxpayer’s federal deduction provided the state and local deduction does not exceed the taxpayer’s federal deduction. To the extent the state and local charitable deduction exceeds the taxpayer’s federal deduction, the taxpayer’s federal deduction is reduced. Finally, the proposed regulations provide an exception whereby the taxpayer’s federal charitable contribution deduction is not reduced if the corresponding state or local credit does not exceed 15 percent of the taxpayer’s federal deduction. Three examples illustrate the application of the proposed regulation:

   • Example 1. A, an individual, makes a payment of $1,000 to X, an entity listed in section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70% of the amount of A’s payment to X. Under paragraph (h)(3)(i) of this section, A’s charitable contribution deduction is reduced by $700 (70% × $1,000). This reduction occurs regardless of whether A is able to claim the state tax credit in that year. Thus, A’s charitable contribution deduction for the $1,000 payment to X may not exceed $300.

   • Example 2. B, an individual, transfers a painting to Y, an entity listed in section 170(c). At the time of the transfer, the painting has a fair market value of $100,000. In exchange for
the painting, B receives or expects to receive a state tax credit equal to 10% of the fair market value of the painting. Under paragraph (h)(3)(v) of this section, B is not required to apply the general rule of paragraph (h)(3)(i) of this section because the amount of the tax credit received or expected to be received by B does not exceed 15% of the fair market value of the property transferred to Y. Accordingly, the amount of B's charitable contribution deduction for the transfer of the painting is not reduced under paragraph (h)(3)(i) of this section.

- **Example 3.** C, an individual, makes a payment of $1,000 to Z, an entity listed in section 170(c). In exchange for the payment, under state M law, C is entitled to receive a state tax deduction equal to the amount paid by C to Z. Under paragraph (h)(3)(ii)(A) of this section, C is not required to reduce its charitable contribution deduction under section 170(a) on account of the state tax deduction.

The proposed regulation is effective for charitable contributions made after August 27, 2018.

- **On the other hand . . . .** The looming trouble spot here is how taxpayers and the IRS discern the difference between abusive “workarounds” enacted in response to new § 164(b)(6) and legitimate state and local tax credit programs such as the Georgia Rural Hospital Tax Credit that preceded TCJA. The Georgia Rural Hospital Tax Credit program was enacted in 2017 to combat the closure of many rural hospitals in Georgia due to financial difficulties. Under the program, individuals and corporations making contributions to designated rural hospitals receive a 90% dollar-for-dollar tax credit against their state income tax liability. Is the Georgia Rural Hospital Tax Credit program adversely affected by proposed regulations under § 164(b)(6)? In our view, the answer is “yes” and a Georgia taxpayer’s federal charitable contribution deduction for a donation to a Georgia rural hospital is reduced by 90 percent. This follows because the proposed regulations do not condition the reduction in a taxpayer’s federal charitable contribution deduction on whether the taxpayer’s state and local deduction otherwise would exceed the $10,000 cap of new § 164(b)(6). We note, however, that it may be possible under state or local law for a taxpayer to waive any corresponding state or local tax credit and thereby claim a full charitable contribution for federal income tax purposes. See Rev. Rul. 67-246, 1967-2 C.B. 104.

c. **The availability of a business expense deduction under § 162 for payments to charities is not affected by the recently issued proposed regulations, says the IRS.** IRS News Release IR-2018-178 (9/5/18). This news release clarifies that the availability of a deduction for ordinary and necessary business expenses under § 162 for businesses that make payments to charities or government agencies and for which the business receives state tax credits is not affected by the proposed regulations issued in August 2018 that generally disallow a federal charitable contribution deduction under § 170 for charitable contributions made by an individual for which the individual receives a state tax credit. See REG-112176-18, Contributions in Exchange for State and Local Tax Credits, 83 F.R. 43563 (8/27/18). Thus, if a payment to a government agency or charity qualifies as an ordinary and necessary business expense under § 162(a), it is not subject to disallowance in the manner in which deductions under § 170 are subject to disallowance. This is true, according to the news release, regardless of whether the taxpayer is doing business as a sole proprietor, partnership or corporation. According to a “frequently asked question” posted on the IRS website, “a business taxpayer making a payment to a charitable or government entity described in § 170(c) is generally permitted to deduct the entire payment as an ordinary and necessary business expense under § 162 if the payment is made with a business purpose.”

6. **Better be careful with that cash-out refinance. You could wind up with home equity indebtedness, the interest on which is no longer deductible. And there’s more good news: the limit on acquisition indebtedness has dropped to $750,000.** Prior to the 2017 Tax Cuts and Jobs Act, Code § 163(a) and (h)(3) allowed a taxpayer to deduct as an itemized deduction the interest on up to $1 million of acquisition indebtedness and up to $100,000 of home equity indebtedness. Acquisition indebtedness is defined as indebtedness secured by a qualified residence that is incurred to acquire, construct, or substantially improve the residence. Home equity indebtedness is defined as any indebtedness secured by a qualified residence that is not acquisition indebtedness. The Tax Cuts and Jobs Act, § 11043, amended § 163(h)(3) by adding § 163(h)(3)(F). For taxable years beginning after
2017 and before 2026, § 163(h)(3)(F) disallows the deduction of interest on home equity indebtedness and limits the amount of debt that can be treated as acquisition indebtedness to $750,000 ($375,000 for married taxpayers filing separately). There is no transition rule for home equity indebtedness. Therefore, the interest on any outstanding home equity indebtedness will become nondeductible beginning in 2018. The provision contains three transition rules that might affect acquisition indebtedness: (1) the new $750,000 limit on acquisition indebtedness does not apply to debt incurred on or before December 15, 2017; (2) any refinancing of indebtedness is treated for purposes of the December 15, 2017, transition date as incurred on the date that the original indebtedness was incurred to the extent the amount of the new indebtedness does not exceed the amount of the refinanced indebtedness (but this rule applies only for the term of the original indebtedness); and (3) a taxpayer who entered into a written, binding contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchases the residence before April 1, 2018 with indebtedness is considered to have incurred acquisition indebtedness prior to December 15, 2017.

- These rules could have an unanticipated effect on taxpayers who engage in a cash-out refinancing of existing acquisition indebtedness. If the amount of the new loan that exceeds the refinanced loan (i.e., the cash-out) is used for purposes unrelated to the home, that portion of the loan will be home equity indebtedness, the interest on which will not be deductible. For example, if a taxpayer refinances $100,000 of acquisition indebtedness by taking out a new loan of $110,000 and using the extra $10,000 to pay off high-interest credit card debt, the extra $10,000 will be home equity indebtedness and the interest on that portion of the loan will not be deductible.

7. Expansion of the 7.5 percent threshold for deduction of medical expenses. Prior to the 2017 Tax Cuts and Jobs Act, medical expenses generally were deductible only to the extent they exceeded 10 percent of a taxpayer’s adjusted gross income. For taxable years beginning after 2012 and ending before 2017, this threshold was reduced to 7.5 percent if the taxpayer or the taxpayer’s spouse had attained age 65 by the close of the year. The 2017 Tax Cuts and Jobs Act, § 11027, amended § 213(f) to provide that the 7.5 percent threshold applies to all taxpayers for taxable years beginning after 2016 and ending before 2019, i.e., to calendar years 2017 and 2018. Further, the legislation provides that this threshold applies for purposes of both the regular tax and the alternative minimum tax.

8. An increased incentive to purchase insurance: say goodbye to the deduction for personal casualty losses (except those in federally declared disaster areas). The 2017 Tax Cuts and Jobs Act, § 11044, amended Code § 165(h) by adding § 165(h)(5), which eliminates the deduction for personal casualty losses, other than those attributable to a federally declared disaster, for taxable years beginning after 2017 and before 2026. Despite this general disallowance, the legislation permits taxpayers to offset the amount of any personal casualty gains by the amount of otherwise-disallowed personal casualty losses.

9. ♫♩I keep on fallin’ in and out of love with you♩♫ Congress has repealed the § 68 overall limitation on overall deductions again. The 2017 Tax Cuts and Jobs Act, § 11046, amended Code § 68 by adding § 68(f), which provides that the overall limitation on itemized deductions does not apply to taxable years beginning after 2017 and before 2026. This limitation reduces the amount of most itemized deductions by the lesser of 3 percent of the amount by which the taxpayer’s adjusted gross income exceeds a specified threshold, or 80 percent of the itemized deductions. Congress first enacted this limitation as part of the Omnibus Budget Reconciliation Act of 1990. In the Economic Growth and Tax Relief Reconciliation Act of 2001, Congress repealed § 68 prospectively on a phased reduction schedule beginning in 2006, with full repeal effective for taxable years beginning after 2009. The provision did not apply in taxable years 2010 through 2012. Congress reinstated § 68 in the American Taxpayer Relief Act of 2012 for taxable years beginning after 2012. The provision was in effect for taxable years 2013 through 2017, and now has been repealed once more.

10. An enhanced child tax credit. The 2017 Tax Cuts and Jobs Act, § 11022, added Code § 24(j), which significantly increases the child tax credit and establishes a new credit for dependents other than qualifying children for taxable years beginning after 2017 and before 2026.
**Child Tax Credit.** The legislation increases the child tax credit from $1,000 to $2,000 per qualifying child and increases the refundable portion of the credit from $1,000 to $1,400 per qualifying child. The $1,400 refundable portion of the credit will be adjusted for inflation for taxable years beginning after 2018. The legislation retains the current-law age limit for the credit, i.e., a person can be a qualifying child only if he or she has not attained age 17 by the end of the taxable year. The refundable portion of the credit is determined in the same manner as under current law, except that the earned income threshold for determining the refundable portion is reduced from $3,000 to $2,500. To claim the child tax credit (either the refundable or nonrefundable portion), a taxpayer must include on the return for each qualifying child with respect to whom the credit is claimed a Social Security Number that was issued before the due date for filing the return. If the child tax credit is not available with respect to a qualifying child because of the absence of a Social Security Number, the taxpayer can claim the new, nonrefundable credit described below with respect to that child.

**New Nonrefundable Credit for Dependents Other Than a Qualifying Child.** The legislation also makes available (as an increase to the basic child tax credit) a new, nonrefundable credit of $500 for each dependent other than a qualifying child. This new credit would apply, for example, with respect to a parent who is the taxpayer’s dependent and therefore a qualifying relative. The new, nonrefundable credit is available only with respect to a dependent who is a citizen, national, or resident of the U.S., i.e., the credit is not available with respect to a dependent who is a resident of the contiguous countries of Canada and Mexico.

**Increased Phase-out Thresholds.** The legislation significantly increases the modified adjusted gross income thresholds at which the credits (both the child tax credit and the new nonrefundable credit) begin to phase out. Under current law, the child tax credit is phased out by $50 for each $1,000 by which the taxpayer’s modified AGI exceeds $55,000 for married taxpayers filing separately, $75,000 for single taxpayers or heads of household, and $110,000 for married taxpayers filing a joint return. Thus, under current law, the credit is phased out entirely for married taxpayers filing a joint return once modified AGI reaches $130,000. The legislation increases the phase-out thresholds to $400,000 for married couples filing a joint return and $200,000 for all other taxpayers. These increased thresholds will increase the number of taxpayers who benefit from the credit.

11. **Mortgage insurance premiums paid through 2017 remain deductible** The Bipartisan Budget Act of 2018, § 40202, retroactively extended through December 31, 2017, the § 163(h)(3)(E) deduction (subject to the pre-existing limitations) for mortgage insurance premiums paid or accrued in connection with acquisition indebtedness with respect to a qualified residence of the taxpayer.

12. **You might be glad you paid your child’s college tuition in December 2017 rather than January 2018.** The Bipartisan Budget Act of 2018, § 40203, retroactively extended through December 31, 2017, the § 222 above-the-line deduction for individuals of a limited amount ($0, $2,000, or $4,000, depending on the taxpayer’s adjusted gross income) of qualified tuition and related expenses for higher education of the taxpayer, the taxpayer’s spouse, or dependents.

13. **Retroactive extension of certain credits for energy efficiency by the Bipartisan Budget Act of 2018.**

   a. **A retroactive incentive for homeowners to make energy-efficient home improvements. Does this make sense?** The Bipartisan Budget Act of 2018, § 40401, retroactively extended the § 25C credit for 10 percent of the amount paid or incurred by a taxpayer for qualified energy efficiency improvements (such as exterior windows, exterior doors, and energy-saving roofs) and 100 percent of the amount paid or incurred by a taxpayer for residential energy property expenditures (such as high-efficiency furnaces, water heaters, and air conditioning systems). The credit is available for qualifying improvements made to a taxpayer’s principal residence and is subject to a lifetime cap of $500. As extended, the credit is available for property placed in service before January 1, 2018.

   b. **Congress has retroactively extended the credit for residential energy efficient property.** The Bipartisan Budget Act of 2018, § 40402, retroactively extended the § 25D 30 percent credit for qualified fuel cell property, qualified small wind energy property, and qualified
geothermal heat pump property. The 30 percent credit is now available for property in these categories placed in service before January 1, 2020, which matches Congress’s previous extension of the credit (in 2015) for solar property. The credit for all categories of eligible property (including solar) phases down to 26 percent for property placed in service after 2019 and before 2021, and to 22 percent for property placed in service after 2020 and before 2022.

14. Standard deduction for 2019. Rev. Proc. 2018-57, 2018-49 I.R.B. 827 (11/15/18). The standard deduction for 2019 will be $24,400 for joint returns and surviving spouses (increased from $24,000), $12,200 for unmarried individuals and married individuals filing separately (increased from $12,000), and $18,350 for heads of households (increased from $18,000).

E. Divorce Tax Issues

1. ♫♪ Breaking up is hard to do.♫♪ But, if you have been thinking about it, split up in 2018 if you want to save taxes. Under the Tax Cuts and Jobs Act, alimony is not deductible by the payor and is not taxable for the recipient. The 2017 Tax Cuts and Jobs Act, § 11051, repealed both Code § 215, which authorized an above-the-line deduction for alimony payments, and Code § 71, which included alimony payments in the recipient’s gross income. For those subject to the new rules, the payor of alimony will not be able to deduct the payments, and the recipient will not include the alimony payments in gross income. This change applies to any divorce or separation instrument (as defined in former Code § 71(b)(2)) executed after 2018. It also applies to any divorce or separation instrument executed before 2018 that is modified after 2018 if the modification expressly provides that the amendments made by the Tax Cuts and Jobs Act will apply. The legislation also made various conforming amendments to other Code provisions.

a. Speaking of other Code provisions, perhaps an “alimony trust” is the solution? Notice 2018-37, 2018-18 I.R.B. 521 (04/12/18). Along with repeal of Code §§ 71 and 215, the 2017 Tax Cuts and Jobs Act, § 11051(b)(1)(C), repealed Code § 682 with the same effective date provision as described above for the repeal of Code §§ 71 and 215. Section 682 governs so-called “alimony trusts” whereby one spouse benefits from the income of a trust established by the other spouse if the trust is part of the decree of divorce or separate maintenance. Generally, if a trust qualifies under Code § 682, then even if the trust would be a grantor trust as to the spouse establishing the trust (e.g., the husband), the other spouse (e.g., the wife) is taxable on the trust’s income in accordance with the normal rules of subchapter J. In Notice 2018-37, the IRS has announced that Treasury regulations will be issued to clarify that § 682 as in effect prior to the enactment of the 2017 Tax Cuts and Jobs Act, § 11051(b)(1)(C), will continue to apply to alimony trusts set up this year (presumably even if modified after 2018 unless the modification expressly states that post-TJCA law should apply). Query (again!) if an alimony trust may be set up and minimally funded this year between “friendly” divorcing couples to allow trust income to be taxed to a former spouse based upon subsequent contributions to the corpus of the trust by the other spouse after 2018. Notice 2018-37 also solicits comments regarding whether guidance is needed under §§ 672(e)(1)(A) (grantor treated as holding any trust power or interest in favor of grantor’s spouse or former spouse); 674(d) (grantor power over beneficial enjoyment of trust limited by a reasonably definite external standard); or 677 (trust income for benefit of grantor).

F. Education

1. Private elementary and secondary schools have a new incentive to raise tuition: up to $10,000 per year can be withdrawn tax-free from § 529 accounts to pay it. The 2017 Tax Cuts and Jobs Act, § 11032, amended Code § 529(c) by adding § 529(c)(7), which permits tax-free distributions from § 529 accounts to pay “expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school.” The limit on distributions for this purpose is $10,000 during the taxable year, which applies per student, not per account. Thus, if a student is a designated beneficiary of more than one § 529 account, the student can receive only $10,000 free of tax for this purpose in a given year regardless of whether the funds are distributed from multiple accounts. This provision applies to distributions occurring after 2017.

a. Breaking news! “Elementary or secondary” school means kindergarten through grade 12. Notice 2018-58, 2018-33 I.R.B. 305 (07/30/18). In this notice, the IRS has
announced that Treasury and the IRS intend to issue proposed regulations regarding § 529 accounts that will provide, pursuant to the 2017 enactment of new § 529(c)(7), that (1) tuition in connection with a designated beneficiary’s enrollment or attendance at an elementary or secondary public, private, or religious school constitutes a qualified higher education expense, and therefore amounts can be withdrawn tax-free to pay it, but that such tax-free distributions are limited to a total of $10,000 per year per designated beneficiary, regardless of whether the funds are distributed from multiple § 529 accounts, and (2) the term “elementary or secondary” means kindergarten through grade 12 as determined under state law, which is consistent with the definition set forth in § 530(b)(3)(B) for Coverdell education savings accounts. The notice also provides that the proposed regulations will address the recontribution of refunded qualified higher education expenses, which might occur, for example, if a student drops a class and receives a refund of tuition. Under § 529(c)(3)(D) (enacted by the 2015 PATH Act), the portion of a distribution that is refunded to an individual who is the beneficiary of a § 529 account by an eligible educational institution is not subject to income tax to the extent the refund is recontributed to a § 529 account of which that individual is the beneficiary not later than 60 days after the date of the refund and does not exceed the refunded amount. The proposed regulations will provide that the entire recontributed amount will be treated as principal (rather than earnings), which is a rule of administrative convenience that avoids certain complexities that otherwise would arise under the rules governing rollovers previously set forth in Notice 2001-81, 2001-52 I.R.B. 617. The notice provides that taxpayers, beneficiaries, and administrators of § 529 accounts can rely on this guidance before the proposed regulations are issued.

G. Alternative Minimum Tax

1. The AMT will apply to fewer individuals because of increased exemption amounts and phase-out thresholds. The 2017 Tax Cuts and Jobs Act, § 12002, amended Code § 55(d) by adding § 55(d)(4), which increases the AMT exemption amount for non-corporate taxpayers as well as the thresholds for alternative minimum taxable income above which the exemption amount phases out. These changes apply to taxable years beginning after 2017 and before 2026; the figures will be adjusted for inflation for taxable years beginning after 2018. The legislation did not change the exemption amount or the phase-out threshold for trusts and estates. The figures for 2018 both before and after the changes made by the 2017 Tax Cuts and Jobs Act are shown in the following tables:

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VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

C. Liquidations

D. S Corporations

1. If you’re a cash-method S corp pining to be a C corp, here’s your chance! The 2017 Tax Cuts and Jobs Act, § 13543, added new § 481(d) and new § 1371(f) to make it easier for cash-method S corporations to convert to C corporations (which typically, but not always, especially after TCJA’s revisions to § 448, are accrual-method taxpayers). Specifically, new § 481(d) provides that any adjustment (such as changing from the cash to the accrual method) otherwise required under § 481(a)(2) with respect to an S to C conversion may be taken into account ratably over six years starting with the year of the change (instead of taking into account the adjustment entirely in the year of change) if three conditions are met: (i) the converting S corporation existed prior to December 22, 2017 (the date of TCJA’s enactment); (ii) the conversion from S to C status takes place prior to December 22, 2019 (two years from the date of TCJA’s enactment); and (iii) all of the shareholders of the S corporation on December 22, 2017, are “in identical proportions” the shareholders of the C corporation. New § 1371(f) further provides that “money” distributed by the above-described converted S corporations after the “post-termination transition period” (generally one year) is allocable to and chargeable against the former S corporation’s accumulated adjustments account (“AAA”) in the same ratio as AAA bears to accumulated earnings and profits (“E&P”). Thus, new § 1371(f) is more favorable to S corporations converting to C status than the normal rule of § 1371(e), which allows distributions of money during the “post-termination transition period,” but not after, to be allocable to and chargeable against AAA. As a practical matter, then, S corporations converting to C corporations within the confines of new § 481(d) and § 1371(f) may make nontaxable, stock-basis reducing distributions of money out of their AAA during the one-year period following the conversion (pursuant to § 1371(e)) as well as wholly or partially (depending upon AAA as compared to E&P) nontaxable, basis-reducing distributions of money after the normal one-year, post-termination transition period. These changes to § 481 and § 1371 are permanent, but of course, will apply only to S to C conversions that meet the criteria of § 481(d) (i.e., pre-TCJA existing S corporations that convert to C status before December 22, 2019, and that have the same shareholders in the same proportions post-Conversion).

2. In line with the continuing expansion of eligible shareholders of subchapter S corporations, ESBTs now may have non-U.S. individuals as current beneficiaries. The 2017 Tax Cuts and Jobs Act, § 13541, makes a technical change to § 1361(c)(2)(B)(v) such that for 2018 and future years an “electing small business trust” (an “ESBT,” as particularly defined in § 1361(e)) may have as a current beneficiary of the ESBT a “nonresident alien” individual. Under § 7701(b)(1)(B), a nonresident alien individual is someone who is neither a citizen nor a resident of the U.S. This change to § 1361 is permanent.

3. Perhaps there’s something special about ESBTs that Congress or the IRS hasn’t told us? The 2017 Tax Cuts and Jobs Act, § 13542, makes another technical change relating to ESBTs by adding new § 641(c)(2)(E) effective for taxable years beginning after 2017. New § 641(c)(2)(E) will allow the charitable contribution limitation and carryover rules of § 170 that apply to individuals to apply to ESBTs (rather than the rules applicable to trusts) when the subchapter S corporation in which the ESBT owns stock makes a charitable contribution deductible under § 170. Essentially, without getting into the details, the charitable contribution limitation and carryover rules of § 170 are more liberal for individuals than for trusts. This change to § 641 is permanent.

Planning note: Speaking of ESBTs, trusts generally are eligible for § 199A’s new 20-percent deduction for “qualified business income.” Thus, even absent estate and gift tax savings, some tax planners are advising principal shareholders of S corporations that they should consider setting up ESBTs for their children and grandchildren to own stock in their S corporations earning “qualified business income.” In particular, if the ESBT’s taxable income (before taking into account § 199A) is at or below $157,500, then “qualified business income” allocable to the ESBT shareholder would
appear to be taxed at a maximum rate of 29.6% (i.e., top rate of 37% applied to taxable income reduced by the 20 deduction) regardless of § 199A’s specified service business limitation or W-2 wage and capital gain.

E. Mergers, Acquisitions and Reorganizations

1. Maybe Chubby Checker said it best: Jack be nimble; Jack be quick. Jack go under [COI] limbo stick. Rev. Proc. 2018-12, 2018-6 I.R.B. 349 (1/24/18). Among other requirements, shareholders of a target corporation must maintain a “substantial” proprietary interest (i.e., stock) in an acquiring corporation to qualify a transaction for tax-deferred reorganization treatment under § 368. The regulations under § 368 set forth this shareholder continuity of interest (“COI”) test. See Reg. § 1.368-1(e). The COI requirement is designed to prevent transactions that resemble sales from qualifying for tax-deferred reorganization treatment. Determining whether adequate COI exists for any particular transaction requires a comparison of the aggregate value of the target shareholders’ stock before the reorganization with the aggregate value of the stock held in the acquiring corporation after the reorganization. The required level of COI—jokingly, the “limbo stick”—varies in height depending upon the type of reorganization attempted (e.g., 50% safe harbor for straight and forward triangular mergers; 80% statutory requirement for reverse triangular mergers). Put differently, if boot in a reorganization is too high, the COI limbo stick is tripped, and the shareholders of the target corporation will not qualify for nonrecognition treatment. Thus, regardless of the type of reorganization attempted, valuation of the target shareholders’ pre- and post-reorganization stockholdings is critical for obtaining nonrecognition treatment.

- **Average trading price valuations allowed.** Subject to other requirements and limitations, since 2011 Treasury and the IRS have permitted applicable COI tests to be met based upon actual trading values of publicly-traded acquiror stock on either the closing date (as defined) or the signing date (as defined). See Reg. § 1.368-1(e)(2). Proposed regulations promulgated in 2011 for publicly-traded acquirors provide that, under specified circumstances, certain average trading price determinations of value are allowed for COI purposes. See Prop. Reg. § 1.368(e)(2)(vi)(A). Commentators noted that average trading price methods often are used to determine the actual consideration paid by an acquiring corporation to target shareholders under acquisition agreements, so those same commentators argued that such average trading price methods should be acceptable for COI purposes in lieu of actual trading prices on either the closing date or signing date. Rev. Proc. 2018-12 reflects Treasury’s and the IRS’s general agreement with the commentators that average trading price valuation methods are acceptable for COI purposes. The revenue procedure describes in detail the average trading price valuation methods that may be used for certain reorganization transactions. In particular, Rev. Proc. 2018-12 specifies that it applies to § 368(a)(1)(A) [mergers], (B) [stock for stock], (C) [stock for assets], and (G) [bankruptcy] reorganizations where the acquiring corporation is publicly traded. The safe harbor valuation methods outlined in the revenue procedure are (i) the average of the daily volume weighted average prices; (ii) the average of the average high-low daily prices; and (iii) the average of the daily closing prices. Of course, the specific requirements and limitations of Rev. Proc. 2018-12 are quite technical and must be carefully considered in connection with any potential reorganization transaction relying upon the revenue procedure for COI purposes. Nonetheless, the takeaway is that if one of the foregoing valuation methods is used to determine the stock consideration paid to target shareholders by a publicly-traded acquiring corporation in one of the specified reorganizations, then such method generally may be used for COI purposes as well. Rev. Proc. 2018-12 states that it only applies for COI purposes (not other valuation purposes) and that if the safe harbors of the revenue procedure are not met, the reorganization nevertheless may qualify for nonrecognition treatment under general federal tax principles. Finally, Rev. Proc. 2018-12 provides that the IRS will entertain requests for rulings and determination letters that fall outside the scope of the revenue procedure.

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

1. After reading a combined 140+ pages, how about next time we just flip a coin? Surely the answer cannot be as simple as the outcome: Owning related-party DISC stock
via a Roth IRA is OK, but owning related-party FSC stock via a Roth IRA is not OK? The following recent cases dramatically illustrate the uncertainties faced by advisors, the IRS, and the courts when deciding between transactions that constitute creative but legitimate tax planning and those that are considered “abusive.” Both cases centered on taxpayers using statutorily-sanctioned tax-planning devices in tandem (Roth IRAs coupled with a DISC or a FSC). Nonetheless, a Sixth Circuit panel unanimously held for the taxpayer while a majority of the Tax Court held for the IRS (even after considering the Sixth Circuit’s decision). Moreover, the Sixth Circuit and the Tax Court reached conflicting conclusions notwithstanding the fact that the taxpayers and the IRS agreed there was no significant difference between the cases in either the relevant facts or the controlling law. If this is no surprise to you, you can stop here. If you are intrigued, read further.

a. Form is substance, says the Sixth Circuit. The IRS is precluded from recharacterizing a corporation’s payments to a DISC held by a Roth IRA. Summa Holdings, Inc. v. Commissioner, 848 F.3d 779 (6th Cir. 2/16/17), rev’g T.C. Memo 2015-119 (6/29/15). Two members of the Benenson family each established a Roth IRA by contributing $3,500. Each Roth IRA paid $1,500 for shares of a Domestic International Sales Corporation (DISC). These members of the Benenson family were the beneficial owners of 76.05 percent of the shares of Summa Holdings, Inc., the taxpayer in this case and a subchapter C corporation. Summa Holdings paid (and deducted) commissions to the DISC, which paid no tax on the commissions. The DISC distributed dividends to each of the Roth IRAs, which paid unrelated business income tax on the dividends (at roughly a 33 percent rate according to the court) pursuant to § 995(g). (The structure involved a holding company between the Roth IRA and the DISC, but the presence of the holding company appears not to have affected the tax consequences.) This arrangement allowed the balance of each Roth IRA to grow rapidly. From 2002 to 2008, the Benensons transferred approximately $5.2 million from Summa Holdings to the Roth IRAs through this arrangement, including $1.5 million in 2008, the year in issue. By 2008, each Roth IRA had accumulated over $3 million. The IRS took the position that the arrangement was an impermissible way to avoid the contribution limits that apply to Roth IRAs. The IRS disallowed the deductions of Summa Holdings for the commissions paid to the DISC and asserted that, under the substance-over-form doctrine, the arrangement should be recharacterized as the payment of dividends by Summa Holdings to its shareholders, followed by contributions to the Roth IRAs by the two members of the Benenson family who established them. The IRS determined that each Roth IRA had received a deemed contribution of $1.1. By virtue of their level of income, the two Benenson family members were ineligible to make any Roth IRA contributions. Pursuant to § 4973, the IRS imposed a 6 percent excise tax on the excess contributions.

The Tax Court’s decision (Summa I). The Tax Court (Judge Kerrigan) upheld the IRS’s recharacterization. Judge Kerrigan relied upon Repetto v. Commissioner, T.C. Memo 2012-168 and Notice 2004-8, 2004-1 C.B. 333, both of which addressed using related-party businesses and Roth IRAs in tandem to circumvent contribution limits. Foreshadowing its argument in Repetto, the IRS had announced in Notice 2004-8 that these arrangements were listed transactions and that it would attack the arrangements on several grounds, including “that the substance of the transaction is that the amount of the value shifted from the Business to the Roth IRA Corporation is a payment to the Taxpayer, followed by a contribution by the Taxpayer to the Roth IRA and a contribution by the Roth IRA to the Roth IRA Corporation.” Importantly, subsequent Tax Court decisions, Polowniak v. Commissioner, T.C. Memo 2016-31 and Block Developers, LLC v. Commissioner, T.C. Memo 2017-142, adopted the IRS’s position in Notice 2004-8 and struck down tandem Roth IRA/related-party business arrangements like the one under scrutiny in Summa I.

The Sixth Circuit’s decision (Summa II). In an opinion by Judge Sutton, the U.S. Court of Appeals for the Sixth Circuit reversed. The court emphasized that “[t]he Internal Revenue Code allowed

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1 Although the Tax Court had both disallowed Summa Holdings’ deductions for the commissions paid to the DISC and upheld imposition of the 6 percent excise tax of § 4973 on the deemed excess Roth IRA contributions made by Summa Holdings’ shareholders, Summa Holdings appealed to the Sixth Circuit only the disallowance of its deductions. The shareholders have appealed to the First and Second Circuits the issue whether they made excess Roth IRA contributions. Those appeals are currently pending.
Summa Holdings and the Benensons to do what they did.” The issue was whether the IRS’s application of the substance-over-form doctrine was appropriate. The court first expressed a great deal of skepticism about the doctrine:

Each word of the “substance-over-form doctrine,” at least as the Commissioner has used it here, should give pause. If the government can undo transactions that the terms of the Code expressly authorize, it’s fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is. “Form” is “substance” when it comes to law. The words of law (its form) determine content (its substance). How odd, then, to permit the tax collector to reverse the sequence—to allow him to determine the substance of a law and to make it govern “over” the written form of the law—and to call it a “doctrine” no less.

Although the court expressed the view that application of the substance-over-form doctrine makes sense when a “taxpayer’s formal characterization of a transaction fails to capture economic reality and would distort the meaning of the Code in the process,” this was not such a case. The substance-over-form doctrine as applied by the IRS in this case, the court stated, was a “distinct version” under which the IRS claims the power to recharacterize a transaction when there are two possible options for structuring a transaction that lead to the same result and the taxpayer chooses the lower-tax option. The court concluded that the IRS’s recharacterization of Summa Holding’s transactions as dividends followed by Roth IRA contributions did not capture economic reality any better than the taxpayer’s chosen structure of DISC commissions followed by dividends to the DISC’s shareholders.

b. Not so fast, says the Tax Court. The IRS can still win a Roth IRA case if a tax-saving corporation’s stock is in substance owned by individual shareholders instead of their Roth IRAs. Mazzei v. Commissioner, 150 T.C. No. 7 (03/05/18). The taxpayers in this case were members of the Mazzei family (husband, wife, and adult daughter). They owned 100 percent of the stock of Mazzei Injector Corp., an S corporation. The taxpayers established separate Roth IRAs that each invested $500 in a Foreign Sales Corporation (“FSC”). Under prior law and somewhat like DISCs, FSCs provided a Code-sanctioned tax benefit because they were taxed at much lower rates than regular corporations pursuant to an express statutory regime. After the taxpayers’ Roth IRAs invested in the FSC, Mazzei Injector Corp. paid the FSC a little over $500,000 in deductible commissions from 1998 to 2002. These deductible payments exceeded the amounts the taxpayers could have contributed to their Roth IRAs over these years, and just as in Summa Holdings, the IRS argued that substance over form principles applied to recharacterize the entire arrangement as distributions by the S corporation to its shareholders, followed by excess Roth IRA contributions subject to the § 4973 excise tax and related penalties. Because the case is appealable to the Ninth Circuit, the Tax Court was not bound by the Sixth Circuit’s decision in Summa Holdings. Thus, the Tax Court could have followed its own decision in Summa Holdings to agree with the IRS that in substance the entire arrangement amounted to an end-run around Roth IRA contribution limits; however, the Tax Court did not adopt this Summa Holdings-inspired approach. Instead, in a reviewed opinion (12-0-4) by Judge Thornton, relying upon Ninth Circuit precedent as well as the U.S. Supreme Court’s decision in Frank Lyon Co. v. United States, 435 U.S. 561 (1978), the Tax Court reasoned that the Roth IRAs had no real downside risk or exposure with respect to holding the FSC stock and thus were not the true owners of the stock. Judge Thornton determined that, for federal income tax purposes, the taxpayers should be considered the owners of the stock, stating:

[B]ecause petitioners (through various passthrough entities) controlled every aspect of the transactions in question, we conclude that they, and not their Roth IRAs, were the owners of the FSC stock for Federal tax purposes at all relevant times. The dividends from the FSC are therefore properly recharacterized as dividends from the FSC to petitioners, followed by petitioners’ contributions of these amounts to their respective Roth IRAs. All of these payments exceeded the applicable contribution limits and were therefore excess contributions. We therefore uphold respondent’s determination of excise taxes under section 4973.

Notably, though, the Tax Court declined to impose penalties on the taxpayers because they relied on independent professional advice in connection with setting up the FSC and their Roth IRAs.
Dissenting opinion. Four Judges (Holmes, Foley, Buch, and Morrison) dissented, with some joining only parts of the dissenting opinion written by Judge Holmes. Judge Holmes reasoned that the majority should have followed the Sixth Circuit’s decision in Summa Holdings instead of engaging in “judge-made doctrine.” In our view, Judge Holmes’s dissenting opinion is both entertaining and insightful, summing up the conflicting opinions in Summa I, Summa II, and Mazzei as follows: “What’s really going on here is that the Commissioner doesn’t like that the Mazzeis took two types of tax-advantaged entities and made them work together.” Judge Holmes also aptly observed:

After the Sixth Circuit released Summa II we told the parties here to submit supplemental briefs. The Mazzeis and the Commissioner agreed that the only difference between these cases and Summa II was that the Mazzeis used a FSC instead of a DISC. The Commissioner said this difference shouldn’t affect our analysis, and he admitted that the Mazzeis followed all of the necessary formalities. He nevertheless said we should ignore Summa II because it’s from a different circuit and only the commission payments’ deductibility was properly before the court there. He said we should instead follow Court Holding, look at the transaction as a whole, and decide the cases based on his views of the statute’s intent, not the Code’s plain language.

The Mazzeis urged us to follow Summa II’s reasoning. They said they should get the FSC and Roth IRA tax benefits the Code explicitly provides and that the Commissioner shouldn’t get to rewrite statutes based on his musings about congressional intent. And they said that their use of an FSC instead of a C corporation was enough to distinguish these cases from Repetto.

Our conclusion? Flip a coin. Tax advisors setting up these tandem Roth IRA/related-party business arrangements, at least where the structure involves a corporation that enjoys statutorily-sanctioned tax benefits—such as a very low 21 percent rate, perhaps?—may prefer to flip a coin than to predict the ultimate outcome, at least outside the Sixth Circuit. One thing is almost certain, though: We will be reading and writing more about tandem Roth IRA/related-party business arrangements in the near future.

c. The First Circuit has agreed with the Sixth Circuit and declined to recharacterize a corporation’s payments to a DISC held by a Roth IRA. Benenson v. Commissioner, 887 F.3d 511 (1st Cir. 4/6/18), rev’g T.C. Memo 2015-119 (6/29/15). In an opinion by Judge Stahl, the U.S. Court of Appeals for the First Circuit has upheld the same Roth IRA-DISC transaction considered by the Sixth Circuit in Summa Holdings, Inc. v. Commissioner, 848 F.3d 779 (6th Cir. 2/16/17). In that transaction, members of the Benenson family established Roth IRAs that acquired shares of a Domestic International Sales Corporation (DISC), to which a subchapter C corporation (Summa Holdings) paid (and deducted) commissions to the DISC. The Tax Court upheld the IRS’s recharacterization of the transaction under the substance over form doctrine. Under the IRS’s view of the transaction, the C corporation’s payments of commissions to the DISC should be recharacterized as nondeductible distributions by the C corporation to its shareholders, followed by the shareholders’ contributions of those amounts to their Roth IRAs in excess of applicable limits, which triggered the 6 percent excise tax of § 4973 The Sixth Circuit addressed the C corporation’s deductions and rejected the IRS’s argument that the C corporation’s deductions should be disallowed under the substance over form doctrine. In this case, the First Circuit considered the appeal of the Tax Court’s decision by shareholders who were residents of Massachusetts, who appealed the Tax Court’s decision that they should be treated as having made excess Roth IRA contributions. Like the Sixth Circuit, the First Circuit declined to apply the substance over form doctrine, which the court characterized as “not a smell test,” but rather a tool of statutory interpretation. The court reasoned that Congress appeared to contemplate ownership of DISCS by IRAs when it enacted relevant statutory provisions such as § 995(g), which imposes unrelated business income tax on distributions that a DISC makes to tax-exempt organizations that own shares of the DISC. The court concluded:

The Benensons used DISCs, a unique, congressionally designed corporate form their family's business was authorized to employ, and Roth IRAs, a congressionally designed retirement account all agree they were qualified to establish, to engage in
long-term saving with eventual tax-free distribution. Such use violates neither the letter nor the spirit of the relevant statutory provisions.

Some may call the Benensons’ transaction clever. Others may call it unseemly. The sole question presented to us is whether the Commissioner has the power to call it a violation of the Tax Code. We hold that he does not. … When, as here, we find that the transaction does not violate the plain intent of the relevant statutes, we can push the doctrine no further.

- In a dissenting opinion, Judge Lynch argued that the IRS’s application of the substance over form doctrine should be upheld. In Judge Lynch’s view, the parties had not used the DISC for the purpose intended by Congress, but rather to evade the Roth IRA contribution limits. Judge Lynch also disagreed with the majority that the relevant statutory provisions contemplated a Roth IRA holding stock in a DISC. At most, Judge Lynch noted, Congress might have intended to allow traditional IRAs to own DISC stock, but taxpayers have not used DISCs as a way to circumvent the contribution limits on traditional IRAs because, in contrast to Roth IRAs, distributions from a traditional IRA are not tax-free.

2. Back to the future: Remember the good ole days before 1986 when C corporations were tax shelters? By introducing a flat corporate tax rate of 21 percent, Congress has given new life to C corporations and will force us to relearn personal holding company, accumulated earnings tax, and other anti-abuse rules (e.g., § 269A) we’ve long ignored. The centerpiece of the 2017 Tax Cuts and Jobs Act is a permanent reduction in corporate tax rates. Section 13001 of the legislation amended § 11(b) to impose tax on taxable income of corporations, including personal service corporations, at a flat rate of 21 percent. Prior to this amendment, § 11(b) provided graduated rates with a top rate of 35 percent (which top rate applied to the first dollar of personal service corporation income). For personal service corporations and companies with significant profit from U.S. operations, the reduction in the corporate rate is a huge benefit. In fact, this rate reduction is estimated to reduce corporate income taxes by roughly $1.3 trillion over the next ten years. Prior to this change, most businesses avoided C corporation status unless they were (or planned to be) publicly traded, were so-called “blocker” corporations, or, in some cases, were taken private by investment funds. Venture capital backed companies also tended to choose C corporation status to simplify their capital structure and tax compliance obligations. Now, however, C corporation status may be a sensible choice for some personal service and other closely-held corporations, especially if the business will be held for the life of the major shareholders (thereby benefiting from the step-up in basis at death) or the shareholders will exit via a stock sale at some indeterminate time in the future. One of the authors has heard anecdotally that many older, highly compensated law firm partners (drawing $1 million or more annually and thus excluded from new § 199A) who expect to retire soon are considering incorporating as old-fashioned personal service corporations, especially those in states with high income tax rates. No doubt, the accumulated earnings tax (§§ 535-537) and the IRS’s power to reallocate income between a shareholder and his or her personal service corporation (§ 269) will come into play to deter such strategies, but a 21 percent rate as compared to a 37 percent rate is tempting. Nevertheless, despite the reduced rate, subchapter C is still a double-tax regime. In particular, asset sales (or deemed asset sales at liquidation) by C corporations will continue to suffer a big tax bite notwithstanding the reduced corporate rate. Furthermore, new § 199A must be considered for any flow-through entities. Bottom line: Although the authors believe that flow-through status remains the best option in most situations, the choice-of-entity analysis just got more complicated and will require even more crystal-ball gazing.

a. Although we will have to relearn some old C corporation anti-abuse provisions, here’s something we can forget: the corporate AMT. The 2017 Tax Cuts and Jobs Act, § 12001, repealed the corporate alternative minimum tax (by amending Code § 55) effective for taxable years beginning after 2017. Corporations that incurred AMT in past years will want to be sure to claim that amount as a credit against regular tax going forward. A special rule regarding the refundable portion of the AMT credit is designed to allow a corporation to use fully in 2018 through 2021 any AMT credits carried forward. Also, corporations that have had other credits (e.g., the R&D credit) limited in past years by the AMT may be able to claim those credits going forward.
b. But wait! Nothing about federal income taxation is ever simple, right? Notice 2018-38, 2018-18 I.R.B. 522 (04/16/18). The IRS has provided guidance to non-calendar taxable year C corporations with regard to the 2017 Tax Cuts and Jobs Act’s reduction in the corporate rate and repeal of the AMT effective as of December 31, 2017. Essentially, in the case of a C corporation with a fiscal taxable year that includes (but does not start with) January 1, 2018, § 15 mandates that a blended rate apply for purposes of calculating regular income tax and the AMT for such fiscal taxable year. Notice 2018-38 provides the following examples of the application of § 15:

**Example.** Corporation X, a subchapter C corporation, uses a June 30 taxable year. For its taxable year beginning July 1, 2017, and ending June 30, 2018, X’s taxable income is $1,000,000, and its [alternative minimum taxable income or “AMTI”] in excess of its AMT exemption amount is $2,000,000.

**Computation under § 11**

Corporation X’s corporate tax under § 11 of the Code is computed by applying § 15(a) as follows:

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1)</td>
<td>Taxable income (Line 30, Form 1120)</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>2)</td>
<td>Tax on Line 1 amount using § 11(b) rates before the Act</td>
<td>340,000</td>
</tr>
<tr>
<td>3)</td>
<td>Number of days in Corporation X’s taxable year before January, 1, 2018</td>
<td>184</td>
</tr>
<tr>
<td>4)</td>
<td>Multiply Line 2 by Line 3</td>
<td>62,560,000</td>
</tr>
<tr>
<td>5)</td>
<td>Tax on Line 1 amount using § 11(b) rate after the Act</td>
<td>210,000</td>
</tr>
<tr>
<td>6)</td>
<td>Number of days in the taxable year after December 31, 2017</td>
<td>181</td>
</tr>
<tr>
<td>7)</td>
<td>Multiply Line 5 by Line 6</td>
<td>38,010,000</td>
</tr>
<tr>
<td>8)</td>
<td>Divide Line 4 by total number of days in the taxable year</td>
<td>171,397</td>
</tr>
<tr>
<td>9)</td>
<td>Divide Line 7 by total number of days in the taxable year</td>
<td>104,137</td>
</tr>
<tr>
<td>10)</td>
<td>Sum of Line 8 and Line 9</td>
<td><strong>$275,534</strong></td>
</tr>
</tbody>
</table>

Under § 15(a), Corporation X’s corporate tax for its taxable year ending June 30, 2018 is $275,534.

**Computation under § 55**

Corporation X’s [tenative minimum tax or “TMT” under § 55] and resulting AMT under § 55 of the Code is computed by applying § 15(a) as follows:

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1)</td>
<td>AMTI in excess of AMT exemption amount (Line 9, Form 4626)</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>2)</td>
<td>TMT on Line 1 amount using § 55(b)(1)(B) rate before the Act</td>
<td>400,000</td>
</tr>
<tr>
<td>3)</td>
<td>Number of days in Corporation X’s taxable year before January, 1, 2018</td>
<td>184</td>
</tr>
<tr>
<td>4)</td>
<td>Multiply Line 2 by Line 3</td>
<td>73,600,000</td>
</tr>
<tr>
<td>5)</td>
<td>Divide Line 4 by total number of days in the taxable year</td>
<td><strong>$201,644</strong></td>
</tr>
</tbody>
</table>

It is unnecessary to compute a TMT for the portion of the taxable year beginning on and after the effective date of § 12001 of the Act because the TMT is repealed as of the effective date for purposes of applying § 15(a). Corporation X’s TMT for its taxable year ending June 30, 2018 is $201,644. Because this TMT amount for the taxable year does not exceed Corporation X’s corporate tax amount of $275,534, Corporation X does not have an AMT liability for its taxable year ending June 30, 2018.

3. A reduced corporate dividends received deduction. The 2017 Tax Cuts and Jobs Act, § 13002, amended Code § 243 and certain other provisions to reduce the corporate dividends
received deduction. Prior to this amendment, a corporation could deduct 100 percent of dividends received from a corporation in its affiliated group, 80 percent of dividends received from a corporation of which the recipient owns 20 percent or more of the stock (measured by vote and value), and 70 percent of dividends received from all other corporations. The legislation reduced the 80 percent and 70 percent figures to 65 percent and 50 percent, respectively. The legislation did not change the 100 percent dividends received deduction. These changes apply to taxable years beginning after 2017.

4. “Lucy, you got some ‘splainin’ to do” about taxable versus nontaxable contributions to capital. The 2017 Tax Cuts and Jobs Act, § 13312, amended Code § 118 to limit the exclusion for nonshareholder contributions to capital. Pursuant to new § 118(b)(2), nonshareholder contributions to capital made by “any governmental entity or civic group (other than a contribution made by a shareholder as such)” after December 22, 2017, no longer are excludable from the recipient corporation’s gross income. Such nontaxable contributions have been made in the past by governmental entities and civic groups to incentivize acquisition and redevelopment projects considered important to those entities and groups. As a nod to these past arrangements, a transition rule generally allows certain capital contributions made under master development plans approved by governmental entities on or before December 22, 2017. See TCJA § 13312(b)(2). Amended § 118 also provides Treasury with regulatory authority to interpret and implement the new rules. See § 118(c).

The foregoing seems plain enough, but there’s more to the story.

Convoluted legislative history. Notably, the House’s version of the 2017 TCJA simply repealed § 118, but as mentioned above the conferees decided instead to amend § 118 merely to eliminate any exclusion from gross income for nonshareholder contributions to capital by governmental entities or civic groups. The Conference Report accompanying the amendment to § 118 clarifies that a municipal tax abatement for locating a business in a particular municipality is not considered a taxable contribution to capital. Moreover, the Conference Report states that the amendments to § 118 do not change the application of the meaningless gesture doctrine, described in Lessinger v. Commissioner, 872 F.2d 519 (2d. Cir. 1989) and related cases, as well as in prior administrative guidance. Thus, incremental shares of stock are not required to be issued by a corporation under § 351 to avoid gross income when existing shareholders of a corporation (including governmental entity or civic group shareholders) make pro-rata contributions to capital. Finally, in a curious reference to which we refer later in this outline in connection with recent partnership capital contribution cases, the Conference Report states “[t]he conferees intend that section 118, as modified, continue to apply only to corporations;” however, the Conference Report also states in part that “[t]he conference agreement follows the policy of the House bill” which, as noted above, repealed § 118. This nuance is important because the legislative history of the House bill stated in connection with the proposed repeal of § 118 that “a contribution of municipal land by a municipality that is not in exchange for stock (or for a partnership interest or other interest) of equivalent value is considered a contribution to capital that is includable in gross income.” (Emphasis added.)

Some deeper background. Prior to the 2017 TCJA, the gross income of a corporation generally did not include contributions to capital made by nonshareholders. Section 118(a) continues to provide a general rule of excludability for nonshareholder contributions to capital, and thus the pre-TCJA version of § 118(a) remains intact. As summarized above, however, TCJA added a new limitation to the general rule of § 118(a). Specifically, §118(b)(2) carves out from the general rule of exclusion any nonshareholder contributions to capital made by governmental entities or civic groups. Other limitations on the exclusion existed and continue to exist under § 118 for certain capital contributions “in aid of construction” (as defined, but carving out contributions made by regulated water or sewage utilities) or “as a customer or potential customer.” See § 118(b)(1). Notwithstanding the foregoing, the pre-TCJA version of § 118 ordinarily allowed a corporation to exclude from gross income nonshareholder contributions to capital made by governmental entities or civic groups for the purpose of inducing the corporation to acquire or construct property within a desired locale. See, e.g., Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950). If property other than money was acquired by a corporation as a nontaxable contribution to capital, then the adjusted basis of the property was zero. If the contribution consisted of money, then the corporation had to reduce the basis of any property acquired with the contributed money within the following 12-month period, and then reduce the basis of other property held by the corporation. See § 362(c)(1) & (2); Reg. § 1.362–2. These rules regarding
basis reductions remain unaffected for any nonshareholder contributions to capital that somehow remain excludable from gross income under amended § 118.

What about noncorporate entities? Section 118 expressly did not and still does not apply to noncorporate entities such as partnerships and LLCs taxed as partnerships. The IRS previously has taken the position that there is no exclusion from gross income for contributions to the capital of noncorporate entities made by a nonowner. Nevertheless, the IRS acknowledges that taxpayers have taken contrary positions under a “common law contribution to capital doctrine.” See generally LMSB Coordinated Issue Paper LMSB4-1008-051, Exclusion of Income: Non-Corporate Entities and Contributions to Capital (Nov. 18, 2008). For those taxpayers, the convoluted language in the Conference Report perhaps should lead to the conclusion that those common law “groundrules” (pun intended) have changed, at least with respect to governmental entity and civic group capital contributions. In fact, considering two recent cases discussed later in this outline regarding LLCs taxed as partnerships, current trends suggest that contributions to the capital of noncorporate entities are not excludable from gross income notwithstanding any “common law contribution to capital doctrine.”

5. ♫“Shed a tear ‘cause I’m missin’ you … All we need is just a little patience”♫ Treasury and the IRS propose to withdraw the final regulations regarding documentation issued under § 385, but they may be back in modified form. REG-130244-17, Proposed Removal of Section 385 Documentation Regulations, 83 F.R. 48265 (9/24/18). Treasury and the IRS have issued a notice of proposed rulemaking that would remove the final regulations issued in 2016 setting forth minimum documentation requirements that ordinarily must be satisfied for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes.

Documentation Regulations. In 2016, Treasury and the IRS published Reg. § 1.385-2, which provides detailed requirements for documentation and financial analysis of instruments issued as indebtedness between related parties similar to what generally would be expected on issuance of debt instruments between unrelated parties. See T.D. 9790, Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 F.R. 72858 (10/21/16). Under this regulation, for an instrument to be treated as debt, documentation and information must be developed at the time an instrument is issued to demonstrate (1) a binding obligation to repay a fixed or determinable sum certain on demand or at one or more fixed dates, (2) that the creditor has the typical legal rights of a creditor to enforce the terms of the instrument including rights to trigger a default and accelerate payments, (3) a reasonable expectation that the issuer intends and would be able to repay, such as cash flow projections, financial statements, business forecasts, asset appraisals, determinations of debt-to-equity and other relevant financial ratios of the issuer (compared to industry averages), and (4) timely evidence of an on-going debtor-creditor relationship. Reg. § 1.385-2(c)(2). The documentation rules generally apply only to interests among members of an “expanded group” (very generally, an affiliated group within the meaning of § 1504(a) connected through stock possessing 80 percent of either voting power or value) if, on the date the interest is created, (1) the stock of any member of the expanded group is publicly traded, (2) all or any portion of the expanded group’s financial results are reported on financial statements with total assets exceeding $100 million, or (3) the expanded group’s financial results are reported on financial statements that reflect annual total revenue that exceeds $50 million. The documentation rules do not apply to intercompany obligations among members of a consolidated group. Reg. § 1.385-2 originally was to apply to interests issued or deemed issued on or after January 1, 2018. In Notice 2017-36, 33 I.R.B. 208 (7/28/17), due to concerns expressed by taxpayers that the applicability date of the proposed regulations did not give taxpayers sufficient time to develop processes to comply with the documentation requirements, the IRS announced that Reg. § 1.385-2 would be amended to apply only to interests issued or deemed issued on or after January 1, 2019.

Withdrawal of the Documentation Regulations. On April 21, 2017, President Trump issued Executive Order 13789 directing the Secretary of the Treasury to review “all significant tax regulations” issued on or after January 1, 2016, that “impose an undue financial burden,” “add undue complexity,” or “exceed [the IRS’s] statutory authority,” and to submit two reports to the President. The second report, issued by Treasury Secretary Mnuchin on October 2, 2017, recommended certain actions with respect to eight sets of regulations, one of which was the documentation rules set forth in the regulations under § 385. Treasury and the IRS now have proposed to withdraw the documentation rules, which are found primarily in Reg. § 1.385-2. The preamble to these proposed regulations states
that Treasury and the IRS will continue to study the issues addressed by the documentation rules and may propose a modified version of them. Any revised regulation setting forth documentation requirements “would be substantially simplified and streamlined to reduce the burden on U.S. corporations and yet would still require sufficient documentation and other information for tax administration purposes.” The proposed withdrawal will be effective on the date these proposed regulations are published as final regulations.

VII. PARTNERSHIPS

A. Formation and Taxable Years

B. Allocations of Distributive Share, Partnership Debt, and Outside Basis

1. ♫♪ You got to know when to hold’em, know when to fold’em, know when to walk away, and know when to run….♫♪ Carried interests still qualify for preferential long-term capital gain rates, but the holding period just increased to 3 years for specified interests in hedge funds and other investment partnerships. For years there has been a big brouhaha over managers of real estate, hedge fund, and other investment partnerships being taxed at preferential long-term capital gain rates (e.g., 20%) on their distributive shares of partnership income notwithstanding the fact that they received their interests in these partnerships as part of their compensation for services rendered (which compensation otherwise would be taxed at ordinary income rates). Congress and eventually President Trump have threatened for several years to take action against this “loophole.” Well, at long last, Congress still has done NOTHING about it, but can claim that it did!

New § 1061. Specifically, the 2017 Tax Cuts and Jobs Act, § 13309, created new § 1061 and redesignated pre-TCJA § 1061 as § 1062. New § 1061 requires a three-year holding period for allocations of income with respect to “applicable partnership interests” to qualify for preferential long-term capital gain rates. Specifically, net long-term capital gain allocated to a partner who holds an applicable partnership interest is characterized as short-term capital gain to the extent the gain is attributable to the disposition of partnership property held by the partnership for three years or fewer. An applicable partnership interest is one that is transferred to (or is held by) a taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any “applicable trade or business.” An applicable trade or business means any activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of “raising or returning capital,” and either “investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition),” or “‘developing specified assets.’” Specified assets for this purpose generally are defined as securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and (big furrowed brow here) “an interest in a partnership to the extent of the partnership’s proportionate interest in any of the foregoing” (e.g., tiered partnerships). There are significant exceptions, though, for (i) employees of another entity holding interests in a partnership that only performs services for that other entity; and (ii) partnership interests acquired for invested capital (including via a § 83(b) for a capital interest in a partnership).

What about § 1231 assets? It is unclear (at least to the authors) whether § 1061’s three-year holding period rule applies to trump (no pun intended) quasi-capital gain treatment under § 1231. Basically, new § 1061 works by transmuting (i) otherwise net long-term capital gain (as defined in § 1222) attributable to an “applicable partnership interest” (i.e., all of a taxpayer’s net long-term capital gain as normally calculated) into short-term capital gain, but (ii) only to the extent such gain exceeds net long-term capital gain (as defined in § 1222) attributable to the disposition of partnership property held by the partnership for three years or more (i.e., net long-term gain that is excluded from transmutation under § 1061). Short- and long-term capital gain (or loss) is defined under § 1222 by reference to a “capital asset” as defined in § 1221 and is determined at the partnership level. Code § 1221 excludes § 1231 assets from the definition of “capital assets.” To wit, in the recent case of CRI-Leslie, LLC v. Commissioner, 882 F.3d 1026 (11th Cir. 2/15/18), aff’g 147 T.C. 217 (9/7/16), the IRS was successful in arguing, over the strenuous objection of the taxpayer, that a § 1231 asset is not a “capital asset” within the meaning of § 1234A (which treats gains and losses realized upon termination of rights with respect to a “capital asset” as capital gain or loss). The taxpayer in CRI-Leslie had entered into a contract to sell a hotel that it owned and had received a deposit of $9.7 million. Ultimately, the buyer
under the contract defaulted and forfeited the $9.7 million deposit, which was retained by the taxpayer. The hotel property was a § 1231 asset, not a capital asset. Relying upon § 1234A, the taxpayer reported the $9.7 million as net long-term capital gain. The IRS, however, asserted a deficiency based upon treating the forfeited $9.7 million deposit as ordinary income. The taxpayer argued that its characterization of the forfeited deposit as long-term capital gain was supported by the legislative history of § 1234A because, according to the taxpayer, Congress enacted § 1234A to “ensure that taxpayers received the same tax characterization of gain or loss whether the property is sold or the contract to which the property is subject is terminated.” Nonetheless, both the Tax Court (Judge Laro) and the Fifth Circuit rejected the taxpayer’s argument that the legislative history of § 1234A supported the taxpayer’s position. Instead, Judge Laro agreed with the IRS that “[s]ince section 1234A expressly refers to property that is ‘a capital asset in the hands of the taxpayer’ and no other type of property, and since property described in section 1231 is excluded explicitly from the definition of ‘capital asset’ in section 1221, we must conclude that the plain meaning of ‘capital asset’ as used in section 1234A does not extend to section 1231 property.” The court was “unable find anything in the legislative history of section 1234A to support [the taxpayer’s] assertion that Congress intended to include section 1231 property within its ambit.” The legislative history accompanying new § 1061 likewise is bereft of any reference to § 1231 property.

Who cares? Isn’t § 1061 just a paper tiger? New § 1061 is deserving of much more study, but we suspect that the provision will catch only those very rare taxpayers who either (i) fail to hold their carried interests for more than three years, or (ii) lack the sophisticated advice to plan around the statute. One commentator characterizes the new statute as a “joke” given that most managers of real estate, hedge funds, and investment partnerships hold their carried interests for well over three years. See Sloan, Carried Interest Reform is a Sham, Washington Post, December 1, 2017. On the other hand, maybe this comment is just “fake news.” New § 1061 is permanent and applies to taxable years beginning after 2017.

a. Does the word “corporation” in the Code include an S corporation? The Treasury Department and the IRS don’t think so. Notice 2018-38, 2018-12 I.R.B. 443 (3/1/18). Under § 1061(c)(4)(A) as enacted by the 2017 Tax Cuts and Jobs Act, an interest in a partnership is not subject to the carried interest rule if it is held “directly or indirectly … by a corporation.” In this notice, the Treasury Department and the IRS have announced that they intend to issue regulations providing guidance on § 1061 and that “those regulations will provide that the term ‘corporation’ for purposes of section 1061(c)(4)(A) does not include an S corporation.” Other than reciting the statutory definitions of “S corporation” and “C corporation,” the notice does not provide any explanation of how the regulations will arrive at that result. According to the notice, the regulations will be effective for taxable years beginning after December 31, 2017.

2. Congress has made a technical correction to § 704(d) that makes partnership outside basis calculations with respect to charitable contributions and foreign taxes the same as for S corporations. If you wish to avoid brain damage, stop reading and trust us that the foregoing statement is accurate. Otherwise, continue reading.

A recap of some basic rules for determining the basis of a partner’s partnership interest. In general, the basis of a partner has in a partnership interest is adjusted upward by the partner’s capital contributions and distributive share of income (including tax-exempt income) and downward (but not below zero) by distributions received by the partner and the partner’s distributive share of losses and nondeductible expenditures. See § 705(a). Under § 704(d), a partner can take into account the partner’s distributive share of losses for any taxable year only to the extent of the basis of the partner’s partnership interest, determined after adjusting the basis for distributions and nondeductible expenditures of the partnership. See Reg. § 1.704-1(d)(2). To the extent such losses are limited in this manner, the excess is carried over to subsequent years and may be used when the partner has sufficient outside basis. See § 704(d); Reg. § 1.704-1(d)(1). But, in the case of charitable contributions and foreign taxes paid or incurred by a partnership, these items are not taken into account in computing partnership taxable income and, consequently, a partner’s distributive share of income or loss of the partnership. See § 703(a)(2)(B) and (C). Instead, a partner separately takes into account his/her/its distributive share of these items under § 702(a)(4) and (6); however, due to a technical glitch in the regulations (see Reg. § 1.704-1(d)(2)), the outside basis limitation of § 704(d) did not apply properly
to take into account a partner’s separately-determined share of partnership charitable contributions. Specifically, if a partner had a positive outside basis, then (prior to the TCJA) the partner claimed the charitable contribution on the partner’s return and reduced outside basis by the partner’s separately-determined share of the adjusted basis of contributed property. If a partner had a zero outside basis, though, such partner still could claim the charitable contribution on the partner’s return, but was not required to reduce outside basis. Further, those same technically-deficient regulations did not address the application of § 704(d) with respect to foreign taxes paid or accrued by a partnership, but even if they did apply to tie a partner’s foreign tax deduction to the partner’s basis in the partnership interest, § 901 allows a partner to take a credit in lieu of a deduction for foreign taxes paid or accrued by the partnership. Hence, in certain circumstances a partner with a zero outside basis could benefit from the partner’s separately-stated share of charitable contributions or foreign taxes paid or incurred by the partnership, while another partner with a positive outside basis had to reduce outside basis for such items.

TCJA’s technical correction to § 704(d). The 2017 Tax Cuts and Jobs Act, § 13503, amended § 704(d) permanently by adding new § 704(d)(3)(A) so that for taxable years beginning after 2017, a partner’s outside basis is reduced by the partner’s separately-stated share of charitable contributions and foreign taxes paid or incurred by the partnership before determining the partner’s allowable share of distributive losses under § 704(d). In the case of a partnership’s charitable contribution of appreciated property, the reduction in a partner’s outside basis is determined by reference to the partner’s share of the partnership’s adjusted basis in the contributed property. In addition, TCJA § 13503 adds new § 704(d)(3)(B) so that, in the case of a partnership’s charitable contribution of property with a fair market value in excess of its adjusted basis, the reduction in outside basis otherwise required by § 704(d)(3)(A) does not apply to the extent of the partner’s separately-determined share of such excess. These changes to § 704(d) make the determination of a partner’s outside basis with respect to charitable contributions and foreign taxes paid the same as the determination of subchapter S shareholder’s outside basis with respect to such items. See § 1366(d)(4); Reg. § 1367-1(f).

3. They were just kidding! Treasury and the IRS have proposed to remove temporary regulations regarding the allocation of partnership liabilities for purposes of the § 707 disguised sale rules. REG-131186-17, Proposed Removal of Temporary Regulations on a Partner’s Share of a Partnership Liability for Disguised Sale Purposes, 83 F.R. 28397 (6/19/18). In 2016, Treasury and the IRS published temporary regulations (707 Temporary Regulations) regarding the allocation of partnership liabilities for purposes of applying the disguised sale rules of § 707. T.D. 9788, Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 F.R. 69282 (10/5/16). On April 21, 2017, President Trump issued Executive Order 13789 directing the Secretary of the Treasury to review “all significant tax regulations” issued on or after January 1, 2016, that “impose an undue financial burden,” “add undue complexity,” or “exceed [the IRS’s] statutory authority,” and to submit two reports to the President. The second report, issued by Treasury Secretary Mnuchin on October 2, 2017, recommended certain actions with respect to eight sets of regulations, one of which was the 707 Temporary Regulations. The second report stated that the novel approach implemented in the 707 Temporary Regulations should be studied systematically and that the Treasury Department and the IRS therefore would consider removing the 707 Temporary Regulations and reinstating prior regulations. Treasury and the IRS now have proposed to do so.

The 707 Temporary Regulations Issued in 2016. Temp. Reg. § 1.707-5T(a)(2), published in 2016, provides that, for purposes of the disguised sale rules, a partner’s share of any partnership liabilities, regardless of whether they are recourse or nonrecourse under Reg. § 1.752-1 through 1.752-3, must be allocated by applying the same percentage used to determine the partner’s share of “excess nonrecourse liabilities” under Reg. § 1.752-3(a)(3), “but such share shall not exceed the partner’s share of the partnership liability under section 752 and applicable regulations (as limited in the application of § 1.752-3(a)(3) to this paragraph (a)(2)).” Reg. § 1.752-3(a)(3) (as amended in T.D. 9787, 81 F.R. 69291 (10/5/16)), provides that, for purposes of the disguised sale rules of Reg. § 1.707-5(a)(2), a partner’s share of an excess nonrecourse liability is determined solely in accordance with the partner’s interest in partnership profits and that the significant item method, alternative method, and additional method do not apply. The combined effect of these rules is that, for purposes of the disguised sale rules, and regardless of whether a liability is recourse or nonrecourse, (1) a contributing partner’s share
of a partnership liability is determined solely by the partner’s share of partnership profits and cannot be determined either under the other methods normally authorized for allocating excess nonrecourse liabilities or with reference to that partner’s economic risk of loss under Reg. § 1.752-2, and (2) no portion of any partnership liability for which another partner bears the risk of loss can be allocated to the contributing partner under the profit-share method. Treasury and the IRS expressed the belief that, for purposes of the disguised sale rules, this allocation method reflects the overall economic arrangement of the partners. According to the preamble to the 707 Temporary Regulations, “[i]n most cases, a partnership will satisfy its liabilities with partnership profits, the partnership’s assets do not become worthless, and the payment obligations of partners or related persons are not called upon.” These rules were designed to be the death knell of leveraged partnership disguised sale transactions ala Canal Corp. v. Commissioner, 135 T.C. 199 (2010), to which reference is made in the 2016 preamble.

The Proposed Withdrawal of the 707 Temporary Regulations. The Treasury Department and the IRS have proposed to remove the 707 Temporary Regulations and to reinstate the regulations under § 1.707-5(a)(2) as in effect prior to the 707 Temporary Regulations. Under those prior rules, (1) a partner’s share of a partnership’s recourse liability is the partner’s share of the liability under § 752 and the regulations thereunder, i.e., recourse liabilities are allocated for purposes of the disguised sale rules under the normal rules for allocating recourse liabilities, and (2) nonrecourse liabilities are allocated by applying the same percentage used to determine the partner’s share of “excess nonrecourse liabilities” under Reg. § 1.752-3(a)(3), which means that a contributing partner’s share of a nonrecourse liability is determined for purposes of the disguised sale rules solely by the partner’s share of partnership profits and that the significant item method, alternative method, and additional method do not apply. The proposed regulations also would reinstate the rule in former Reg. § 1.707-5(a)(2)(i) and (ii) for so-called § 1.752-7 contingent liabilities that a partnership liability is a recourse or nonrecourse liability to the extent that the obligation would be a recourse liability under Reg. § 1.752-1(a)(1) or a nonrecourse liability under § 1.752-1(a)(2), respectively, if the liability was treated as a partnership liability for purposes of section 752. The preamble to the proposed regulations indicates that “[t]he Treasury Department and the IRS continue to study the issue of the effect of contingent liabilities with respect to section 707, as well as other sections of the Code.” Finally, the proposed regulations would reinstate Examples 2, 3, 7, and 8 under Reg. § 1.752-1-5(f) with a modification to the language in Example 3 to reflect an amendment made in 2016 to Reg. § 1.707-5(a)(3) regarding an anticipated reduction in a partner’s share of a liability that is not subject to the entrepreneurial risks of partnership operations.

Temporary Regulations on Bottom Dollar Guarantees Unaffected. The proposed regulations do not propose to withdraw Temp. Reg. § 1.752-2T(b)(3), issued in 2016, which addresses so-called bottom-dollar guarantees. Under Reg. § 1.752-2, a partnership liability is recourse to the extent that any partner or related person bears the economic risk of loss (EROL) for the liability. A partner or related person bears the EROL to the extent the partner or related person would have a payment obligation if the partnership liquidated in a worst-case scenario in which all partnership liabilities are due and all partnership assets generally are worthless. In 2016, along with the 707 Temporary Regulations, Treasury and the IRS issued Temp. Reg. § 1.752-2T(b)(3), which (like the final regulation that preceded it) provides that “[t]he determination of the extent to which a partner or related person has an obligation to make a payment under [Reg. § 1.752-2(b)(1)] is based on the facts and circumstances at the time of the determination,” and that “[a]ll statutory and contractual obligations relating to the partnership liability are taken into account.” However, the Temp. Reg. § 1.752-2T(b)(3) carves out an exception under which “bottom dollar” guarantees and indemnities (or their equivalent, termed “bottom dollar payments”) will not be recognized. The second report mentioned earlier, issued by Treasury Secretary Mnuchin on October 2, 2017, stated that Treasury and the IRS believe that Temp. Reg. § 1.752-2T(b)(3) concerning bottom dollar payment obligations does not meaningfully increase regulatory burdens and should be retained to prevent abuses. Accordingly, the proposed regulations do not propose to withdraw Temp. Reg. § 1.752-2T(b)(3).

Effective Date. The 707 Temporary Regulations are proposed to be removed thirty days following the date that these proposed regulations are published as final regulations. The amendments to Reg. § 1.707-5 are proposed to apply to any transaction with respect to which all transfers occur on or after thirty days following the date these proposed regulations are published as final regulations.
Nevertheless, taxpayers can apply these proposed regulations instead of the 707 Temporary Regulations to any transaction with respect to which all transfers occur on or after January 3, 2017.

C. Distributions and Transactions Between the Partnership and Partners

1. No, you May not. T.D. 9833, Partnership Transactions Involving Equity Interests of a Partner, 83 F.R. 26580 (6/8/18). The Treasury Department and the IRS have finalized, with only minor, nonsubstantive changes, Temp. Reg. § 1.337(d)-3T, Temp. Reg. § 1.732-1T(c), and corresponding proposed regulations issued in 2015. See T.D. 9722, Partnership Transactions Involving Equity Interests of a Partner, 80 F.R. 33402 (6/12/15). These regulations are intended to prevent a corporate partner from avoiding recognition under § 311(b) of corporate-level gain through transactions with a partnership involving equity interests of the corporate partner. An example of the type of transaction—commonly called a “May Company” transaction—is as follows: A corporation enters into a partnership and contributes appreciated property. The partnership then acquires stock of that corporate partner, and later makes a liquidating distribution of this stock to the corporate partner. Under § 731(a), the corporate partner does not recognize gain on the partnership’s distribution of its stock. By means of this transaction, the corporation has disposed of the appreciated property it formerly held and acquired its own stock, permanently avoiding its gain in the appreciated property. If the corporation had directly exchanged the appreciated property for its own stock, § 311(b) would have required the corporation to recognize gain upon the exchange. Under the regulations, if a transaction has the effect of an exchange by a corporate partner of its interest in appreciated property for an interest in stock of the corporate partner owned, acquired, or distributed by a partnership (a “Section 337(d) Transaction”), the corporate partner must recognize gain under a “deemed redemption” rule.

Deemed Redemption Rule. Under the deemed redemption rule, a corporate partner in a partnership that engages in a Section 337(d) Transaction must recognize gain at the time, and to the extent, that the corporate partner’s interest in appreciated property (other than stock of the corporate partner) is reduced in exchange for an increased interest in stock of the corporate partner. The complicated deemed redemption rule is triggered by the partnership’s purchase of stock of a corporate partner (or stock or other equity interests of any corporation that controls the corporate partner within the meaning of § 304(c), except that § 318(a)(1) and (3) do not apply for that purpose); gain recognition can be triggered without a subsequent distribution. The regulations provide general principles that apply in determining the amount of appreciated property effectively exchanged for stock of the corporate partner. The corporate partner’s economic interest with respect to both the stock of the corporate partner and all other appreciated property of the partnership must be determined based on all facts and circumstances, including the allocation and distribution rights set forth in the partnership agreement. The gain from the hypothetical sale used to compute gain under the deemed redemption rule is determined by applying the principles of § 704(c). The corporate partner’s recognition of gain from a Section 337(d) Transaction triggers two basis adjustments. First, the partnership increases its adjusted basis in the appreciated property that is treated as the subject of a Section 337(d) Transaction by the amount of gain that the corporate partner recognizes with respect to that property as a result of the Section 337(d) Transaction regardless of whether the partnership has a § 754 election in effect. Second, the basis of the corporate partner’s interest in the partnership is increased by the amount of gain the corporate partner recognizes. In limited circumstances, a partnership’s acquisition of stock of the corporate partner does not have the effect of an exchange of appreciated property for that stock. For example, if a partnership with an operating business uses the cash generated in that business to purchase stock of the corporate partner, the deemed redemption rule does not apply because the corporate partner’s share in appreciated property has not been reduced, and thus no exchange has occurred. The rules also do not apply if all interests in the partnership’s capital and profits are held by members of an affiliated group (defined in § 1504(a)) that includes the corporate partner.

Distribution of Corporate Partner’s Stock. A distribution of the corporate partner’s stock to the corporate partner by the partnership also can trigger gain recognition. In addition to any gain previously recognized under the deemed redemption rule, if stock of a corporate partner is distributed to the corporate partner, the corporate partner must recognize gain to the extent that the partnership’s basis in the distributed stock exceeds the corporate partner’s basis in its partnership interest (as reduced by any cash distributed in the transaction) immediately before the distribution.
De Minimis Exception. The rules described above do not apply if a de minimis exception is satisfied. The de minimis exception applies if three conditions are met: (1) the corporate partner and any related persons own less than 5 percent of the partnership, (2) the partnership holds stock of the corporate partner worth less than 2 percent of the value of the partnership’s gross assets, including stock of the corporate partner, and (3) the partnership has never, at any time, held more than $1 million in stock of the corporate partner or more than 2 percent of any particular class of stock of the corporate partner.

Effective Date. The final regulations apply to transactions that occur on or after June 12, 2015.

D. Sales of Partnership Interests, Liquidations and Mergers

1. The Tax Court gives the IRS a lesson on the intersection of partnership and international taxation: subject to the exception in § 897(g), a foreign partner’s gain from the redemption of its interest in a U.S. partnership was not income effectively connected with the conduct of a U.S. trade or business. Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner, 149 T.C. No. 3 (7/13/17). The taxpayer, a corporation organized under the laws of Greece, held a 15 percent interest (later reduced to 12.6 percent) in Premier Chemicals, LLC, an LLC organized under Delaware law and classified for federal tax purposes as a partnership. The taxpayer accepted Premier’s offer to redeem its partnership interest and received a total of $10.6 million, half of which was paid in 2008 and half in January 2009. The taxpayer and Premier agreed that the payment in January 2009 was deemed to have been paid on December 31, 2008, and that the taxpayer would not share in any profits or losses in 2009. The taxpayer realized $1 million of gain from the 2008 redemption payment and $5.2 million from the 2009 redemption payment. The taxpayer filed a return on Form 1120-F for 2008 on which it reported its distributive share of partnership items, but did not report any of the $1 million realized gain from the 2008 redemption payment. The taxpayer did not file a U.S. tax return for 2009 and thus did not report any of the $5.2 million realized gain from the 2009 redemption payment. The IRS issued a notice of deficiency in which it asserted that all of the $6.2 million of realized gain was subject to U.S. tax because it was U.S.-source income effectively connected with the conduct of a U.S. trade or business. The taxpayer conceded that $2.2 million of the gain was subject to U.S. taxation pursuant to § 897(g), which treats amounts received by a foreign person from the sale or exchange of a partnership interest as amounts received from the sale or exchange of U.S. real property to the extent the amounts received are attributable to U.S. real property interests. The taxpayer’s concession left $4 million of realized gain in dispute. The Tax Court (Judge Gustafson) held that the $4 million of disputed gain was not income effectively connected with the conduct of a U.S. trade or business and therefore was not subject to U.S. taxation. (The court found it unnecessary to interpret the tax treaty in effect between the U.S. and Greece because U.S. domestic law did not impose tax on the gain and the IRS did not contend that the treaty imposed tax beyond U.S. domestic law.) In reaching this conclusion, the court addressed several issues.

The court first analyzed the nature of the gain realized by the taxpayer. Under § 736(b)(1), payments made in liquidation of the interest of a retiring partner that are made in exchange for the partner’s interest in partnership property are treated as a distribution to the partner. Treatment as a distribution triggers § 731(a)(1), which provides that a partner recognizes gain from a distribution to the extent the amount of money received exceeds the partner’s basis in the distribution the partnership interest and directs that the gain recognized “shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.” Pursuant to § 741, gain recognized from the sale or exchange of a partnership interest is “considered as gain or loss from the sale or exchange of a capital asset” except to the extent provided by § 751. (The IRS did not contend that § 751 applied.) The taxpayer asserted that these provisions lead to the conclusion that the taxpayer’s gain must be treated as arising from the sale of a single asset, its partnership interest, which is a capital asset. The government argued that the taxpayer’s gain must be treated as arising from the sale of separate interests in each asset owned by the partnership. Otherwise, the government argued, the rule in § 897(g), which imposes U.S. tax to the extent amounts received from the sale of a partnership interest are attributable to U.S. real property interests, would be rendered inoperable. The court agreed with the taxpayer.

Section 897(g), the court explained,

actually reinforces our conclusion that the entity theory is the general rule for the sale or exchange of an interest in a partnership. Without such a general rule, there would be
The court noted that this conclusion is consistent with the court’s prior decision in *Pollack v. Commissioner*, 69 T.C. 142 (1977).

The court next addressed whether the $4 million of disputed gain was effectively connected with the taxpayer’s conduct of a U.S. trade or business. Pursuant to § 875(1), the taxpayer was considered to be engaged in a U.S. trade or business because the partnership of which it was a partner, Premier, was engaged in a U.S. trade or business. Accordingly, the issue was narrowed to whether the disputed gain was effectively connected with that trade or business. Because foreign-source income is considered effectively connected with a U.S. trade or business only in narrow circumstances, which the IRS acknowledged were not present, the taxpayer’s disputed gain could be considered effectively connected income only if it was U.S.-source income. Pursuant to the general rule of § 865(a), income from the sale of personal property by a nonresident is foreign-source income. The IRS asserted that an exception in § 865(c)(2) applied. Under this exception, if a nonresident maintains an office or other fixed place of business in the United States, income from a sale of personal property is U.S.-source if the sale is attributable to that office or fixed place of business. The court assumed without deciding that Premier’s U.S. office would be attributed to the taxpayer under § 864(c)(5). Accordingly, the issue was whether the gain was attributable to Premier’s U.S. office. Under § 864(c)(5)(B), income is attributable to a U.S. office only if the U.S. office is a material factor in the production of the income and the U.S. office “regularly carries on activities of the type from which such income, gain, or loss is derived.” The court concluded that neither of these requirements was satisfied. The court examined Reg. § 1.864-6(b)(2)(i) and concluded that, although Premier’s business activities might have had the effect of increasing the value of the taxpayer’s partnership interest, those business activities did not make Premier’s U.S. office a material factor in the production of the taxpayer’s gain. Further, the court concluded, even if the U.S. office was a material factor, Premier did not regularly carry on activities of the type from which the gain was derived because “Premier was not engaged in the business of buying or selling interests in itself and did not do so in the ordinary course of business.” Because the disputed gain was not U.S.-source income, it was not effectively connected with the conduct of a U.S. trade or business and therefore not subject to U.S. taxation.

- In reaching its conclusion that the taxpayer’s gain was not effectively connected with the conduct of a U.S. trade or business, the court rejected the IRS’s contrary conclusion in Rev. Rul. 91-32, 1991-1 C.B. 107. In that ruling, according to the court, the IRS concluded that gain realized by a foreign partner from the disposition of an interest in a U.S. partnership should be analyzed asset by asset, and that, to the extent the assets of the partnership would give rise to effectively connected income if sold by the entity, the departing partner’s pro rata share of such gain should be treated as effectively connected income.

The court characterized the analysis in the ruling as “cursory” and declined to follow it.

- The taxpayer should have reported some of its gain in 2008, should have filed a 2009 U.S. tax return reporting gain in 2009, and should have paid tax with respect to both years because all of the gain realized from the 2008 distribution and some of the gain realized from the 2009 distribution was attributable to U.S. real property interests held by the U.S. partnership, Premier. Nevertheless, the court declined to impose either the failure-to-file penalty of § 6651(a)(1) or the failure-to-pay penalty of § 6651(a)(2) because the taxpayer had relied on the advice of a CPA and therefore, in the court’s view, established a reasonable cause, good faith defense.

a. Grecian Magnesite may have won the battle, but the IRS has won the war with respect to a non-U.S. partner’s sale of an interest in a partnership doing business in the U.S. (thereby codifying the IRS’s position in Rev. Rul. 91-32). The 2017 Tax Cuts and Jobs Act, § 13501, amended § 864(c) by adding § 864(c)(8). New § 864(c)(8) provides that, effective for dispositions after November 27, 2017, gain or loss on the sale or exchange of all (or any portion of) a partnership interest owned by a nonresident alien individual or a foreign corporation in a partnership engaged in any trade or business within the U.S. is treated as effectively connected with a U.S. trade

72
or business (and therefore taxable by the U.S. unless provided otherwise by treaty) to the extent that the transferee would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The amount of gain or loss treated as effectively connected under this rule is reduced by the amount of such gain or loss that is already taxable under § 897 (relating to U.S. real property interests). TCJA § 13501 makes corresponding changes to the withholding rules for effectively connected income under § 1446. These changes to § 864(c) and § 1446 statutorily reverse the Tax Court’s recent decision in *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner*, 149 T.C. No. 3 (7/13/17) and effectively adopt the IRS’s position in Rev. Rul. 91-32, 1991-1 C.B. 107.

2. No more technical terminations of partnerships. How will we get out of § 754 elections? The 2017 Tax Cuts and Jobs Act, § 13504, amended Code § 708(b) to repeal the § 708(b)(1)(B) rule regarding technical terminations of partnerships. Prior to amendment, § 708(b)(1)(B) treated a partnership as terminated if, within any 12-month period, there was a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. This change applies to taxable years beginning after 2017. One effect of a technical termination of a partnership was that it terminated elections that had been made by the partnership. An example of this is the election under § 754 to adjust the basis of partnership assets upon certain distributions of property or upon the transfer of a partnership interest. The § 754 election formerly ended when a technical termination of a partnership occurred. Because technical terminations no longer occur, a § 754 election now can be revoked during the life of a partnership only with the consent of the IRS.

E. Inside Basis Adjustments

1. Fun’s over! Automatic § 754 elections (and corresponding downward inside basis adjustments) are now triggered more easily under § 743(d). Under pre-TCJA law, § 743(d) applied to transfers of interests in partnerships with a “substantial built-in loss.” A substantial built-in loss exists for this purpose if the partnership’s aggregate adjusted basis in its assets exceeds their aggregate fair market value by more than $250,000 immediately after the transfer. The 2017 Tax Cuts and Jobs Act, § 13502, amended § 743(d) to add that, notwithstanding the absence of a substantial built-in loss of more than $250,000 in the partnership’s assets, a substantial built-in loss also exists if the transferee of a partnership interest would be allocated (based upon a hypothetical liquidation of the partnership’s assets at fair market value) a loss in excess of $250,000 immediately after the transfer. The Con*

For example, a partnership of three taxable partners (partners A, B, and C) has not made an election pursuant to section 754. The partnership has two assets, one of which, Asset X, has a built-in gain of $1 million, while the other asset, Asset Y, has a built-in loss of $900,000. Pursuant to the partnership agreement, any gain on sale or exchange of Asset X is specially allocated to partner A. The three partners share equally in all other partnership items, including in the built-in loss in Asset Y. In this case, each of partner B and partner C has a net built-in loss of $300,000 (one third of the loss attributable to Asset Y) allocable to his partnership interest. Nevertheless, the partnership does not have an overall built-in loss, but a net built-in gain of $100,000 ($1 million minus $900,000). Partner C sells his partnership interest to another person, D, for $33,333. Under the provision, the test for a substantial built-in loss applies both at the partnership level and at the transferee partner level. If the partnership were to sell all its assets for cash at their fair market value immediately after the transfer to D, D would be allocated a loss of $300,000 (one third of the built-in loss of $900,000 in Asset Y). A substantial built-in loss exists under the partner-level test added by the provision, and the partnership adjusts the basis of its assets accordingly with respect to D.
This change applies to transfers of partnership interests after 2017.

F. Partnership Audit Rules

1. Bye bye TEFRA! The Bipartisan Budget Act of 2015 § 1101, Pub. L. No. 114-74, signed by the President on 11/2/15, made sweeping changes to the partnership audit rules. The TEFRA rules (in §§ 6221-6231) and Electing Large Partnership rules (in §§ 6240-6242, 6245-6248, 6251-6252, and 6255) have been repealed and replaced in new §§ 6221-6223, 6225-6227, 6231-6235, and 6241, with an entity-level audit process that allows the IRS to assess and collect the taxes against the partnership unless the partnership properly elects out. The new rules will simplify the current complex procedures on determining who is authorized to settle on behalf of the partnership and also avoid the IRS’s need to send various notices to all of the partners. Under the new provisions the IRS may reduce the potential tax rate assessed against the partnership to take into account factors such as tax-exempt partners and potential favorable capital gains tax rates. The new rules should significantly simplify partnership audits. As a result, the audit rate of partnerships might increase. Although partnerships with 100 or fewer partners can elect out of the new rules, § 6221(b), such election is not available if there is another partnership as a partner. Implementation of the new rules is deferred; the new rules apply to partnership taxable years beginning after 12/31/17. Partnership agreements should be amended to take into account these changes.

   a. The early bird catches the worm (or is that eats the worm at the bottom of the tequila bottle?). T.D. 9780, Election into the Partnership Audit Regime Under the Bipartisan Budget Act of 2015, 81 F.R. 51795 (8/5/16). The Treasury and IRS have promulgated Temp. Reg. § 301.9100-22T dealing with the time, form, and manner for making an election to have the new partnership audit regime, §§ 6221-6223, 6225-6227, 6231-6235, and 6241, enacted in the Bipartisan Budget Act of 2015, apply to returns filed for tax years beginning after 11/2/15 and before 1/1/18. Under Temp Reg. § 301.9100-22T(b) an election to have the new partnership audit regime apply must be made within 30 days of the date of the written notice from the IRS that the partnership return has been selected for examination. The election must be in writing, signed by the tax matters partner, and must include the name, taxpayer identification number, address, and telephone number of the individual who signs the statement, as well as the partnership’s name, taxpayer identification number, and tax year to which the statement applies. The statement must include representations that the partnership is not insolvent and does not reasonably anticipate becoming insolvent, the partnership is not currently and does not reasonably anticipate becoming subject to a title 11 bankruptcy petition, and the partnership has sufficient assets, and reasonably anticipates having sufficient assets, to pay the potential imputed underpayment that may be determined during the partnership examination. The election must designate the partnership representative (§ 6223). An election may not be revoked without the IRS’s consent. Temp. Reg. § 301.9100-22T(c) allows a partnership that has not been issued a notice of selection for examination to make an election with respect to a partnership return for the purpose of filing an administrative adjustment request under § 6227 (as amended); this election may only be made after 12/31/17. The temporary regulation is effective on 8/5/16.

   b. The “thawed” version of the centralized partnership audit rules is here, and all 277 pages of the new rules still stink for partnerships and partners (but at least the regs didn’t change much, and the Federal Register version is only 69 pages)! REG-136118-15, Centralized Partnership Audit Regime, 82 F.R. 27334-01 (6/14/17). As we all know by now, effective for tax years beginning after December 31, 2017, the old TEFRA partnership audit rules (in §§ 6221-6231) and Electing Large Partnership rules (in §§ 6240-6242, 6245-6248, 6251-6252, and 6255) have been repealed and replaced by a new “Centralized Partnership Audit Regime” contained in §§ 6221-6223, 6225-6227, 6231-6235, and 6241. The IRS originally released proposed regulations under the new regime in January 2017, but the Trump administration’s regulatory freeze forced those regulations to be withdrawn just two days after they were released. The Treasury Department has now reissued the proposed regulations in substantially the same form as the version released in January. Only two minor changes were made from the original version of the proposed regulations issued in January: (i) an example with respect to netting ordinary income and depreciation was deleted (see the January version of Prop. Reg. § 301.6225-1(f) Ex. 3), and (ii) the portion of the regulations seeking comments concerning tiered partnership “push-out” adjustments (discussed below) was expanded. The scope and
The complexity of the new “Centralized Partnership Audit Regime” preclude in-depth coverage here, but the highpoints are summarized below.

The Practical Effect. Virtually all partnership agreements (including, of course, most LLC operating agreements) should be amended to reflect the new Centralized Partnership Audit Regime. The new regime cannot be ignored because it fundamentally alters the obligations of the partnership and the partners to each other and to the IRS.

Overview. The new rules implement an entity-level audit process that allows the IRS to assess and collect the taxes from the partnership unless the partnership properly elects out of the regime or properly “pushes out” the tax liability to its partners. Under the new centralized process, the IRS audits the partnership’s items of income, gain, loss, deduction, and credit, and the partners’ distributive shares thereof, for a partnership’s taxable year (the “reviewed year”). Then, the IRS sends the partnership a “notice of proposed partnership adjustment” (“NOPPA”). See § 6221; Prop. Reg. § 301.6221(a)-1. Thereafter, the partnership has a 330-day period (subject to agreed-upon extensions) to respond to the IRS’s proposed adjustments, including the ability to request modifications (discussed below) to any proposed tax liability imposed upon the partnership. Next, at the conclusion of the audit process the IRS sends a “final notice of partnership adjustment” (“FPA”) to the partnership (the “adjustment year”). Absent filing a petition in the Tax Court, the tax liability (including penalties) of the partners relating to the reviewed year must be satisfied by the partnership in the adjustment year. See § 6231; Prop. Reg. § 301.6231-1. The partnership, not the partners, is liable for any finally determined underpayment of tax (an “imputed underpayment” as defined by the regulations) by the partners from the reviewed year even if those partners are not the same as the partners in the adjustment year. See § 6225(a)-(b); Prop. Reg. 301.6225-1.

Modifications to Partnership Level Adjustment. Modifications to a proposed partnership-level adjustment can be asserted by the partnership based upon mitigating factors (e.g., tax-exempt partners, amended returns filed by partners from the reviewed year, lower tax rates applied to some partners, etc.). To assert such modifications, the partnership must submit a “request for modification with respect to a partnership adjustment” to the IRS within 270 days (subject to consensual extension) of the date of the NOPPA. See § 6225(c); Prop. Reg. § 301.6225-2. The purpose of allowing partnership-asserted modifications is to determine as accurately as possible the amount of tax owed by the partners as a result of the partnership-level adjustment without requiring the IRS to assess and collect the tax separately from each partner (as was the case under TEFRA). Accordingly, as compared to TEFRA, the new regime substantially eases the IRS’s administrative burden with respect to partnership audits and collection of taxes, but correspondingly increases the administrative burden imposed upon partnerships and their partners. Expect the audit rate of partnerships to increase under the new regime.

“Push-Out” Election. As an alternative to assessment and collection of tax from the partnership, the partnership may elect to “push out” the imputed underpayment to the appropriate partners from the reviewed year. The affected partners then become liable for the tax attributable to the imputed underpayment rather than the partnership itself. The push-out election must be made by the partnership representative within 45 days (not subject to extension) of the mailing of the final partnership adjustment (“FPA”) under § 6231. See § 6226; Prop. Reg. § 301.6226-1.

Some Finer Points. Special rules govern the treatment of adjustments from a reviewed year that do not result in an imputed underpayment and are therefore otherwise taken into account by the partnership and the partners in the adjustment year. See Prop. Reg. § 301.6225-3. Moreover, the impact of the adjustments on capital accounts and outside basis across reviewed years and adjustment years is reserved under the proposed regulations. See Prop. Reg. § 301.6225-4. The new regime also imposes tougher rules on partners who treat items inconsistently with the partnership’s treatment of such items. See § 6222; Reg. § 301.6222-1.

Partnership Representatives. Unlike the familiar “tax matters partner” designation under TEFRA, the new regime permits any person (even a non-partner) with a substantial presence in the U.S. to be designated the “partnership representative” in the audit, assessment, and collection process. The partnership representative is designated by the partnership for each tax year on its annual information return (Form 1065). Moreover, any action taken by the partnership representative vis-à-vis the IRS is binding upon the partnership regardless of the partnership agreement or state law to the contrary. See § 6223; Prop. Reg. §§ 301.6223-1, 301.6223-2.
Election Out of the New Regime for Small Partnerships. Partnerships with 100 or fewer partners may elect out of the new regime, but not if the partnership has another partnership or certain other flow-through entities as a partner, possibly including single-member LLCs (the effect of which currently is unknown under the proposed regulations). Depending upon certain special rules, S corporations may or may not disqualify a partnership from electing out of the new regime. See § 6621(b); Prop. Reg. § 301.6621(b)-1. Eligible partnerships that elect out of the new regime will subject their partners to pre-TEFRA audit procedures (i.e., partners will be audited and assessed separately and possibly inconsistently).


d. Treasury has issued final regulations on electing out of the new partnership audit regime. T.D. 9829, Election Out of the Centralized Partnership Audit Regime, 83 F.R. 4 (1/2/18). The Treasury Department and the IRS have finalized, with some changes, the portion of the proposed regulations that address electing out of the new Centralized Partnership Audit Regime (REG-136118-15, Centralized Partnership Audit Regime, 82 F.R. 27334-01 (6/14/17).) Like the proposed regulations, final Reg. § 301.6221(b)-1 provides that a partnership with 100 or fewer partners that does not have certain kinds of partners can make an election not to be subject to the new regime on the partnership’s timely filed return, including extensions, for the taxable year to which the election applies. To constitute a valid election, the election must include all information required by the IRS in forms, instructions, or other guidance. This final regulation applies to partnership taxable years beginning after December 31, 2017.

2. A disregarded LLC is a pass-thru partner for purposes of the small partnership exception to the TEFRA audit rules. Seaview Trading, LLC v. Commissioner, 858 F.3d 1281 (9th Cir. 6/7/17). Seaview Trading, LLC, a Delaware limited liability company that was classified as a partnership for federal tax purposes, had two members, each of which was a single-member LLC. One of these was AGK Investments LLC, which was wholly owned by Robert Kotick, and the other was KMC Investments LLC, wholly owned by Mr. Kotick’s father. The IRS audited Mr. Kotick’s 2001 return and disallowed certain deductions with respect to his investment in Seaview, but did not disallow his share of a loss passed through from Seaview, which arose from Seaview’s investment in a common trust fund. After the limitations period on assessment for 2001 with respect to Mr. Kotick had expired, the IRS audited Seaview and issued a Final Partnership Administrative Adjustment (FPAA) in which the IRS disallowed Seaview’s loss from its trust investment. Mr. Kotick challenged the FPAA by filing a petition in the Tax Court. AGK, Mr. Kotick’s wholly owned LLC, filed a separate petition. Mr. Kotick argued that the FPAA was invalid because Seaview was not subject to the TEFRA audit rules pursuant to the small partnership exception of § 6231(a)(1)(B)(i). The Tax Court (Judge Foley) dismissed Mr. Kotick’s petition on the grounds that (1) Seaview did not fall within the § 6231(a)(1)(B)(i) small partnership exception to the TEFRA audit rules, and (2) AGK, rather than Mr. Kotick, was the TMP of Seaview and therefore the court lacked jurisdiction to consider the petition filed by Mr. Kotick. In an opinion by Judge Smith, the U.S. Court of Appeals for the Ninth Circuit
affirmed. Absent a contrary election by the partnership, the § 6231(a)(1)(B)(i) small partnership exception excludes from the TEFRA audit rules “any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner.” However, pursuant to Reg. § 301.6231(a)(1)-(a)(2), the small partnership exception does not apply “if any partner in the partnership during the taxable year is a pass-thru partner” as defined in § 6231(a)(9). Section 6231(a)(9) defines a pass-thru partner as “a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership …. .” The court acknowledged that the two single-member LLCs, AGK and KMC, were disregarded for federal tax purposes pursuant to the check-the-box regulations. Nevertheless, the court held, these LLCs were pass-thru partners. In reaching this conclusion, the court gave Skidmore deference to Rev. Rul. 2004-88, 2004-2 C.B. 165. See Skidmore v. Swift & Co., 323 U.S. 134 (1944). In Rev. Rul. 2004-88, the IRS ruled that, because a disregarded LLC held legal title to a partnership interest it was “a similar person through whom other persons hold an interest in the partnership” and therefore a pass-thru partner. The court also held that Mr. Kotick lacked standing to file a Tax Court petition on behalf of Seaview because he was not Seaview’s TMP. Seaview had failed to designate a TMP for 2001, and therefore AGK, as the holder of the largest profits interest, was the TMP pursuant to § 6231(a)(7)(B). Accordingly, the court upheld the Tax Court’s dismissal of Mr. Kotick’s petition for lack of jurisdiction.

a. ♪♫They call me mellow yellow.♫♪ Well, actually, the D.C. Circuit calls it a TEFRA partnership. Mellow Partners v. Commissioner, 890 F.3d 1070 (D.C. Cir. 5/22/18). In an opinion by Judge Edwards, the U.S. Court of Appeals for the District of Columbia Circuit held that a partnership with two partners, each of which was a single-member LLC, was a TEFRA partnership that was subject to the TEFRA audit regime. The issue in the case was the same one presented in Seaview Trading, LLC v. Commissioner, 858 F.3d 1281 (9th Cir. 6/7/17), i.e., whether a partnership with a disregarded entity as a partner qualifies for the § 6231(a)(1)(B)(i) small partnership exception, which excludes from the TEFRA audit rules “any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner.” Pursuant to Reg. § 301.6231(a)(1)-1(a)(2), the small partnership exception does not apply “if any partner in the partnership during the taxable year is a pass-thru partner” as defined in § 6231(a)(9). Section 6231(a)(9) defines a pass-thru partner as “a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership …. .” Like the Ninth Circuit in Seaview Trading, the D.C. Circuit held that a single-member LLC that is a disregarded entity is a pass-thru partner as defined in § 6231(a)(9). Therefore, the partnership did not qualify for the small partnership exception and was subject to the TEFRA audit rules. The court also rejected the taxpayer’s challenge to the accuracy-related penalties that had been upheld by the Tax Court. The taxpayer challenged the penalties on the ground that the IRS had not obtained the written supervisory approval of the penalties as required by § 6751(b)(1). See Chai v. Commissioner, 851 F.3d 190 (2d Cir. 3/20/17). The court declined to consider this argument because the taxpayer had failed to raise it in the Tax Court and therefore had not preserved it for appeal.

3. Liability for withholding taxes under §§ 1446 and 1461 is a partnership item and therefore properly before the Tax Court in a partnership-level proceeding. YA Global Investments v. Commissioner, 151 T.C. No. 2 (8/8/18). The IRS issued both a notice of final partnership administrative adjustment and a notice of deficiency with respect to YA Global Investments, LP, a TEFRA partnership. The IRS asserted that the partnership, which was based in the Cayman Islands, was engaged in the conduct of a trade or business in the U.S. and had failed to withhold on effectively connected taxable income allocable to its foreign partners as required by § 1446. Therefore, according to the IRS, the partnership was liable for the taxes it had failed to withhold pursuant to § 1461, which provides that “[e]very person required to deduct and withhold any tax under … chapter [3] is hereby made liable for such tax.” The partnership’s tax matters partner filed a petition for readjustment of the partnership items and the partnership filed a petition in response to the notice of deficiency. Both parties filed motions to dismiss for lack of jurisdiction in which they argued that liability for withholding taxes under §§ 1446 and 1461 is not a partnership item and therefore not properly before the court in a partnership-level proceeding. The Tax Court (Judge Buch) held that
A liability stemming from duty to withhold under section 1446 is a partnership liability and therefore properly before the Court in a partnership-level proceeding, as are penalties relating to the partnership-item adjustment. The court reasoned that liability for the taxes required to be withheld under § 1446 is a partnership item because it is a liability imposed on the partnership. Under Reg. § 301.6231(a)(3)-1(a)(v), partnership liabilities are partnership items.

G. Miscellaneous

1. Nonowner contributions to the capital of partnerships and LLCs taxed as partnerships are not excludable, and the common law contribution to capital doctrine is on life support if not dead. The 2017 TCJA amended Code § 118 effective after December 22, 2017, such that nonshareholder contributions to the capital of corporations made by governmental entities or civic groups no longer are excludable from the recipient corporation’s gross income. Previously, such capital contributions were nontaxable, and they occasionally were made to incentivize corporations either to locate in particular communities or to acquire or redevelop distressed property in a community (or do both). In addition, the Conference Report accompanying the changes to § 118, along with the cases summarized below, probably leads to the conclusion that similarly-motivated capital contributions to noncorporate entities (i.e., partnerships and LLCs taxed as partnerships) no longer are excludable from gross income (if they ever were), even though such contributions are outside the purview of either old or amended § 118.

a. No good deed goes unpunished. Ginsburg v. United States, 136 Fed. Cl. 1 (1/31/18). In this decision, the Court of Federal Claims held that the State of New York’s payment of approximately $1.8 million to an LLC (taxed as a partnership) to incentivize and reward redevelopment of brownfield property is includable in the taxpayer-member’s gross income. The taxpayer owned 90% of an LLC taxed as a partnership for federal income tax purposes. The taxpayer’s LLC participated in New York’s Brownfield Development Tax Credit program in connection with acquiring an abandoned shoe factory in 2004 and eventually restoring it as a 134-unit residential building by 2011. New York’s Brownfield Tax Credit program allows certain credits against state income taxes based upon investment in qualifying brownfield property. Further, if the credit is fully used by a taxpayer to offset applicable New York state income taxes, the excess of the credit over the amount used against state income taxes is paid to the taxpayer. Accordingly, after certifying that the taxpayer’s LLC had complied with the terms of the Brownfield Development Tax Credit program, in 2013 New York paid the taxpayer’s LLC approximately $1.8 million in satisfaction of the taxpayer’s excess credit amount. The taxpayer took the position on his 2013 federal income tax return that his 90% allocable share of the $1.8 million payment was excludable from gross income as a nontaxable capital contribution to the LLC. (New York law allowed exclusion of the payment for New York income tax purposes.) Upon audit, the IRS determined that the payment constituted gross income to the LLC and thus to the taxpayer as part of his allocable share of partnership income. This adjustment resulted in additional gross income to the taxpayer for 2013 and a corresponding underpayment of approximately $602,000. The taxpayer paid the underpayment, filed a refund claim, and then brought this action in the Court of Federal Claims.

Analysis: Upon cross motions for summary judgment, Court of Federal Claims (Judge Hodges) agreed with the government that the $1.8 million constituted gross income to the taxpayer’s LLC and thereby to the taxpayer. The government had argued, and the court agreed, that the payment was includable by the broad terms of § 61(a) (gross income from whatever source derived) and that no statutory exclusions or exceptions applied. The taxpayer argued unsuccessfully that the $1.8 million payment was (i) a nontaxable contribution to the LLC’s capital, (ii) a nontaxable recovery of the LLC’s investment in the Brownfield project owned by the LLC, or (iii) a nontaxable state “general-welfare” grant to the LLC. The taxpayer acknowledged that under any of the above theories the taxpayer’s basis in the brownfield project would be adjusted downward by the amount excludable. Judge Hodges reasoned that, because the taxpayer could not point to an express provision of the Code to support his nontaxable contribution to capital theory, no such exclusion applied. Furthermore, Judge Hodges reasoned that the payment to the partnership could not be a recovery of the LLC’s investment in the project because the payment came from a third party (the State of New York), not from the seller of
the property. Judge Hodges expressed the view that the recovery of capital doctrine applies only in the context of buyers and sellers of “goods,” and in that context, a payment can be nontaxable as a purchase price adjustment. (We believe the court was wrong about basis recovery being limited to sales of “goods.” Regardless, the taxpayer’s “recovery of investment” argument probably was not a winner anyway. For instance, see the court’s analysis in Uniquest Delaware, discussed immediately below.) Finally, Judge Hodges determined that New York’s payment to the taxpayer’s LLC did not qualify for the “general-welfare” exclusion recognized in Rev. Rul. 2005-46, 2005-2 C.B. 120 (state disaster relief grants) because the tax credit in question was not conditioned on a showing of need.

- The holding of the Court of Federal Claims regarding the unavailability of the general welfare exclusion is consistent with the Tax Court’s holding in Maines v. Commissioner, 144 T.C. 123 (2015). In Maines, the Tax Court held that the refundable portions of certain New York targeted economic development credits that remained after first reducing state tax liability were accessions to the taxpayers’ wealth and were includable in gross income under § 61 for the year in which the taxpayers received payment or, under the constructive receipt doctrine, were entitled to receive payment, even if they elected to carry forward the credit. The Tax Court concluded that the taxpayers could not exclude the payments under the general welfare exclusion because the payments were not conditioned on a showing of need.

b. Yet again, no good deed goes unpunished. But perhaps there could have been a workaround? Uniquest Delaware, LLC v. United States, 294 F.Supp.3d 107 (W.D.N.Y. 3/27/18). In this decision, the U.S. District Court for the Western District of New York held that a grant paid by the New York State Empire State Development Corporation (which appears to have been a government-funded corporation) to an LLC taxed as a partnership was not excludable from the LLC’s gross income as a contribution to capital. The taxpayer in this case was the LLC (unlike Ginsburg v. United States, 136 Fed. Cl. 1 (1/31/18), in which the taxpayer was a partner-member of the LLC). The LLC, a TEFRA partnership, had two equal members, each of which was a disregarded single-member LLC, that in turn were each wholly-owned by separate subchapter S corporations. The case arose in connection with a TEFRA partnership audit of the LLC, a fact which was important to the court’s ultimate decision (as explained further below). In 2009, the LLC received an $11 million grant from the New York State Empire State Development Corporation for the restoration of a building in Buffalo. The original grant proposal expressly stated that “[t]here is no element of compensation of specific, quantifiable or other services to the government agencies involved; the grants contemplated by this offer are being offered solely for the purpose of obtaining an advantage for the general community.” The LLC did not include the $11 million grant in its income on its partnership tax return for 2009. During the audit and at IRS Appeals, the IRS asserted that the $11 million grant was included in the LLC’s gross income in 2009 and ultimately issued an FPAA accordingly. The taxpayer-LLC then sought judicial review of the FPAA in the U.S. District Court for the Western District of New York.

Analysis: As in Ginsburg, the IRS’s argument in this case was simple: § 61(a) requires inclusion of the $11 million grant in gross income, and no exception or exclusion in the Code provides otherwise. The taxpayer-LLC, similar to the taxpayer in Ginsburg, argued alternatively that the $11 million grant was either (i) excludable under the “common law contribution to capital doctrine” or (ii) akin to a “rebate” that resulted in an adjustment to the taxpayer-LLC’s basis in the building, but which was not includable in gross income. [As to this latter “rebate” argument, see Rev. Rul. 76-96, 1976-1 C.B. 23 (rebates paid by car manufacturers, but not the dealer who sold the car, are not income but instead reduce the purchaser’s basis in the car). Rev. Rul. 76-96 has been suspended in part on other grounds by Rev. Rul. 2005-28, 2005-1 C.B. 997.] Judge Wolford ruled against the taxpayer-LLC with respect to both arguments. Regarding the taxpayer-LLC’s “common law contribution to capital doctrine” argument, the court reasoned that the cases supporting the doctrine involved corporate taxpayers only, and the holdings in these cases were codified by § 118 (the pre-TCJA version), which expressly does not apply to noncorporate entities. Regarding the taxpayer-LLC’s “rebate” argument, Judge Wolford ruled that the $11 million grant is distinguishable, stating “unlike a retail customer who purchases a car with the knowledge that a rebate is forthcoming, [the taxpayer] purchased the [Buffalo Building] and then subsequently sought and received the [$11 million grant]. Therefore, the [$11 million grant] cannot be considered a discount or reduction in the purchase price of the building.”
**Indirect §§ 118/702 Argument:** The taxpayer-LLC argued that, even if § 118 applies only to corporations, the court should indirectly rule it applicable to resolve the dispute with the IRS because the ultimate owners of the taxpayer-LLC were subchapter S corporations. The taxpayer further argued in this regard that § 118 (pre-TCPA) would have allowed the S corporation members of the taxpayer-LLC to exclude the grant from gross income. Therefore, the taxpayer-LLC argued, if the S corporation members could have excluded the grant under § 118, then the grant ultimately should be held nontaxable by virtue of § 702’s distributive share approach to partner-level income. With respect to this final argument, Judge Wolford ruled that because TEFRA audit procedures treat the taxpayer-LLC as an entity separate from its owners, the partner-level treatment by the ultimate owners of the LLC was not within the court’s subject-matter jurisdiction. See § 6226(1) and American Boat Co., LLC v United States, 583 F.3d 471, 478 (7th Cir. 2009) (“A court does not have jurisdiction to consider a partner-level defense in a partnership-level proceeding.”)

**Planning pointer:** Had the subchapter S corporations first received the $11 million grant from New York and then contributed the funds to the taxpayer-LLC as additional capital contributions, we believe the grant would not have been taxable pursuant to the pre-TCPA version of § 118 and § 721, respectively. On the other hand, perhaps the terms of the grant would not allow the funds to be paid to the S corporation members because the acquisition and development was performed by the taxpayer-LLC, not the S corporation members.

**VIII. TAX SHELTERS**

A. Tax Shelter Cases and Rulings

1. The Ninth Circuit channels the economic substance doctrine to tell the Tax Court that it was too quick to dismiss transferee liability in a midco case. Slone v. Commissioner, 788 F.3d 1049 (9th Cir. 6/18/15), amended, 2015 WL 5061315 (8/28/15), vacating and remanding, T.C. Memo. 2012-57 (3/1/12). The taxpayer's family-owned corporation sold all of its assets for cash, resulting in a gain of over $38 million and an estimated combined federal and state income tax liability of over $15 million. None of the proceeds had been distributed at the time Fortrend and MidCoast made an unsolicited offer to purchase the stock of the corporation, which ultimately was accepted at a purchase price of $35,753,000, plus assumption of the corporation's liabilities for federal and state income taxes owed as of the closing date. Not unsurprisingly, the taxes were never paid and the IRS asserted transferee liability against the shareholders. Because the asset sale and stock sale were independent of each other and the shareholders “had no reason to believe that Fortrend’s methods were illegal or inappropriate, . . . neither the substance over form doctrine nor any related doctrines applied to recast the stock sale as a liquidating distribution.” Thus, because the IRS’s transferee liability theory was grounded on recasting the stock sale as a liquidation, the IRS lost in the Tax Court because under this view the taxpayer was not a “transferee.”

On appeal, the Tax Court’s decision was vacated and remanded in a decision written by Judge Ikuta. According to the Ninth Circuit, the Tax Court erred in respecting the form of the shareholders’ stock sale because it applied an erroneous standard. The Court of Appeals’ majority opinion first noted that the “Supreme Court has long recognized ‘the importance of regarding matters of substance and disregarding forms,’ United States v. Phellis, 257 U.S. 156, 168 because ‘[t]he incidence of taxation depends upon the substance of a transaction,’ Commr v. Court Holding Co., 324 U.S. 331, 334 (1945).’” The court then looked to its economic substance doctrine precedents to conclude that the same “approach is applicable for determining whether a taxpayer is a transferee for purposes of § 6901. Accordingly, when the Commissioner claims a taxpayer was ‘the shareholder of a dissolved corporation’ for purposes of 26 C.F.R. § 301.6901-1(b), but the taxpayer did not receive a liquidating distribution if the form of the transaction is respected, a court must consider the relevant subjective and objective factors to determine whether the formal transaction ‘had any practical economic effects other than the creation of income tax losses.’” However, the majority concluded that it could not determine on appeal whether the shareholder was a transferee because the Tax Court “did not address either the subjective or objective factors we apply in characterizing a transaction for tax purposes, as it failed to make any finding on whether the shareholders had a business purpose for entering into the stock purchase transaction other than tax avoidance, or whether the stock purchase transaction had economic substance other than shielding the ... shareholders from tax liability.” The Tax Court was
directed on remand to make the findings necessary to correctly apply the transferee test as articulated by the Court of Appeals. “[T]he tax court should apply the relevant subjective and objective factors to determine whether the Commissioner erred in disregarding the form of the transaction in order to impose tax liability on the shareholders as ‘transferees’ under § 6901.”

- Judge Noonan concurred with the majority’s holding that the Tax Court erred by applying the wrong standard and that economic substance doctrine principles properly applied to determine whether to disregard the form of the transaction in order to determine whether the shareholders were transferees under § 6901. But he thought the record was sufficient to hold that the stock sale transaction had no economic substance and that the shareholders were transferees under § 6901. He would have remanded to the Tax Court only on the question of state law substantive liability.

a. The Ninth Circuit has reversed the Tax Court yet again in this midco case. Slone v. Commissioner, 896 F.3d 1083 (9th Cir. 7/24/18), vacating and remanding T.C. Memo. 2016-115 (6/13/16). This case has considerable history, as recounted above, but in both instances the Tax Court held for the taxpayers only to have the Ninth Circuit reverse in favor of the IRS. In this second round in the Ninth Circuit, the IRS appealed the Tax Court’s decision (Judge Haines) that the form of the transaction (a stock sale) could not be ignored to impose transferee liability on the taxpayers unless the taxpayers knew that the “entire transactional scheme” was intended to avoid taxes. Judge Haines determined that the IRS had not met its burden of proof on this issue. In an opinion by Judge Schroeder, however, the Ninth Circuit concluded that the “record contains ample evidence” the taxpayers were at the very least on “constructive notice that the entire scheme has no purpose other than tax avoidance.” The court stated as follows:

“This record establishes that the Petitioners were, at the very least, on constructive notice of such a purpose. In reaching a contrary conclusion, the Tax Court confused actual and constructive notice, in effect allowing Petitioners to shield themselves through “the willful blindness the constructive knowledge test was designed to root out.” Diebold, 736 F.3d at 189–90; see Salus Mundi, 776 F.3d at 1020.

In the Ninth Circuit’s view, the transaction constituted a constructive liquidation (not a stock sale) resulting in transferee liability being imposed upon the taxpayers. The court reversed and remanded for entry of judgment in favor of the IRS.

2. You only need to read the first two sentences of this S corporation ESOP case to know that it’s a loser for the taxpayer. Pacific Management Group et al. v. Commissioner, T.C. Memo 2018-131 (8/20/18). You know it’s not going to go well for the taxpayers when the first two sentences of the Tax Court’s opinion read as follows: “These consolidated cases involve a complex tax shelter scheme featuring four C corporations, five individual shareholder-employees of the C corporations, five employee stock ownership plans (ESOPs), five S corporations, and (inevitably) a partnership. This scheme was devised by [attorney], who serves as co-counsel for the petitioners in these cases.” Essentially, the “scheme” (as Judge Lauber labeled it) enabled the taxpayers’ C corporations to pay purportedly deductible “factoring fees” and “management fees” to the taxpayers’ partnership over the years 2002 through 2005 in order to minimize or eliminate any corporate level tax. The partnership then allocated the income from those payments to S corporations, with one S corporation having been established for each of the five principals, with their allocable shares of partnership income being determined based upon their relative percentage ownership of stock in the C corporations. The principals received and paid taxes on their salaries from their respective S corporations, but the excess profits over their salaries accumulated tax free in the five separate S corporations that were owned by five separate ESOPs. Judge Lauber, after 80 pages of facts and analysis, held that the so-called “factoring fees” and “management fees” claimed by that the taxpayer C corporations were in fact either disguised dividends or improperly assigned income taxable to the five principals. Regarding the “factoring fees,” Judge Lauber found that the arrangement lacked economic substance, and instead was merely a device to extract profits from the C corporations disguised as tax-deductible payments. Regarding the “management fees,” which were compensation and bonuses paid to the principals for their services, Judge Lauber applied the Elliott factors to determine whether the payments constituted reasonable compensation. See Elliotts, Inc. v. Commissioner, 716 F.2d 1241, 1245-1247 (9th Cir. 1983), rev’g and remanding T.C. Memo. 1980-
Applying those factors, Judge Lauber found that only a portion of the bonus payments constituted reasonable compensation. The balance of the bonuses constituted nondeductible dividends by the C corporations. Ultimately, the Tax Court agreed with the IRS’s proposed adjustment of approximately $1.75 million of additional taxable income among the five principals. With respect to certain of the five principals, underpayment penalties also were imposed based upon their individual circumstances after taking into account other, unrelated income for the years in issue.

B. Identified “tax avoidance transactions”

C. Disclosure and Settlement

D. Tax Shelter Penalties

1. Jurisdiction is not arithmetic—you can’t divide $24.9 million by 193. Diversified Group, Inc. v. United States, 123 Fed. Cl. 442 (9/29/15). The Court of Federal Claims (Judge Sweeny), in a case of first impression, held that it lacked jurisdiction in a suit seeking a refund of a partial payment of a § 6707 penalty assessed for failure to register a tax shelter as required § 6111. The plaintiff argued that the penalty was divisible, that it was not necessary to pay the full amount of the penalty prior to bringing suit but only to pay the penalty with respect to one of the 193 individual transactions involving the tax shelter. The court rejected this argument, holding that the $24.9 million penalty for failure to register the tax shelter related to a single act.

   Although it is true that the IRS calculated the amount of the penalty based upon each client’s aggregate investment in the tax shelter, neither the number of clients that participated in the tax shelter nor the number of commercial steps necessary to accomplish that participation in the tax shelter triggers liability under § 6707. Consequently, the penalty is not divisible for any reason, including the number of clients who participated in the tax shelter.

   Thus, the full payment rule for seeking a refund established by Flora v. United States, 357 U.S. 63 (1958), had not been met because the penalty was not divisible and “‘[e]xceptions to the full payment rule have been recognized by the courts only where an assessment covers divisible taxes.’ Rocovich v. United States, 933 F.2d 991, 995 (Fed. Cir. 1991). A tax or penalty is divisible when ‘it represents the aggregate of taxes due on multiple transactions.’”

   a. The Federal Circuit sees it the same way. Diversified Group, Inc. v. United States, 841 F.3d 975 (Fed. Cir. 11/10/16). In an opinion by Chief Judge Prost, the U.S. Court of Appeals for the Federal Circuit affirmed the Claims Court’s decision. The plaintiff argued that the $24.9 million § 6707 penalty was divisible because it was calculated based upon each client’s aggregate investment in the tax shelter. The plaintiff emphasized that a separate Form 8264 (the form by which a tax shelter is registered) necessarily would be required for each client’s investment because it would be impossible to fill out a Form 8264 for the entire tax shelter on the first day it was offered for sale because, at that time, many of the details that the form requires are unknown. Accordingly, the plaintiff argued, each filing should be considered a separate instance of tax shelter registration under § 6111. The court concluded, however, that § 6707 penalties are not divisible into the individual transactions or investors that may comprise a single tax shelter:

   Section 6707(a) provides that “if a person ... fails to register such tax shelter ... such person shall pay a penalty with respect to such registration.” This language makes clear that liability for a § 6707 penalty arises from the single act of failing to register the tax shelter (which, under Temp. Treas. Reg. § 301.611-1T, A-1, A-47, is failing to file the necessary Form(s) 8264). This omission creates a single source of liability, regardless of how many individuals or transactions are involved in the tax shelter. Liability cannot be sub-divided beyond this.

   b. A District Court in New York reaches the same conclusion. Larson v. United States, 118 A.F.T.R.2d 2016-7004 (S.D.N.Y 12/28/16). The IRS assessed more than $160 million in penalties against the taxpayer under § 6707 for failure to register two tax shelters as required by § 6111. The tax shelters involved were the Foreign Leveraged Investment Program (“FLIP”), also known as the Offshore Portfolio Investment Strategy (“OPIS”), and the Bond Linked Issue Premium
Structure (“BLIPS”). The penalties were later reduced to $67.6 million to reflect payments made by other persons who were jointly and severally liable. The taxpayer paid $1.4 million and brought this action seeking a refund of the $1.4 million and abatement of all assessed penalties. The District Court (Judge Caproni), relying on the holdings in *Diversified Group, Inc. v. United States*, 841 F.3d 975 (Fed. Cir. 11/10/16) and *Pfaff v. United States*, 117 A.F.T.R.2d 2016-981 (D. Colo. 3/10/16), held that the § 6707 penalties imposed on the taxpayer were not divisible. Because the taxpayer had not paid the full amount of the tax for which he sought a refund, as required by the full payment rule of *Flora v. United States*, 357 U.S. 63 (1958), the court granted the government’s motion to dismiss for lack of subject matter jurisdiction. In reaching this conclusion, the court rejected the taxpayer’s argument that application of the full payment rule to his situation violated the due process clause of the Fifth Amendment. He argued that, taking into account his inability to challenge the penalty in the Tax Court because of the absence of a notice of deficiency, application of the full payment rule violated his right to due process because he could not pay the penalty and could not seek review of his claim without paying the penalty. The court similarly rejected the taxpayer’s claim for judicial review under the Administrative Procedure Act, in which the taxpayer asserted that the IRS’s penalty assessment and denial of his refund claim were arbitrary, capricious, and an abuse of discretion, and his argument that the § 6707 penalty was an excessive fine that violates the Eighth Amendment. Finally, the court dismissed for failure to state a claim the taxpayer’s claim to compel the IRS to give him information relating to payments from others who are jointly and severally liable.

c. The Second Circuit agrees. *Larson v. United States*, 888 F.3d 578 (2d Cir. 4/25/18). In an opinion by Judge Wesley, the U.S. Court of Appeals for the Second Circuit has affirmed the District Court’s decision. The court rejected the taxpayer’s argument that the full payment rule of *Flora v. United States*, 357 U.S. 63 (1958) (*Flora I*) and *Flora v. United States*, 362 U.S. 145 (1960) (*Flora II*) applies only to cases involving tax deficiencies. The taxpayer’s argument was that (1) taxpayers are required to make full payment of the tax allegedly due before bringing suit for a refund in a U.S. District Court or the U.S. Court of Federal Claims only when the taxpayer has had the opportunity to seek judicial review in the Tax Court, and (2) the full payment rule does not apply in cases such as this one, which involved an assessable penalty for which no review is available in the Tax Court. The court recognized that “*Flora I* and *Flora II* acknowledge the existence and availability of Tax Court review,” but concluded that “Tax Court availability was not essential to the Supreme Court’s conclusion in either opinion.” The court also rejected the taxpayer’s argument that application of the full payment rule violated his Fifth Amendment right to due process. The taxpayer’s prepayment opportunity for a conference with the IRS Appeals Division, the court held, satisfied the requirement of due process. The court similarly rejected the taxpayer’s claim for judicial review under the Administrative Procedure Act. The court suggested that Congress had implicitly precluded prepayment judicial review through “the full payment rule of § 1346(a)(1),” and even if it had not, Congress had provided special and adequate review procedures (post-payment review in refund litigation) that make APA review inappropriate. The court also concluded that the District Court lacked subject matter jurisdiction over the taxpayer’s claim that the § 6707 penalty was an excessive fine that violates the Eighth Amendment. The court ended its opinion with the following:

We close with a final thought. The notion that a taxpayer can be assessed a penalty of $61 million or more without any judicial review unless he first pays the penalty in full seems troubling, particularly where, as Larson alleges here, the taxpayer is unable to do so. But, “[w]hile the Flora rule may result in economic hardship in some cases, it is Congress’ responsibility to amend the law.” *Rocovich v. United States*, 933 F.2d 991, 995 (Fed. Cir. 1991).

**IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING**

**A. Exempt Organizations**

1. Congress shoots a probable NCAA “airball”: After TCJA, it will cost 21 percent more to pay big-time, private school coaches like Coach K (Duke-$7.2M); but Wildcat fans celebrate as Coach Calipari (Kentucky-$6.5M) gets an “assist” from Congress. Presumably believing that $1 million salaries at tax-exempt organizations are per se unreasonable, Congress decided to take a “shot” (*pun intended*) at curtailing them under TCJA. Specifically, the 2017 Tax Cuts
and Jobs Act, § 13602, adds Code § 4960 to impose a 21 percent excise tax on “applicable tax-exempt organizations” (“ATEOs”) and broadly-defined “related organizations” paying over $1 million annually to “covered employees.” In addition to § 527 political organizations and § 521 farmers cooperatives, ATEOs include the following two additional types of organizations: (i) those exempt from tax under § 501(a) (most nonprofits, including churches, hospitals, and private schools); and (ii) those “with income excluded from taxation under § 115(l)” (income of certain public utilities and income derived from “any essential governmental function and accruing to a State or any political subdivision thereof”). A “covered employee” is defined as any one of the five highest compensated employees of an ATEO either (i) for the current taxable year or (ii) for any year beginning after December 31, 2016. Licensed medical or veterinarian professionals, however, are excluded from the definition of “covered employee.” New § 4960 is permanent and effective for taxable years beginning after 2017. Given that many tax-exempt organizations have taxable years ending June 30 or October 31, many potentially affected organizations will have time to either comply or attempt to avoid new § 4960.

a. The probable NCAA “airball.” Congress apparently thought that new § 4960 defined an ATEO so that both public and private colleges and universities would have to pay the 21 percent excise tax on compensation exceeding $1 million. The legislative history accompanying § 4960 states: “An [ATEO] is an organization exempt from tax under section 501(a), an exempt farmers’ cooperative, a Federal, State or local governmental entity with excludable income, or a political organization.” See H.R. Conf. Rep. No. 115-466, at 492 (Dec. 15, 2017) (emphasis added). At least one well-respected exempt organization scholar, however, has pointed out that, at least according to the IRS, “[i]ncome earned by a state, a political subdivision of a state, or an integral part of a state or political subdivision of a state” is not taxable regardless of § 115, citing Rev. Rul. 87-2, 1987-1 C.B. 18. Instead, it is the IRS’s position that public colleges and universities are not taxable under our federalist system unless and until Congress enacts a specific statutory provision subjecting such state-affiliated organizations to tax like § 511(a)(2)(B) (state colleges and universities are subject to unrelated business income tax). See the blog post by Professor Ellen P. Aprill here, and her full law review article on the subject: Ellen P. Aprill, The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Government Affiliates, 23 J. Corp. Law 803 (1997).

b. And another thing ... Churches are exempt from taxation under § 501(a) along with hospitals and private schools. But we wouldn’t bet money that any church paying its pastor more than $1 million annually is going to pay an excise tax under new § 4960 without a fight based on the First Amendment. Ultimately, the church may lose such a fight because it is clear that churches are subject to the unrelated business income tax of § 511, but if a church can pay its pastor $1 million a year, it can pay a tax lawyer to litigate too.

c. Interim guidance on the § 4960 21 percent excise tax on applicable tax-exempt organizations. Notice 2019-9, 2019-___ I.R.B. ___ (12/31/18). In this notice, the IRS announced that Treasury and the IRS will issue proposed regulations under § 4960, the provision enacted by the 2017 Tax Cuts and Jobs Act that imposes an excise tax at the highest rate in § 11 (currently 21 percent) on “applicable tax-exempt organizations” (“ATEOs”) and broadly-defined “related organizations” paying over $1 million annually to “covered employees.” The notice provides, in Q&A format, extensive interim guidance on new § 4960. Until further guidance is issued, taxpayers may base their positions upon a good faith, reasonable interpretation of § 4960, including its legislative history, to comply with the requirements of the statute. The notice provides that the positions reflected in it constitute a good faith, reasonable interpretation of the statute. The preamble to the notice describes certain positions that will be regarded as not consistent with a good faith, reasonable interpretation of the statutory language. Among other guidance, the notice provides in Q&A 5 that public universities with IRS determination letters recognizing their tax-exempt status under § 501(c)(3) are ATEOs and therefore subject to § 4960, but “a governmental unit (including a state college or university) that does not have a determination letter recognizing its exemption from taxation under section 501(a) and does not exclude income from gross income under section 115(1) is not an ATEO” and therefore is not subject to § 4960. Nevertheless, the notice provides that such a governmental unit may be liable for the excise tax imposed by § 4960 if it is a related organization under § 4960(c)(4)(B) with respect to an ATEO.
2. Successful private colleges and universities really must be in the dog house because, in addition to taxing them for highly-paid coaches, Congress has decided to tax their endowments too! And, just to keep us on our toes, the legislative history says the statute turns on the number of an institution’s “tuition paying” students, but § 4968 simply reads “students.” The 2017 Tax Cuts and Jobs Act, § 13701, adds § 4968 which imposes a new 1.4 percent annual excise tax upon the net investment income of certain private colleges and universities and affiliated organizations with endowments worth $500,000 or more per full-time student. The excise tax imposed by new § 4968 is similar in many respects to the annual excise tax imposed upon private foundations under § 4940. In particular, new § 4968 applies to an “applicable educational institution” which is defined as institution: (i) that is an “eligible educational institution” as described in § 25A(f)(2) (which in turn refers to 20 U.S.C. § 1088); (ii) that has at least 500 students during the preceding taxable year more than 50 percent of which are in the U.S.; (iii) that is not described in the first section of § 511(a)(2)(B) (state colleges and universities); and (iv) that has assets (other than assets used directly in carrying out the institution’s exempt purpose) with an aggregate fair market value as of end of the preceding taxable year of at least $500,000 per student. For this latter purpose, the number of students of an institution is based on the daily average number of full-time students attending the institution, with part-time students taken into account on a full-time student equivalent basis. Moreover, the legislative history of new § 4968 states that the $500,000 per student figure should be calculated based upon “tuition paying” students; however, the Senate Parliamentarian struck that language from § 4968 immediately before it was passed by the House and Senate. Whether regulations can fill in the gap is anybody’s guess. New § 4968 is permanent and effective for taxable years beginning after 2017, again giving fiscal-year private colleges and universities time to cope.

a. Maybe students negotiating for scholarships at private colleges and universities now have a little more leverage. As originally passed late in 2017, new § 4968 taxed private colleges and universities (and affiliates) with endowments worth $500,000 or more per “student” (as defined in the statute to account for full and part-time students); however, the legislative history of new § 4968 stated that the $500,000 per student figure should be calculated based upon “tuition-paying” students. The discrepancy between the statute and the legislative history was created because the Senate Parliamentarian struck the “tuition-paying” language from § 4968 immediately before the 2017 Tax Cuts and Jobs Act ultimately was passed by Congress. Thanks to the Bipartisan Budget Act of 2018, § 41109, though, § 4968 is amended to include the “tuition-paying” modifying language. Thus, only those private colleges and universities (and affiliates) with endowments worth $500,000 or more per tuition-paying student will be subject to the new 1.4 percent annual excise tax.

b. Then again . . . maybe not! Notice 2018-55, 2018-26 I.R.B. 773 (06/08/18). The IRS has announced that proposed regulations under new § 4968 will determine “net investment income” gains and losses of an “applicable educational institution” by reference to an endowment asset’s fair market value as of December 31, 2017, not its historical adjusted basis (unless historical adjusted basis is greater than fair market value as of December 31, 2017). This special rule allowing an applicable educational institution to use the greater of (i) fair market value as of the end of the taxable year of enactment of the statute or (ii) historical adjusted basis for purposes of calculating net investment income is patterned after the approach taken in 1969 with respect to private foundations subject to § 4940. See § 4940(c)(1) (greater of adjusted basis or fair market value as of December 31, 1969). Therefore, net investment income of applicable educational institutions subject to new § 4968 should be minimal for the next year or so. Notice 2018-55 further announces that proposed regulations under new § 4968 (i) will take into account net investment losses only to the extent of net investment gains (with no allowance for capital loss carryovers or carrybacks) and (ii) will permit related organizations described in § 4968(d)(2) to consolidate gains and losses for purposes of calculating net investment income. Notice 2018-55 also invites comments by September 6, 2018, regarding the to-be-proposed regulations under new § 4968.

3. Oh goody! Changes to the UBIT rules too! The 2017 Tax Cuts and Jobs Act, §§ 13702 and 13703, also made certain changes to the determination of unrelated business income with respect to tax-exempt organizations. Most tax-exempt organizations are subject to federal income tax at regular rates (corporate rates for exempt corporations and trust rates for exempt trusts) on net income (i.e., after permissible deductions) from a trade or business, regularly carried on, that is unrelated to
the organization’s exempt purpose (other than its need for revenue). Exceptions exist for most types of passive, investment income as well as for narrow categories of other types of income (e.g., thrift store sales). See §§ 511-514.

Stop using good UBI money to chase bad UBI money! Under pre-TCJA law, if an exempt organization had unrelated business income from one activity, but unrelated losses from another activity, then the income and losses could offset, meaning that the organization would report zero or even negative UBI. Congress apparently doesn’t like this result, so under new § 512(a)(6) income and losses from separate unrelated businesses no longer may be aggregated. This new UBI provision is effective for taxable years beginning after 2017, thus giving fiscal year nonprofits some time to plan. Moreover, under a special transition rule, unrelated business income net operating losses arising in a taxable year beginning before January 1, 2018, that are carried forward to a taxable year beginning on or after such date, are not subject to § 512(a)(6).

Congress doesn’t like using UBI to help fund fringe benefits, so when your organization’s employees are pumping iron at the charity’s free gym, you can pump up your UBI too. Under new § 512(a)(7), an organization’s unrelated business taxable income is increased by the amount of any expenses paid or incurred by the organization that are not deductible because of the limitations of § 274 for (i) qualified transportation fringe benefits (as defined in § 132(f)); (ii) a parking facility used in connection with qualified parking (as defined in § 132(f)(5)(C)); or (iii) any on-premises athletic facility (as defined in § 132(j)(4)(B)). New § 512(a)(7) is effective for amounts paid or incurred after 2017, so affected tax-exempt organizations need to deal with this change immediately.

Perhaps worth noting here: Because the TCJA reduced the top federal income tax rate on C corporations to 21 percent, it likewise reduced to 21 percent the top rate on UBI of tax-exempt organizations formed as nonprofit corporations, which are the vast majority. So, the news for tax exempts is not all bad.

a. A tax law oxymoron: nonprofit trades or businesses. Huh? Notice 2018-67, 2018-36 I.R.B. 409 (8/21/18). Organizations described in §§ 401(a) (pension and retirement plans) and 501(c) (charitable and certain other entities) generally are exempt from federal income taxation. Nevertheless, §§ 511 through 514 impose federal income tax upon the “unrelated business taxable income” (“UBTI”) of such organizations including for this purpose state colleges and universities. The principal sources of UBTI are §§ 512 and 513 “unrelated trade or business” gross income (minus deductions properly attributable thereto) and § 514 “unrelated debt-financed income” (minus deductions), including a partner’s allocable share of income from a partnership generating UBTI. Prior to TCJA, exempt organizations could aggregate income and losses from unrelated trades or businesses before determining annual UBTI potentially subject to tax. Excess losses (if any) after aggregating all UBTI-related items of an exempt organization created a net operating loss subject to the rules of § 172. [See Reg. § 1.152(a)-1(a) prior to enactment of TCJA. After TCJA, § 172 permits only carryforwards.] Effective for taxable years beginning after 2017, however, TCJA added new § 512(a)(6) to disaggregate unrelated trades or businesses of exempt organizations for purposes of determining UBTI. Specifically, new § 512(a)(6) provides that for any exempt organization with more than one unrelated trade or business: (1) UBTI must be computed separately (including for purposes of determining any net operating loss deduction) for each such unrelated “trade or business;” and (2) total annual UBTI is equal to (i) the sum of positive UBTI from each such separate “trade or business” minus (ii) the specific $1,000 deduction allowed by § 512(b)(12). Under a special transition rule, unrelated business income net operating losses arising in a taxable year beginning before January 1, 2018 and carried forward to a taxable year beginning on or after such date, are not subject to new § 512(a)(6).

Now we get to the crux of the matter. The logical result of new § 512(a)(6) is that every exempt organization must segregate its unrelated trade or business income and losses for purposes of determining its annual UBTI. Yet, Treasury and IRS have never defined separate “trades or businesses” for this purpose or, frankly, for any other federal income tax purpose. Further complicating matters, TCJA also enacted a related subsection, new § 512(a)(7), that increases an exempt organization’s UBTI by expenses for which a deduction is disallowed under certain provisions of §§ 274 and 132 (specified transportation, parking, and athletic facility fringe benefits) unless the expense is “directly connected with an unrelated trade or business which is regularly carried on by the organization.” Thus, new
§ 512(a)(7) also requires identification of each unrelated “trade or business” of an exempt organization, but § 512(a)(7) has the further deleterious effect of potentially creating UBTI for an exempt organization that otherwise has no unrelated trade or business. In Notice 2018-67, Treasury and IRS take the first step toward providing guidance with respect to both § 512(a)(6) and (7) and delineating separate trades or businesses for UBIT purposes.

What’s in the Notice? Aside from requesting comments, Notice 2018-67 is lengthy (36 pages) and contains thirteen different “SECTIONS,” ten of which address substantive, technical aspects of new § 512(a)(6) and (7). The high points are summarized below, but Notice 2018-67 is a must read for tax advisors to § 501(c) organizations, state colleges and universities, and § 401(a) pension and retirement plans, especially where those entities have UBTI from partnership interests they hold as investments. To summarize:

1. General Rule. Until proposed regulations are published, all exempt organizations affected by the changes to § 512(a)(6) and (7) may rely upon a “reasonable, good-faith interpretation” of §§ 511 through 514, considering all relevant facts and circumstances, for purposes of determining whether the organization has more than one unrelated trade or business. Because of the way § 512(a)(6) operates, exempt organizations will be inclined to conclude that they have only one unrelated trade or business, but that is not easy to do given the so-called “fragmentation” principle of § 513(c) and Reg. § 1.513-1(b). For example, advertising income earned by an exempt organization (e.g., National Geographic) from ads placed in the organization’s periodical is UBIT even if subscription income is not UBIT. For an exempt organization this general rule includes using a reasonable, good-faith interpretation when determining: (a) whether to separate debt-financed income described in §§ 512(b)(4) and 514; (b) whether to separate income from a controlled entity described in § 512(b)(13); and (c) whether to separate insurance income earned through a controlled foreign corporation as described in § 512(b)(17). The use of the 6-digit code North American Industry Classification System (“NAICS”) for segregating trades or businesses will be considered a reasonable, good-faith interpretation until regulations are proposed.

2. Partnership Interests. In general, partnership activities are attributable to partners such that holding a partnership interest can result in multiple lines of UBIT being considered allocable to an exempt organization partner. Until proposed regulations are issued, however, exempt organizations (other than § 501(c)(7) social clubs) may rely upon either of two rules for aggregating multiple lines of UBIT from a partnership, including UBIT attributable to lower-tier partnerships and unrelated debt-financed income:
   - The “interim rule” that permits the aggregation of multiple lines of UBIT from an exempt organization’s interest in a single partnership if the partnership meets either a “de minimis test” or a “control test.” The de minimis test generally is met if the exempt organization partner holds a 2 percent or less capital and profits interest in a partnership. The control test generally is met if the exempt organization partner holds a 20 percent or less capital interest in a partnership and does not have “control or influence” over the partnership. Control or influence over a partnership is determined based upon all relevant facts and circumstances. For purposes of determining an exempt organization’s percentage interest in a partnership under the interim rule, partnership interests held by disqualified persons (as defined in § 4958), supporting organizations (as defined in § 509(a)(3)), and controlled entities (as defined in § 512(b)(13)(D)) must be considered.
   - The “transition rule” that permits the aggregation of multiple lines of UBIT from an exempt organization’s interest in a single partnership if the interest was acquired prior to August 21, 2018. For example, if an organization has a 35 percent interest in a partnership [acquired] prior to August 21, 2018, it can treat the partnership as being in a single unrelated trade or business even if the partnership’s investments generated UBIT from various lower-tier partnerships that were engaged in multiple types of trades or businesses (or, presumably, from debt-financed income).

3. IRC § 512(a)(7). Income under § 512(a)(7) [i.e., the UBIT increase for expenses not directly connected with an unrelated trade or business regularly carried on by the organization and for
which a deduction is disallowed under certain provisions of §§ 274 and 132 (specified transportation, parking, and athletic facility fringe benefits)) is not income from a trade or business for purposes of § 512(a)(6). Thus, such UBIT appears to be entirely separate from § 512(a)(6) income and therefore not offset by any deductions or losses.

4. **GILTI.** An exempt organization’s inclusion of global intangible low-taxed income (“GILTI”) under § 951A is treated as a dividend which is not UBIT (pursuant to § 512(b)(1)) unless it is debt-financed (and thus included in UBIT under § 512(b)(4)).

b. **Guidance on determining the increase to UBIT for employer-provided parking.** Notice 2018-99, 2018-52 I.R.B. 1067 (12/10/18). In this notice, the IRS announced that Treasury and the IRS will issue proposed regulations under §§ 274 and 512 that will include guidance on determining the calculation of increased unrelated business taxable income (UBIT) of tax-exempt organizations that provide qualified transportation fringes (and also the nondeductible parking expenses and other expenses for qualified transportation fringes provided by non-tax-exempt employers). Until further guidance is issued, employers that own or lease parking facilities where their employees park can rely on interim guidance provided in the notice to determine the increase in the amount of UBIT under § 512(a)(7) attributable to nondeductible parking expenses. The guidance in the notice for determining the increase in UBIs mirrors the guidance for determining the nondeductible parking expenses of non-tax-exempt employers summarized earlier in this outline. The notice explains that an increase to UBIT is not required “to the extent the amount paid or incurred is directly connected with an unrelated trade or business that is regularly carried on by the organization” because, in such a case, the expenses for qualified transportation fringes are disallowed by § 274(a)(4) as a deduction in calculating the UBIs of the unrelated trade or business. The notice confirms that the effect of the increase in UBIT can be to require a tax-exempt organization to file Form 990-T, Exempt Organization Business Income Tax Return, if the organization’s gross income included in computing UBIT is $1,000 or more. The rules for determining the increase in UBIT are illustrated by examples 9 and 10 in the notice.

4. **The Tax Court has held that referral fees paid to an exempt organization by a debt collection firm are subject to UBIT because the fees were neither “royalties” nor for services “primarily for the convenience” of the organization’s hospital-members.** New Jersey Council of Teaching Hospitals v. Commissioner, 149 T.C. No. 22 (12/20/17). The taxpayer was a § 501(c)(3) tax-exempt supporting organization that facilitated the common charitable activities of its members. The taxpayer’s members were tax-exempt teaching hospitals in New Jersey. The taxpayer’s revenue consisted of annual dues paid by its hospital-members for educational programs and other healthcare-related activities, as well as certain payments received from third parties that contracted with the taxpayer and the taxpayer’s hospital-members. Essentially, the taxpayer would endorse certain third parties providing services to hospitals, and if a hospital-member contracted with the third party, then the taxpayer would receive specified payments from the third party. These third-party payments derived from credit card programs, internet providers, research and polling services, equipment maintenance firms, transportation providers, debt collection agencies, and group purchasing arrangements. The Service audited the taxpayer for the years 2004 through 2007, and determined that certain of the third-party payments received by the taxpayer constituted unrelated business income. Specifically, the Service contended that payments received by the taxpayer from a debt-collection agency and a group purchasing program during the years at issue were taxable as unrelated business income. Accordingly, the Service determined that the taxpayer had a total UBIT deficiency of approximately $820,000 attributable to the years 2004 through 2007. The taxpayer contended, alternatively, that the payments from the debt collection agency were either “royalties” (excluded from UBIT by § 512(b)(2)), or from an activity conducted “primarily for the convenience” of the taxpayer’s hospital-members (excludable because under § 513(a)(2) such an activity is not considered an unrelated trade or business). With respect to the payments received from the group purchasing arrangement, the taxpayer did not argue the “royalty” exception applied, but the taxpayer did argue that the “primarily for convenience” exception applied. The Tax Court (Judge Lauber) held for the IRS with respect to both types of payments. Regarding the taxpayer’s contention that the payments from the debt collection agency were “royalties,” Judge Lauber pointed to the taxpayer’s agreement with the agency. The agreement did not purport to license any part of the taxpayer’s intellectual property
5. The IRS finalizes Form 1024-A for social welfare organizations to use to apply for recognition of (c)(4) status and receive an IRS determination letter. Rev. Proc. 2018-10, 2018-7 I.R.B. 355 (1/24/18). The IRS has released a final version of Form 1024-A, Application for Recognition of Exemption Under Section 501(c)(4) of the Internal Revenue Code. The new Form 1024-A may be used by (c)(4) “social welfare organizations” to apply for a determination letter from the Service recognizing their exempt status. The new form is a byproduct of the controversy that arose several years ago regarding § 501(c)(4) social welfare organizations. The Protecting Americans from Tax Hikes Act of 2015 (Pub. L. No. 114-113, div. Q) (the PATH Act), addressed the controversy by adding § 506 to the Code. Section 506 accomplished two objectives. Sections 506(a)-(d) require purported § 501(c)(4) organizations to notify the Secretary of the Treasury (the Secretary) no later than 60 days after the organization is established. The Treasury and the IRS subsequently promulgated Form 8976 for this purpose; however, Form 8976 is merely a notification form. It is not a formal application to the IRS for recognition of exempt status under § 501(c)(4). In fact, unlike a § 501(c)(3) charitable organization (which uses Form 1023 to apply for recognition of exempt status), a § 501(c)(4) social welfare organization is not required to apply to the IRS for a determination letter recognizing its exempt status, and many § 501(c)(4) organizations do not so apply. For those § 501(c)(4) organizations that do wish to apply, however, the PATH Act also added new § 506(f). Section 506(f) permits (but does not require) § 501(c)(4) social welfare organizations to apply to the IRS for a determination letter recognizing the organization’s exempt status in a manner similar to the mandatory process used for § 501(c)(3) charitable organizations. The final version of the Form 1024-A recently published by the IRS was designed for this purpose, fulfilling the statutory mandate of § 506(f). Note that additional requirements may apply to credit counseling organizations seeking recognition of exempt status under § 501(c)(4). See § 501(q). Now that Form 1024-A is finalized, § 501(c)(4) organizations no longer will use Form 1024 (which is used by other types of § 501(c) organizations except § 501(c)(3) organizations to apply for a determination letter recognizing their exempt status.

6. Newman’s Own just got its “own” tax exemption so that we can continue to enjoy delicious salad dressings, pizzas, and other food that makes both our tummies and our hearts feel good. Newman’s Own is popularly known for donating 100 percent of its profits to charity. What many may not have known, however, is that the ownership structure of Newman’s Own potentially subjected it to an excise tax under the private foundation excess business holdings rules of § 4943. The Bipartisan Budget Act of 2018, § 41110, remedies this problem by creating a new exception in § 4943(g) for “independently-operated philanthropic business holdings” of private foundations. Although the new exception is complicated and requires careful study by those potentially benefitting, it essentially allows private foundations that have been bequeathed 100% of the voting interests in a business enterprise to avoid the general rule of § 4943, which requires such business enterprises to be sold by the private foundation within a 5- to 10-year period. To qualify, in addition to having been donated to (not purchased by) the private foundation, the business enterprise generally
must distribute 100 percent of its annual profits to the owning foundation and must have an independent board of directors separate from the board of the owning foundation. New § 4943(g) is effective for taxable years beginning after December 31, 2017.

7. Well, the IRS doesn’t call it an “F” reorg, but that’s what tax-exempts can do after this ruling. Rev. Proc. 2018-15, 2018-9 I.R.B. 379 (02/08/18). Obsoleting Rev. Rul. 67-390 and Rev. Rul. 77-469, the IRS has ruled in Rev. Proc. 2018-15 that reorganizations, redomestications, and certain other corporate restructurings involving exempt organizations do not require a new application for exemption (Form 1023) by the surviving entity. Under Rev. Proc. 2018-15, a “corporate restructuring” of a § 501(c) organization means “incorporation under the laws of a state, reincorporation of a corporation incorporated under the laws of one state under the laws of a different state, filing articles of domestication for a corporation incorporated under the laws of one state under the laws of a different state, or a statutory merger of one corporation with and into another corporation.” If a § 501(c) organization engages in such a corporate restructuring after January 1, 2018, and the surviving organization is (1) a domestic business entity; (2) classified as a corporation under § 301.7701-2(b)(1) or (2); and (3) carries out the same purposes as the exempt organization that engaged in the corporate restructuring, then it does not need to file a new exemption application (Form 1023) with the IRS. Further, for § 501(c)(3) organizations (the most common type of tax-exempts under § 501(c)), the articles of organization of the surviving organization must continue to meet the organizational test of Reg. § 1.501(c)(3)-1(b), including § 1.501(c)(3)-1(b)(4) (regarding dedication of assets to exempt purposes). Thus, qualifying incorporations, reincorporations, redomestications, and mergers of most § 501(c) entities effectively are treated as “F” reorganizations, allowing the organization to continue its exempt status merely by notifying the IRS on the organization’s annual Form 990. The organization’s tax identification number also remains the same. Finally, Rev. Proc. 2018-15 does not apply to any corporate restructuring in which (1) the restructuring organization or the surviving organization is a disregarded entity, limited liability company, partnership, or foreign business entity; or (2) the surviving organization obtains a new EIN.

- The IRS’s prior published position along with limited case law had held that any type of change in form (even mere reincorporation from one state to another) required a § 501(c)(3) organization to reapply to the IRS (Form 1023) for recognition of the organization’s tax-exempt status. See American New Covenant Church v. Commissioner, 74 T.C. 293 (1980) (unincorporated association becomes a nonprofit corporation); Rev. Rul. 77-469, 1977-2 C.B. 196 (same); Rev. Rul. 67-390 (describing four distinct transactions—incorporation of an exempt trust, incorporation of an exempt association, reincorporation by Act of Congress, and reincorporation from one state to another—all requiring new applications for exempt status). Recent private letter rulings indicated that the IRS was reconsidering its position. See PLR 201426028 (06/27/14) (legislatively mandated, intrastate conversion from “public nonprofit corporation” status to “nonprofit corporation” does not require reapplication for exemption); PLR 201446025 (08/20/14) (a reincorporation or “redomestication” of an exempt, nonprofit corporation from one state to another does not require reapplication for exemption).

8. Taxpayer’s healthcare consulting nonprofit diagnosed as terminal under IRC § 501(c)(3). Abovo Found., Inc. v. Commissioner, T.C. Memo 2018-57 (4/30/18). Based upon the facts set forth in its application for exempt status (IRS Form 1023) and the administrative record, the Tax Court (Judge Foley) holds that the taxpayer, a Texas nonprofit corporation, failed the operational test and thus cannot qualify as tax-exempt under § 501(c)(3). Although the taxpayer met the requirements of the organizational test under § 501(c)(3) (i.e., the taxpayer had the proper § 501(c)(3) restrictive language in its articles and bylaws), a § 501(c)(3) also must meet an operational test to be exempt. Part of the operational test requires that an organization operate primarily for exempt purposes, and that no part of the organization’s net earnings inure to the benefit of any private individual. The taxpayer disclosed in its Form 1023 that it planned to hire Dr. Okonkwo — a military veteran, medical doctor, and board certified expert in patient safety and risk management — as President and taxpayer’s sole employee to deliver quality-management and patient-safety consulting services on behalf of the taxpayer. The taxpayer argued that its operations would “lessen the burdens of government” and thus should qualify as exempt. The taxpayer’s Form 1023 and the administrative record, however, disclosed that Dr. Okonkwo would be paid a market rate for his services (i.e., a $217,000 salary plus an annual
bonus of up to $100,000). Furthermore, no facts in the record demonstrated that the taxpayer would act on behalf of or otherwise lessen the burdens of government. Instead, Judge Foley determined that the taxpayer would (i) serve as as a “facade for Dr. Okonkwo’s consulting activities;” (ii) help him develop his “business relationships;” (iii) further his consulting career as a board certified expert in patient safety and risk management; and (iv) potentially confer a private benefit on him of annual compensation in excess of $300,000. As a result, Judge Foley denied the taxpayer exempt status under § 501(c)(3).

9. Has so-called “dark money” become virtually invisible (except to the IRS, of course)? Rev. Proc. 2018-38, 2018-31 I.R.B. 280 (07/16/18). Oversimplifying a bit for the sake of convenience, since 1969 § 6033(b)(5) has required § 501(c)(3) organizations to disclose on their annual information returns (Forms 990) certain contributions as well as “the names and addresses of [the organization’s] substantial contributors” for the year. Section 507(d)(2) defines a “substantial contributor” as any person contributing $5,000 or more to an organization if such amount is greater than 2 percent of the total contributions to the organization during the taxable year. Section 1.6033-2 of the regulations extended this disclosure requirement to other types of organizations exempt under § 501(a), including § 501(c)(4) “social welfare” organizations and § 501(c)(6) “trade associations.” In particular, some § 501(c)(4) social welfare organizations have been created and funded to engage in lobbying and political campaign activity that is prohibited to § 501(c)(3) organizations. This use of § 501(c)(4) organizations has been termed “dark money” by some and is controversial. Although the names and addresses of “dark money” contributors were supposed to be redacted on the organization’s Form 990 made publicly available by the IRS pursuant to § 6104(b), some inadvertent disclosures have occurred. Reportedly, a few of the largest organizations impacted have been entities affiliated with the National Rifle Association, the U.S. Chamber of Commerce, and Americans for Prosperity, the latter being tied to billionaires Charles and David Koch. See R. Rubin, “U.S. Treasury Restricts Donor Disclosure Requirement for Some Nonprofit Groups,” Wall St. J. (July 16, 2018). After Rev. Proc. 2018-38, though, substantial contributors’ names and addresses are no longer required to be disclosed on a non-(c)(3) organization’s annual Form 990. As stated in the revenue procedure, “The IRS does not need personally identifiable information of [such] donors to be reported . . . in order for it to carry out its responsibilities. The requirement to report such information increases compliance costs for some private parties, consumes IRS resources in connection with the redaction of such information, and poses a risk of inadvertent disclosure of information that is not open to public inspection.” The reporting changes announced by Rev. Proc. 2018-38 are effective for taxable years ending on or after December 31 2018. Notwithstanding this relief from disclosure granted to § 501(a) organizations other than (c)(3)s, Rev. Proc. 2018-38 states that the affected organizations must maintain donor information in the organization’s books and records in case such information is requested by the IRS.

B. Charitable Giving

1. Taxpayers have a greater ability to deduct charitable contributions for relief efforts in areas affected by Hurricanes Harvey, Irma, or Maria. The Disaster Relief and Airport and Airway Extension Act of 2017 (“2017 Disaster Relief Act”), Pub. L. No. 115-63, was signed by the President on September 29, 2017. Section 504(a) of the 2017 Disaster Relief Act provides special rules for charitable contributions for the benefit of victims of Hurricanes Harvey, Irma, or Maria. Normally, the limit that applies to the deduction for most charitable contributions by individuals is 50 percent of the taxpayer’s contribution base, which, generally speaking, is adjusted gross income. Lower limits can apply depending on the type of recipient and the type of property contributed. The limit that applies to the deduction for most charitable contributions by corporations generally is 10 percent of taxable income. Contributions that exceed these limits generally can be carried forward five years. The legislation provides that “qualified contributions” by an individual are not subject to the normal limits, and instead are allowed up to the amount by which the taxpayer’s contribution base (AGI) exceeds the other charitable contributions the taxpayer makes, i.e., those subject to the normal limit. In effect, this permits individual taxpayers to deduct qualified contributions up to 100 percent of the taxpayer’s contribution base (AGI) after taking into account other charitable contributions. Further, qualified contributions are not subject to the normal overall limit on itemized deductions of § 68. For corporations, the limit on qualified contributions is the amount by which the corporation’s taxable income exceeds the corporation’s other charitable contributions, i.e., the corporation can deduct
qualified contributions up to 100 percent of taxable income after taking into account other charitable contributions. Qualified contributions by an individual or a corporation that that exceed the relevant limit can be carried forward five years. A qualified contribution is defined as a charitable contribution (as defined in § 170(c)) that meets three requirements: (1) the contribution must be paid in cash to an organization described in § 170(b)(1)(A) during the period from August 23 through December 31, 2017, for relief efforts in the Hurricane Harvey disaster area, Hurricane Irma disaster area, or Hurricane Maria disaster area, (2) the taxpayer must obtain from the organization a contemporaneous written acknowledgment that the contribution was used (or will be used) for such relief efforts, and (3) the taxpayer must elect the application of this special rule. For partnerships or S corporations, the election is made separately by each partner or shareholder. The legislation does not specify the manner of making the election. Presumably, taking the deduction on the return will constitute an election.

a. Congress has enacted a similar increase in the limit on deductions for charitable contributions towards relief efforts in areas affected by California wildfires. The Bipartisan Budget Act of 2018, § 20104(a) of Division B, provides that “qualified contributions” by an individual are not subject to (1) the normal limits on charitable contributions, and instead are allowed up to 100 percent of the taxpayer’s contribution base (AGI) after taking into account other charitable contributions, and (2) are not subject to the normal overall limit on itemized deductions of § 68. For corporations, the limit on qualified contributions is 100 percent of taxable income after taking into account other charitable contributions. Qualified contributions by an individual or a corporation that that exceed the relevant limit can be carried forward five years. A qualified contribution is defined as a charitable contribution (as defined in § 170(c)) that meets three requirements: (1) the contribution must be paid in cash to an organization described in § 170(b)(1)(A) during the period from October 8, 2017, through December 31, 2018, for relief efforts in the California wildfire disaster area, (2) the taxpayer must obtain from the organization a contemporaneous written acknowledgment that the contribution was used (or will be used) for such relief efforts, and (3) the taxpayer must elect the application of this special rule. For partnerships or S corporations, the election is made separately by each partner or shareholder.

- This provision may have little effect for most individuals for two reasons. First, beginning in 2018, many more individuals will take the increased standard deduction enacted as part of the 2017 Tax Cuts and Jobs Act and will not itemize their deductions on Schedule A of Form 1040. Second, pursuant to the 2017 Tax Cuts and Jobs Act, the § 68 overall limit on itemized deductions does not apply to taxable years beginning after 2017 and before 2026.


a. If the legislation does not cause you to take the standard deduction, you can deduct even more of your cash contributions to public charities. The 2017 Tax Cuts and Jobs Act, § 11023, added new Code § 170(b)(1)(G) and redesignated existing § 170(b)(1)(G) as § 170(b)(1)(H). New § 170(b)(1)(G) increases the limit that applies to the deduction of certain charitable contributions by individuals. Prior to the Tax Cuts and Jobs Act, the limit on the deduction for charitable contributions that an individual made to a public charity or certain other organizations was 50 percent of the individual’s contribution base, which, generally speaking, is adjusted gross income. The legislation increased this percentage to 60 percent for cash contributions that an individual makes to public charities and certain other organizations specified in § 170(b)(1)(A). Any contribution that exceeds this limit can be carried forward to each of the succeeding five years. This increased limit applies to taxable years beginning after 2017 and before 2026.

b. If you don’t get a contemporaneous written acknowledgment for your charitable contribution over $250, the donee charity no longer can bail you out with an amended Form 990. Plus, Treasury and the IRS can check at least one regulatory project off the “to do” list. Under Code § 170(f)(8), a taxpayer’s charitable contribution of $250 or more is disallowed unless the taxpayer obtains a “contemporaneous written acknowledgement” (“CWA”) of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution. On the other hand, § 170(f)(8)(D) provides an exception to the CWA requirement if the donee charity files a return,
on such form and in accordance with such regulations as the Secretary may prescribe, that includes the same content. Yet, the IRS’s position (which has been upheld 8-3-6 by the Tax Court in a reviewed opinion by Judge Lauber) has been that the § 170(f)(8)(D) exception is not available unless and until the Treasury Department and the IRS issue final regulations implementing the exception, which to date they have not done. See, e.g., 15 West 17th Street LLC v. Commissioner, 147 T.C. No. 19 (12/22/16). The 2017 Tax Cuts and Jobs Act, § 13705, permanently repealed § 170(f)(8)(D) effective for taxable years beginning after December 31, 2016.

c. No more charitable contribution deduction for 50-yard line seats!

Normally, a taxpayer who receives a substantial return benefit for a payment to a charity (e.g., admission to the museum) cannot claim a charitable contribution deduction for the payment. Under pre-TCJA law, though, special rules applied to certain payments to colleges and universities in exchange for rights to purchase preferred tickets or seating at athletic events. These special rules (§ 170(l)) generally permitted the taxpayer to treat 80 percent of a payment to a college or university as a charitable contribution even when preferred seating or ticket rights were granted in exchange if (i) the amount was paid to or for the benefit of a school with a regular faculty and curriculum and meeting certain other requirements; and (ii) such amount would have been allowable as a charitable contribution deduction but for the fact that the taxpayer received (directly or indirectly) as a result of the payment the right to purchase tickets for seating at the school’s athletic events. The 2017 Tax Cuts and Jobs Act, § 13704, permanently amended § 170(l) so that no charitable contribution deduction is allowed with respect to payments for the right to purchase tickets or seating at a school’s athletic events. The amendment to § 170(l) is effective for contributions made in taxable years beginning after 2017.

3. Used underwear is just not worth what it “used” to be! T.D. 9836, Substantiation and Reporting Requirements for Cash and Noncash Charitable Contribution Deductions, 83 F.R. 36417 (7/30/18). The Treasury Department and the IRS have finalized, with only minor changes, proposed regulations (which addressed the deductibility of “good condition” but used clothing and other household items, among other things) (REG-140029-07, Substantiation and Reporting Requirements for Cash and Noncash Charitable Contribution Deductions, 73 F.R 45908 (8/7/18)) regarding substantiation and reporting requirements for cash and noncash charitable contributions. The proposed and now final regulations [principally, Reg. §§ 1.170A-15 through 1.170A-18] reflect the enactment of certain provisions of the American Jobs Creation Act of 2004 [§ 170(f)(11) and (12)] and the Pension Protection Act of 2006 [§ 170(f)(16) and (17)]. Section 170(f) contains numerous limitations on the charitable contribution deduction with respect to donations of certain items of property (e.g., remainder interests, partial interests, insurance policies, used vehicles, stuffed animals, used clothing and household goods, etc.). Complicating matters further, § 170 also contains three distinct subsections [§ 170(f)(8), (11), and (17)] pertaining to substantiation and recordkeeping requirements for both cash and “noncash” (i.e., property) contributions. The proposed and now final regulations attempt to clarify and reconcile several of the foregoing limitations in § 170 with the distinct substantiation and recordkeeping rules in § 170. The five major changes from the proposed regulations (REG-140029-07) are as follows. One, due to the Tax Court’s decision in Crimi v. Commissioner, T.C. Memo 2013-51 (reasonable-cause is inherently facts and circumstances specific), the final regulations do not provide a standard for a “reasonable-cause” excuse for failure to meet the substantiation requirements. Two, when substantiating noncash contributions that exceed $500, a donor can treat similar items contributed during the tax year as one property. Three, the substantiation requirements apply to carryover years as well as the year of donation. Four, if a Form 8323 is required in connection with a donation, the appraiser’s taxpayer identification number (or EIN of the appraiser’s business) must be included. Lastly, the final regulations clarify that a completed Form 8323 does not substitute for any required contemporaneous written acknowledgment. Thankfully, no changes were made to the rules regarding donations of used clothing, so we can continue to take a deduction (albeit small) for donations of old underwear. The final regulations are effective for contributions made after July 30, 2018. For further details, read on.

Cash or Monetary Contributions. Reg. § 1.170A-15 provides that the substantiation requirements of § 170(f)(17) regarding cash or monetary contributions of less than $250 may be met if the taxpayer has one of two items: (i) a “bank record” (a monthly bank statement with a photocopy or image
obtained from the bank of the front of the check indicating the name of the charity, or a credit card statement for contributions made via credit card), or (ii) a “written communication” (essentially, a receipt) from the charity showing the name of the charity, the date of the contribution, and the amount of the contribution. Separate contributions of less than $250 made during a year are not aggregated for this purpose. See Reg. § 1.170a-13(F)(1). Notwithstanding the foregoing, a written communication is not required to substantiate contributions of less than $250 to certain charitable trusts (see Reg. § 1.170A-15(g)); however, if the contribution is $250 or more, a “contemporaneous written acknowledgment” (see below) from the charitable trust apparently is required. Further, a written communication from a charity is not necessary to substantiate unreimbursed, out-of-pocket expenses incurred incident to the rendition of services to a charitable organization; however, taxpayers must maintain records of such expenses. For cash or monetary contributions of $250 or more, pursuant to § 170(f)(8), the minimal “bank record” or “written communication” requirement must be met plus the donor must have a so-called “contemporaneous written acknowledgment” from the charity indicating the name of the donor, whether the charity provided goods or services in exchange for the contribution, and the amount of the contribution. The contemporaneous written acknowledgment may be electronic and, in general, is “contemporary” if it is delivered to the taxpayer before the taxpayer files a return for the year of the contribution. Further, the contemporaneous written acknowledgment may substitute for the minimal “written communication” requirement for cash or monetary contributions under $250 (and, as a practical matter, almost always will be provided in lieu of a receipt) if it also shows the date of the contribution. For unreimbursed “out of pocket” expenses of $250 or more, a donor may meet the substantiation requirement by having a written record of each such expense and a contemporaneous statement by the charity describing the services and indicating whether goods or services were provided to the taxpayer in return for the expense. A contribution made by payroll deduction may be substantiated by (i) a pay stub, Form W-2, or other document furnished by the employer that sets forth the amount withheld during the taxable year for payment to a charity, together with (ii) a pledge card or other document prepared by or at the direction of the charity that shows the name of the organization.

Noncash Contributions. Reg. § 1.170A-16 provides that for noncash contributions of less than $250, a taxpayer must substantiate the deduction with a “written communication” (essentially, a receipt) from the charity showing the name and address of the charity, the date of the contribution, and an adequate description of the property (see Reg. § 1.170A-16(a)(ii) for what is considered “adequate,” especially for securities). If obtaining a written communication from the charity is impractical (such as for contributions made at unattended drop sites), then a taxpayer must substantiate the donation with “reliable written records” (generally, the same information as a charity-provided receipt, but see Reg. § 1.170A-16(a)(2) for details). For noncash contributions of $250 or more up to $500, the taxpayer must substantiate such contributions with a contemporary written acknowledgment from the charity. For noncash contributions of more than $500 but not more than $5,000, substantiation requires a contemporaneous written acknowledgment plus a properly completed Form 8283 (Section A) (which requires detailed information concerning the property contributed, including the taxpayer’s cost or other basis in the property). For noncash contributions of more than $5,000, substantiation requires a contemporaneous written acknowledgment, a “qualified appraisal” prepared by a “qualified appraiser,” and a properly completed Form 8283 (Section B); however, a qualified appraisal is not required for publicly-traded securities and certain other readily-valuable property. See Reg. § 1.170A-16(d)(2). For noncash contributions of more than $500,000, substantiation requires that all of the above requirements be met plus the qualified appraisal must be attached to the taxpayer’s return claiming the deduction.

Qualified appraisal and qualified appraiser. Reg. § 1.170A-17 sets forth the detailed requirements for a “qualified appraisal” and a “qualified appraiser.” These requirements did not change significantly from those set forth in the proposed regulations; however, in order to provide appraisers with a reasonable amount of time to meet new education and experience requirements, the final regulations under § 1.170A-17 apply only to contributions made after January 1, 2019.

4. Deduction for charitable contribution of façade easement denied to long-term lessee of building, Harbor Lofts Associates v. Commissioner, 151 T.C. No. 3 (8/27/18). The Tax Court has held that a taxpayer with a long-term lease of two historic buildings was not entitled to a charitable

94
contribution deduction for donating façade easements over the buildings to a historical preservation organization. The taxpayer was a partnership that had leased the buildings for a 47-year term from the fee owner, the Economic Development & Industrial Corporation of Lynn (“EDIC”), a public corporation authorized under Massachusetts law. The 47-year lease between the taxpayer and EDIC made the taxpayer responsible for all insurance, utility, maintenance, and other costs associated with occupying the buildings and entitled the taxpayer to a portion of any proceeds if the land and buildings were taken under eminent domain. The taxpayer-lessee and EDIC jointly contributed the façade easement to the historical preservation organization in December of 2009. The taxpayer then claimed a charitable contribution deduction of almost $4.5 million on its 2009 return. On audit, the IRS challenged the claimed charitable contribution deduction arguing that, although the façade easement may have been “granted in perpetuity” by EDIC, the taxpayer’s contribution of a façade easement essentially was a waiver of the taxpayer’s “time-limited” contract rights. Thus, the taxpayer did not make a contribution of a “qualified real property interest” as required by § 170(h)(2)(C). In response, the taxpayer argued that by jointly contributing the façade easement with the fee owner, EDIC, the “granted in perpetuity” requirement was met and that the taxpayer’s long-term leasehold interest in the façade of the buildings coupled with EDIC’s fee interest equated with a “qualified real property interest.” Moreover, the taxpayer argued that it should be treated as the equitable and tax owner of the buildings due to the nature of the long-term lease. The Tax Court (Judge Buch) denied the taxpayer’s charitable contribution deduction. Judge Buch concluded that, under Massachusetts law, the taxpayer held only a leasehold interest, not a fee interest, and that Massachusetts law characterized the taxpayer’s leasehold interest as personal property. Judge Buch further reasoned that the taxpayer’s leasehold was a personal property right, not a “qualified real property interest” within the meaning of § 170(h)(2)(C). Judge Buch also determined that, in any event, the taxpayer was incapable of granting a perpetual restriction over the façade of the buildings because the taxpayer did not hold perpetual rights. Judge Buch distinguished the facts in this case from one in which tenants-in-common grant deductible conservation easements due to the fact that EDIC and the taxpayer were not tenants in common, but rather lessor and lessee under Massachusetts law. Finally, Judge Buch ruled that, even if the taxpayer were considered the equitable owner of the buildings for federal income tax purposes, the façade easement granted by the taxpayer was not a “grant in perpetuity” because it was limited by the 47-year term of the lease.

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. A majority of the Tax Court refuses to call a procedural foot-fault on the IRS, but not all the judges see it that way. Graev v. Commissioner, 147 T.C. No. 16 (11/30/16). The taxpayers had claimed a charitable contribution deduction for the donation of a facade conservation easement that ultimately was disallowed by the Tax Court (140 T.C. 377 (2013)). The IRS examining agent determined that the taxpayers were liable for the § 6662(h) 40 percent gross valuation misstatement penalty, and he prepared a penalty approval form for which he obtained written approval from his immediate supervisor. On that form only the § 6662(h) 40 percent penalty was asserted. The agent prepared a notice of deficiency that included the 40 percent penalty. However, before the notice of deficiency was issued, a Chief Counsel attorney reviewed a draft and, through a memorandum approved by his supervisor, the attorney advised that an alternative § 6662(a) 20 percent accuracy-related penalty should be added to the notice. The notice of deficiency was revised to include the 20 percent § 6662(a) accuracy-related penalty, the calculation of which in the notice of deficiency yielded a zero 20 percent penalty to avoid stacking with the 40 percent penalty. The notice of deficiency was issued as revised, but the revised notice with the alternative 20 percent penalty was not reviewed or approved by the examining agent’s supervisor. After the IRS conceded that the 40 percent gross valuation misstatement penalty did not apply, it asserted the alternative 20 percent accuracy-related penalty as a non-zero amount, since the stacking issue no longer existed. The taxpayers argued that, because the notice of deficiency showed a zero amount for the § 6662(a) 20 percent penalty, the IRS failed to comply with the requirements of § 6751(a), which requires that a computation of the penalty be included in the notice of deficiency, and § 6751(b), which requires that the “initial determination of ... [the] assessment” of the penalty be “personally approved (in writing) by the immediate supervisor ... or such higher level official as the Secretary may designate,” and that these
failures barred assessment of the 20 percent penalty. In a reviewed opinion by Judge Thornton, the Tax Court (9-3-5) held that: (1) the notice of deficiency complied with the requirements of § 6751(a); (2) because the penalty had not yet been assessed, the taxpayers’ argument that the IRS failed to comply with § 6751(b)(1) was premature; and (3) the 20 percent accuracy-related penalty for a substantial understatement applied. With respect to the first holding, regarding compliance with § 6751(a), the court reasoned as follows:

The notice of deficiency clearly informed petitioners of the determination of the 20% penalty (as an alternative) and clearly set out the computation (albeit reduced to zero, as it had to be then, to account for the greater 40% penalty). The notice of deficiency thus complied with section 6751(a).

Moreover, even if petitioners were correct that the IRS failed to include a computation of a penalty as required by section 6751(a), such a failure would not invalidate a notice of deficiency. In similar contexts this Court has held that procedural errors or omissions are not a basis to invalidate an administrative act or proceeding unless there was prejudice to the complaining party.

With respect to the third holding regarding application of the 20 percent accuracy-related penalty, the court rejected the taxpayers’ defenses and concluded that: (1) the taxpayers had not established that they had reasonable cause for claiming the charitable contribution deductions and acted in good faith; (2) “the authorities that support [the taxpayers’] deductions for the cash and conservation easement contributions are not substantial when weighed against the contrary authorities;” and (3) the taxpayers had no reasonable basis for their return position and had not adequately disclosed on their return the relevant facts concerning their deductions because they had not disclosed a side letter from the National Architectural Trust (NAT) (the easement holder) obligating the NAT to refund the taxpayers’ cash contribution and work to remove the easement if the IRS disallowed entirely their charitable contribution deductions for the easement.

A concurring opinion by Judge Nega (with whom Judges Goeke and Pugh joined) would have reached the same result as the majority on the ground that the taxpayers were not prejudiced, and would have left “to another case the more detailed statutory analysis performed by both the majority and the dissent.”

A dissent by Judge Gustafson (joined by Judges Colvin, Vasquez, Morrison and Buch) would not have sustained the penalty on the ground that the IRS failed to comply with § 6751(b)(1) because “the responsible revenue agent included a 20% accuracy-related penalty on the notice of deficiency without first obtaining the ‘approv[al] (in writing)’ of his ‘immediate supervisor’.”

a. But the Second Circuit serves the Tax Court some Chai. Chai v. Commissioner, 851 F.3d 190 (2d Cir. 3/20/17), aff’g in part, vacat’g in part, and rev’g in part T.C. Memo. 2015-42 (3/11/15). The taxpayer in this case received in 2003 a $2 million payment for serving as an accommodation party in connection with tax shelters. The taxpayer did not report the payment as income and took the position that the $2 million was a nontaxable return of capital. The IRS issued a notice of deficiency for 2003 increasing the taxpayer’s income by the $2 million payment and asserting both a deficiency in self-employment tax and a 20 percent accuracy-related penalty. (The notice of deficiency did not assert a deficiency in income tax because the taxpayer had offsetting losses from a partnership subject to the TEFRA audit rules. Those losses ultimately were disallowed at the partnership level and the IRS amended its answer in this Tax Court proceeding to assert a deficiency in income tax. This sequence of events led to several interesting procedural issues with respect to the deficiency in income tax.) In his post-trial briefing in the Tax Court, the taxpayer raised for the first time the same argument regarding the penalty as the taxpayer had raised in Graev v. Commissioner, 147 T.C. No. 16 (11/30/16), i.e., that the IRS was barred from assessing the 20 percent accuracy-related penalty because it had failed to comply with the requirement of § 6751(b) that the “initial determination of ... [the] assessment” of the penalty must be “personally approved (in writing) by the immediate supervisor ... or such higher level official as the Secretary may designate.” The Tax Court (Judge Cohen) refused to address this argument on the basis that it was untimely because the taxpayer had raised it for the first time post-trial. In an opinion by Judge Wesley, the Second reversed the Tax Court’s ruling on the penalty issue. (The Second Circuit
affirmed the Tax Court’s ruling that the $2 million payment was subject to self-employment tax and vacated its ruling that it had no jurisdiction to consider the increased deficiency in income tax asserted by the IRS. In light of the taxpayer’s concession that the $2 million was includible in gross income, the Second Circuit remanded with instructions to uphold the additional income tax deficiency.) The Second Circuit found the view of the majority in Graev on the penalty issue unpersuasive and sided with the dissenting judges in Graev. The court focused on the language of § 6751(b) and concluded that it is ambiguous regarding the timing of the required supervisory approval of a penalty. Because of this ambiguity, the court examined the statute’s legislative history and concluded that Congress’s purpose in enacting the provision was “to prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle.” That purpose, the court reasoned, undercuts the Graev majority’s conclusion that approval of the penalty can take place at any time, even just prior to assessment. The court held “that § 6751(b)(1) requires written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty.” Further, the court held “that compliance with § 6751(b) is part of the Commissioner’s burden of production and proof in a deficiency case in which a penalty is asserted. … Read in conjunction with § 7491(c), the written approval requirement of § 6751(b)(1) is appropriately viewed as an element of a penalty claim, and therefore part of the IRS’s prima facie case.”

b. The Tax Court has adopted the Second Circuit’s approach to the required supervisory approval of penalties, but nevertheless upheld the imposition of penalties on these taxpayers, Graev v. Commissioner, 149 T.C. No. 23 (12/20/17). In a reviewed, supplemental opinion by Judge Thornton, the Tax Court (9-1-6) has reversed the portions of its opinion in Graev v. Commissioner, 147 T.C. No. 16 (11/30/16) that held it was premature to consider whether § 6751(b) barred assessment of the § 6662(a) accuracy-related penalties asserted by the IRS. In Chai v. Commissioner, 851 F.3d 190 (2d Cir. 3/20/17), the U.S. Court of Appeals for the Second Circuit held “that § 6751(b)(1) requires written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty.” Further, the Second Circuit held “that compliance with § 6751(b) is part of the Commissioner’s burden of production and proof in a deficiency case in which a penalty is asserted.” Because this case is appealable to the Second Circuit, and in the interest of promoting uniformity on an issue that affects many cases, the Tax Court accepted the Second Circuit’s holding. Accordingly, the question in this case was whether the IRS had obtained the required written approval of the accuracy-related penalties by the date the notice of deficiency was issued or by the date the IRS filed an answer or amended answer asserting the penalty. The IRS asserted the 20 percent accuracy-related penalty with respect to both the taxpayers’ non-cash charitable contribution (the façade conservation easement) and their cash charitable contribution. The penalty with respect to the cash contribution was asserted for the first time in an amended answer by the IRS Chief Counsel attorney handling the litigation, and the taxpayers conceded that this penalty received the requisite approval by the Associate Area Counsel. The taxpayers contended that § 6751(b)(1) barred assessment of the 20 percent penalty with respect to the their noncash charitable contribution. The IRS had prepared a proposed notice of deficiency that asserted a 40 percent accuracy-related penalty under § 6662(h), which was the penalty proposed by the Revenue Agent who had conducted the audit and approved by the Revenue Agent’s immediate supervisor. An attorney in the IRS Chief Counsel’s Office reviewed the proposed notice of deficiency and recommended that the IRS assert an alternative position with respect to the penalty, i.e., that the § 6662(a) 20 percent penalty applied. The recommendation was approved by the attorney’s immediate supervisor (the Associate Area Counsel) and included in the final notice of deficiency, which was signed by an IRS Technical Services Territory Manager. The taxpayers made the following three-part argument: (1) the Office of IRS Chief Counsel serves in only an advisory capacity until proceedings begin in the Tax Court, (2) the IRS Chief Counsel attorney who recommended the alternative penalty in this case accordingly had no authority to make an initial determination of a penalty that appeared in the notice of deficiency, and therefore (3) the IRS had not complied with the requirement of § 6751(b)(1) that there be an “initial determination of [the] assessment” of the penalty that is approved by the immediate supervisor of the person making the initial determination. In essence, the taxpayers attempted to distinguish between advice, as had been provided by the IRS Chief Counsel attorney who recommended the penalty, and an “initial
determination,” which is required by the statute. The court rejected the taxpayers’ arguments and held that § 6751(b)(1) did not bar assessment of the alternative 20 percent penalty because the IRS Chief Counsel attorney who first recommended the penalty made the requisite “initial determination,” which was approved by the attorney’s immediate supervisor, the Associate Area Counsel.

- In a concurring opinion, Judge Lauber, joined by Judges Marvel, Thornton, Pugh, and Ashford, emphasized that § 6751(b)(1) should be interpreted in light of its purpose, which, as discussed by the Second Circuit in Chai v. Commissioner, 851 F.3d 190 (2d Cir. 3/20/17), was to prevent IRS employees from threatening unjustified penalties in an effort to encourage taxpayers to settle. This purpose, Judge Lauber wrote, supports the Tax Court majority’s approach of treating the action of the IRS official who first proposes that a penalty be asserted as the “initial determination” of the assessment of the penalty. In contrast, Judge Lauber argued, the position expressed in Judge Buch’s dissenting opinion (that an initial determination can be made only by an IRS officer with the technical authority to make a penalty determination or issue a notice of deficiency) would mean that “an IRS official would be free to use penalties as a battering ram against taxpayers, without obtaining supervisory approval under section 6751(b), so long as he lacked authority to do what he was doing.”

- In a lengthy opinion, Judge Holmes concurred in the result only.

- In a dissenting opinion, Judge Buch, joined by Judges Foley, Vasquez, Goeke, Gustafson, and Morrison, agreed with the majority that the court should adopt the holding of the Second Circuit in Chai v. Commissioner, 851 F.3d 190 (2d Cir. 3/20/17), but disagreed “on the issue of whether a recommendation from an attorney within the IRS Office of Chief Counsel can constitute ‘the initial determination’ to impose a penalty for purposes of section 6751(b)(1).” Judge Buch emphasized that the IRS Office of Chief Counsel serves in an advisory capacity. “Because the [IRS Chief Counsel] attorney has the authority only to advise or recommend, we would hold that the attorney’s recommendation to assert a penalty is not the initial determination that must be approved in writing.”

c. In determining whether the § 6751(b)(1) supervisory approval requirement has been met, an IRS settlement officer need not read the mind of the supervisor; a signature is sufficient. Blackburn v. Commissioner, 150 T.C. No. 9 (4/5/18). A corporation, which apparently was the taxpayer’s employer, failed to pay its employment tax liabilities and failed to file certain Forms 941, Employer’s Quarterly Federal Tax Return. The IRS assessed trust fund recovery penalties against the taxpayer under § 6672. In a collection due process hearing, the IRS settlement officer determined to uphold the IRS’s proposed collection of the penalty. The taxpayer sought review of the IRS’s determination in the Tax Court and argued that the settlement officer had failed to comply with § 6330(c)(1), which provides:

The appeals officer shall at the hearing obtain verification from the Secretary that the requirements of any applicable law or administrative procedure have been met.

The taxpayer argued that the settlement officer had not verified the IRS’s compliance with the supervisory approval requirement of § 6751(b)(1). The IRS’s evidence of supervisory approval was Form 4183, Recommendation re: Trust Fund Recovery Penalty, which was dated prior to assessment of the trust fund recovery penalty. The Form 4183, which was generated by the IRS’s computer system, did not contain the supervisor’s signature but showed the supervisor’s name in the signature block for the supervisor. The taxpayer argued that the signature of the supervisor, by itself, was inadequate to comply with § 6751(b)(1), and that § 6330(c)(1) requires a settlement officer to verify compliance by engaging in “a factual analysis of the thought process of the supervisor” and to make “a determination that the thought process was ‘meaningful.’” The IRS argued that (1) the supervisory approval requirement of § 6751(b)(1) does not apply to the § 6672 trust fund recovery penalty, and (2) even if
it does apply, it was not an abuse of discretion for the settlement officer to find compliance because there was sufficient evidence of supervisory approval. The Tax Court (Judge Goeke) declined to address the legal question whether the supervisory approval requirement of § 6751(b)(1) applies to the § 6672 trust fund recovery penalty. The court held that, even if supervisory approval was required, a record of compliance existed in this case. The court reasoned that its prior decisions “have consistently upheld a settlement officer’s verification of assessments when the administrative record reflects compliance with administrative procedures” and have permitted “reliance upon standard administrative records” to verify assessments. In Davis v. Commissioner, 115 T.C. 35 (2000), the court held in connection with a CDP hearing that it was not an abuse of discretion for the IRS to rely on Form 4340, Certificate of Assessment and Payments, to verify assessment of a tax where the taxpayer had not shown any irregularity in the assessment procedure that would raise a question. Form 4340, like the Form 4183 in this case, does not require a signature. Accordingly, the court held that it was not an abuse of discretion for the settlement officer to find that the IRS had met the requirements of applicable law and administrative procedure. The court therefore granted the IRS’s motion for summary judgment.

2. Congress has directed Treasury to issue preparer due diligence requirements with respect to head-of-household filing status. The 2017 Tax Cuts and Jobs Act, § 11001(b), amended Code § 6695(g) to extend the preparer due diligence requirements to returns or claims for refund that claim eligibility for head-of-household filing status. This change is effective for taxable years beginning after 2017.

a. Return preparers need to be extra careful with not only the earned income tax credit, but also with the child tax credit, additional child tax credit, the American Opportunity Tax Credit, and head-of-household filing status. T.D. 9842, Tax Return Preparer Due Diligence Penalty Under Section 6695(g), 83 F.R. 55632 (11/7/18). The Treasury Department and the IRS have finalized amendments to Reg. § 1.6695-2 to implement changes made by the Protecting Americans from Tax Hikes Act of 2015 (2015 PATH Act) and the 2017 Tax Cuts and Jobs Act. The 2015 PATH Act extended the § 6695(g) preparer due diligence requirements for taxable years beginning after 2015 to returns or claims for refund including claims of the child tax credit (CTC), additional child tax credit (ACTC), and American Opportunity Tax Credit (AOTC), in addition to the earned income credit (EIC). The 2017 Tax Cuts and Jobs Act amended Code § 6695(g) to extend the preparer due diligence requirements to returns or claims for refund that claim eligibility for head-of-household filing status effective for taxable years beginning after 2017. Previously, Treasury and the IRS issued proposed and temporary regulations in 2016 addressing the changes made by the 2015 PATH Act (see T.D. 9799, Tax Return Preparer Due Diligence Penalty Under Section 6695(g), 81 F.R. 87444 (12/5/16)) and issued proposed regulations in 2018 addressing the changes made by the 2017 Tax Cuts and Jobs Act and revising the 2016 proposed regulations (see REG-103474-18, Tax Return Preparer Due Diligence Penalty Under Section 6695(g), 83 F.R. 33875 (7/18/18)). These final regulations adopt the 2016 and 2018 proposed regulations without substantive change. As a result of the legislative changes, one return or claim for refund may contain claims for more than one credit or claim head-of-household filing status, all of which are subject to the due diligence requirements. Each failure to comply with the due diligence requirements set forth in the regulations results in a penalty, and therefore more than one penalty could apply to a single return or claim for refund. Examples in the regulations illustrate how multiple penalties could apply when one return or claim for refund is filed and illustrate the types of situations in which return preparers must make inquiries and document the inquiries and responses. The final regulations are effective November 7, 2018, but they generally apply to tax returns and claims for refund prepared on or after December 5, 2016, for tax years beginning after December 31, 2015, except for the rules relating to the determination of a taxpayer’s eligibility for head-of-household filing status, which apply to tax returns and claims for refund prepared on or after November 7, 2018, for tax years beginning after December 31, 2017.

3. Better be careful who you hire as CFO, and raise all your arguments against liability as a responsible person at the summary judgment stage, not afterwards. McClendon v. United States, 119 A.F.T.R.2d 2017-1037 (S.D. Tex. 3/6/17). The government successfully established through a motion for summary judgment that the taxpayer, a physician, was liable under § 6672 for a $4.3 million penalty equal to the amount of unpaid federal employment taxes owed by his medical
practice. The CFO he had hired had embezzled funds and ultimately pleaded guilty to felony counts of theft. When the taxpayer learned of the unpaid taxes, he made a loan to the practice to allow it to make payroll, and these funds went to the employees rather than the government. The government used this preferential payment as the basis for establishing that the taxpayer had willfully violated his duty to pay the taxes due. The taxpayer moved for reconsideration and argued that his liability should be limited to the $100,000 preferential payment that was the basis for his liability. The court rejected this argument for two reasons. First, the taxpayer had failed to raise it in response to the government’s motion for summary judgment. Second, even if he had raised it in a timely manner, the taxpayer had failed to meet his burden to prove the absence of funds available to pay the taxes due:

At the summary judgment stage, as now, Dr. McClendon did not try to prove up the funds available to [the practice] or show that whatever funds existed were encumbered so that he had no obligation to pay them to the IRS. Instead, he effectively argues that, at summary judgment, it was the government’s burden to demonstrate his liability for each dollar of the penalty. Not so. Dr. McClendon was presumptively liable for the balance of the IRS penalty assessed against him. The government moved for summary judgment and argued that the evidence did not create a genuine factual dispute material to deciding whether the IRS penalty was properly assessed. That discharged the government’s summary judgment burden. Dr. McClendon, who would bear the burden at trial, then had the burden to submit or identify record evidence showing that he was not liable.

a. In this § 6672 trust fund recovery case, the Fifth Circuit has reversed and remanded for trial on the issue of the amount of available, unencumbered funds in the business’s bank accounts after the responsible person became aware of the unpaid withholding taxes. *McClendon v. United States*, 892 F.3d 775 (5th Cir. 6/14/18). In the District Court, Dr. McClendon (now deceased) argued that his liability under § 6672 should be limited to $100,000, the amount of the loan he made to the business to allow it to make payroll after he had learned of the unpaid employment taxes. The District Court rejected this argument as untimely because Dr. McClendon had not raised it in his response to the government’s motion for summary judgment and instead had raised it for the first time in his motion for reconsideration after the District Court had granted summary judgment in the government’s favor. Nevertheless, the District Court considered the merits of the argument and concluded that Dr. McClendon had failed to meet his burden of submitting or identifying record evidence in the record to show the amount of the business’s funds that were unencumbered and available to pay the unpaid taxes. In an opinion by Judge Davis, the U.S. Court of Appeals for the Fifth Circuit has vacated the District Court’s grant of summary judgment and remanded for trial on the issue of the amount of available, unencumbered funds in the business’s bank accounts after discovery of the unpaid withholding taxes. The court first noted that its review of the District Court’s denial of Dr. McClendon’s motion to reconsider its grant of summary judgment is *de novo* because the District Court reached the merits of the motion and considered materials submitted in connection with it. The court cited *Barnett v. I.R.S.*, 988 F.2d 1449 (5th Cir. 1993), for the proposition that, when the government asserts that a responsible person willfully failed to pay employment taxes by using the business’s unencumbered funds to pay the business’s non-IRS creditors, the responsible person’s liability under § 6672 is limited to the amount of “available, unencumbered funds deposited into [the business’s] bank accounts after [the responsible person] became aware that the accrued withholding taxes were due.” Dr. McClendon, the court explained, had testified in his deposition and in his affidavit regarding the actions taken and the funds available once the unpaid withholding taxes came to light, including his $100,000 loan and the amount of receivables and insurance proceeds paid to the IRS, and had submitted copies of checks payable to the IRS that he asserted represented the closing balance in the business’s accounts shortly after the unpaid taxes were discovered. To oppose the government’s motion for summary judgment, the court stated, Dr. McClendon was not required to provide an accounting of the business’s funds. The court cited the Eleventh Circuit’s recent decision in *United States v. Stein*, 881 F.3d 853 (11th Cir. 2018), in which the court held that an affidavit can create an issue of material fact that precludes summary judgment if the affidavit is self-serving and uncorroborated. Similarly, the Fifth Circuit reasoned, “[w]e can find no such corroboration requirement under § 6672.” In the court’s view, Dr. McClendon had come forward with sufficient evidence to establish an issue of material fact warranting trial regarding the amount of available, unencumbered funds.
Judge Jones concurred in the court’s opinion. She wrote separately to emphasize that, given Dr. McClendon and his partners had relied on their CFO for a decade before the CFO began embezzling, their reliance on his representations regarding the payment of employment taxes seemed plausible, and therefore she did not see how the District Court could rule as a matter of law on the government’s argument that Dr. McClendon had willfully failed to pay employment taxes by acting with reckless disregard of a known or obvious risk that trust funds would not be remitted. She also stated that, in her view, the government had acted irresponsibly by introducing 285 pages of exhibits in support of its motion, including the business’s records, and then arguing that Dr. McClendon had not met his burden at the summary judgment stage:

To challenge the legal consequences of McClendon’s $100,000 cash infusion is one thing; to claim, in the face of his sworn affidavit and documents, and their own access to corroborative financial records, that this isn’t enough to raise a fact issue is irresponsible at best.

Judge Higginson dissented and argued that the court should affirm the District Court’s grant of summary judgment in favor of the government.

4. Congress has reduced to zero the Affordable Care Act’s penalty for failure to maintain minimum essential coverage for months beginning after 2018. The 2017 Tax Cuts and Jobs Act, § 11081, amended Code § 5000A(c) to reduce to zero the penalty enacted as part of the Affordable Care Act for failing to maintain minimum essential coverage. This change applies to months beginning after 2018. Accordingly, for 2017 and 2018, individual taxpayers still must answer the question on the return concerning whether they and other household members had minimum essential coverage and will be subject to the penalty of § 5000A(c) (referred to as the shared responsibility payment) for failure to maintain such coverage. Under § 5000A(c)(1) and Reg. § 1.5000A-4(a), the individual shared responsibility payment for months during which an individual fails to maintain minimum essential coverage is the lesser of: (1) the sum of the monthly penalty amounts (generally 1/12 of the greater of a fixed dollar amount—$695 per adult with a family maximum of $2,085 for 2017—or a percentage—2.5 percent for 2017—of the amount by which household income exceeds the filing threshold), or (2) the sum of the monthly national average bronze plan premiums for the shared responsibility family—$272 per month per individual for 2017.

5. Updated instructions on how to rat yourself out. Rev. Proc. 2019-9, 2019-2 IRB 292 (12/20/18). This revenue procedure updates Rev. Proc. 2018-11, 2018-5 I.R.B. 335 (1/26/18), and identifies circumstances under which the disclosure on a taxpayer’s income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d), relating to the substantial understatement aspect of the accuracy-related penalty, and for the purpose of avoiding the tax return preparer penalty under § 6694(a), relating to understatements due to unreasonable positions. There have been no substantive changes. The revenue procedure does not apply with respect to any other penalty provisions, including § 6662(b)(1) accuracy-related penalties. If this revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275-R, as appropriate, attached to the return for the year or to a qualified amended return. A corporation’s complete and accurate disclosure of a tax position on the appropriate year’s Schedule UTP, Uncertain Tax Position Statement, is treated as if the corporation had filed a Form 8275 or Form 8275-R regarding the tax position. The revenue procedure applies to any income tax return filed on a 2018 tax form for a taxable year beginning in 2018 and to any income tax return filed on a 2018 tax form in 2019 for a short taxable year beginning in 2019.

6. The IRS does not bear the burden of proof with respect to penalties in a partnership-level proceeding, says the Tax Court. Dynamo Holdings, Limited Partnership v. Commissioner, 150 T.C. No. 10 (5/7/18). The IRS issued a notice of final partnership administrative adjustment with respect to three taxable years of Dynamo Holdings, Limited Partnership. In addition to adjustments to partnership items, the IRS determined that accuracy-related penalties applied under § 6662(a) and (b)(1)-(2) for negligence and substantial understatements of income tax. In Graev v. Commissioner, 149 T.C. No. 23 (12/20/17), the court had held that the IRS’s burden of production includes evidence of written supervisory approval of penalties as required by § 6751(b)(1). In this case, the IRS had introduced some evidence of written supervisory approval, but the evidence, according to
the court, was inconclusive and it was not clear whether the IRS had met the burden of production. Accordingly, among other issues, the court considered whether the IRS bears the burden of production with respect to penalties determined in a TEFRA partnership-level proceeding. Section 7491(c) provides:

Notwithstanding any other provision of this title, the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.

In a unanimous, reviewed opinion by Judge Buch (with Judge Vasquez not participating), the Tax Court held that the IRS does not bear the burden of production with respect to penalties in a partnership-level proceeding. To the extent that the court’s prior decisions have suggested to the contrary (such as RERI Holdings I, LLC v. Commissioner, 149 T.C. 1 (7/3/17), and Curtis Inv. Co. v. Commissioner, T.C. Memo. 2017-150), the court will not follow them. In reaching this conclusion, the court relied in part on the plain language of the statute, which requires a “proceeding with respect to the liability of any individual.” Partnership-level proceedings, the court reasoned, do not determine liability and are not with respect to individuals. The court also expressed concern about the practical effect of applying § 7491(c) in a partnership-level proceeding. Doing so would require the court (contrary to the purpose of the TEFRA audit procedures) to devote time and resources to identifying the ultimate taxpaying partners. As an example, if one partner were a corporation and another were an individual, the IRS would bear the burden of production as to penalties with respect to one partner but not the other, which might require the court to render separate holdings. The partnership had not raised the lack of supervisory approval of the penalties in its petition, at trial, or in its post-trial briefing and therefore had waived asserting the lack of supervisory approval as a defense to penalties. Because the IRS, according to the court’s holding, does not bear the burden of production with respect to penalties in a partnership-level proceeding, the court denied the partnership’s motion to dismiss as to penalties.

7. Is the Pope Catholic? The Tax Court does not need the written approval of a supervisor before imposing penalties for delay or frivolous arguments under § 6673(a)(1). Williams v. Commissioner, 151 T.C. No. 1 (7/3/18). Section 6673(a)(1) authorizes the Tax Court to impose a penalty of up to $25,000 when a taxpayer has initiated or maintained proceedings primarily for delay, advanced a position that is frivolous or groundless, or has unreasonably failed to pursue available administrative remedies. In this case, the Tax Court (Judge Ruwe) held, not surprisingly, that § 6751(b), which provides that no penalty under Title 26 can be assessed “unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination,” does not apply to the Tax Court when it imposes penalties under § 6673(a)(1).

B. Discovery: Summons and FOIA

1. Non-government attorneys KEEP OUT! REG-132434-17. Proposed Regulations on Certain Non-Government Attorneys Not Authorized to Participate in Examinations of Books and Witnesses as a Section 6103(n) Contractor, 83 F.R. 13206 (3/28/18). Treasury and the IRS have issued a notice of proposed rulemaking that would significantly narrow final regulations issued in 2016 that permit service providers with whom the IRS contracts to receive books and records provided in response to a summons and participate in a summons interview. Section 6103(n) and Reg. § 301.6103(n)-1(a) permit the disclosure of returns and return information to any person for purposes of tax administration to the extent necessary in connection with the acquisition of property or certain services (such as processing, storage and reproduction) related to returns or return information. The final regulations issued in 2016 clarified that such persons with whom the IRS or Chief Counsel contracts for services could not only receive and review books, papers, and records produced in compliance with a summons issued by the IRS, but also in the presence and under the guidance of an IRS officer or employee, participate fully in the interview of a witness summoned by the IRS to provide testimony under oath. See T.D. 9778, Participation of a Person Described in Section 6103(n) in a Summons Interview Under Section 7602(a)(2) of the Internal Revenue Code, 81 F.R. 45409 (7/14/16). Commentators, including the State Bar of Texas Tax Section, had recommended removing the provisions permitting contractors to participate in a summons interview because, among other reasons, doing so would “avoid the unsettled question of whether a private contractor has the legal authority to
examine a witness.” 2014 TNT 180-24 (9/16/14). After publishing Notice 2017-38, 2017-30 I.R.B. 147 (7/7/17) [which related to the subsequently issued Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, Dep’t of Treasury, Press Release (10/2/17), and Department of the Treasury, 2017-2018 Priority Guidance Plan (10/20/17)], the IRS identified eight sets of regulations that “impose an undue financial burden,” “add undue complexity,” or “exceed [the IRS’s] statutory authority.” The above-mentioned final regulations under § 7602 were one of the eight targeted for revision. Accordingly, Prop. Reg. § 301.7602-1(b)(3) provides new rules that significantly narrow the scope of the current regulations under § 7602 by excluding non-government attorneys from receiving summoned books, papers, records, or other data or from participating in the interview of a witness summoned by the IRS to provide testimony under oath. The proposed regulations contain a limited exception for an attorney hired by the IRS as a specialist in foreign, state, or local law, including tax law, or in non-tax substantive law that is relevant to an issue in the examination, such as patent law, property law, or environmental law, or is hired for knowledge, skills, or abilities other than providing legal services as an attorney. The preamble to the proposed regulations explains the change as follows:

The Summons Interview Regulations require the IRS to retain authority over important decisions when section 6103(n) contractors question witnesses, but there is a perceived risk that the IRS may not be able to maintain full control over the actions of a non-government attorney hired by the IRS when such an attorney, with the limited exception described below, questions witnesses. The actions of the non-governmental attorney while questioning witnesses could foreclose IRS officials from independently exercising their judgment. Managing an examination or summons interview is therefore best exercised solely by government employees, including government attorneys, whose only duty is to serve the public interest. These concerns outweigh the countervailing need for the IRS to use non-government attorneys, except in the limited circumstances set forth in proposed paragraph (b)(3)(ii). Treasury and the IRS remain confident that the core functions of questioning witnesses and conducting examinations are well within the expertise and ability of government attorneys and examination agents.

The proposed regulations apply to examinations begun or administrative summonses served by the IRS on or after March 27, 2018.

- The IRS’s position in the proposed regulations represents a change in policy. The IRS made a controversial decision to engage the law firm Quinn Emanuel Urquhart & Sullivan, LLP, as a private contractor to assist in the IRS’s examination of Microsoft’s 2004 to 2006 tax years. A federal district court expressed concern about this practice, but upheld enforcement of the summonses issued by the IRS to Microsoft. See United States v. Microsoft Corp., 154 F. Supp. 3d (W.D. Wash. 2015).

2. Citing § 7611, purported church exorcises devilish IRS summons. The lesson for the IRS? For God’s sake, get the “John Hancock” of at least the TE/GE Commissioner before sending a church tax inquiry or examination notice under § 7611! United States v. Bible Study Time, Inc., 295 F.Supp.3d 606 (3/13/18). The District Court of South Carolina stayed a summons enforcement action because the IRS failed to substantially comply with the notice requirements of § 7611(a) (church tax inquiries and examinations). The taxpayer, Bible Study Time, Inc., purported to be a church. The IRS issued a summons to the taxpayer in connection with an inquiry and examination of the taxpayer’s tax-exempt status as a church. [Previously, the taxpayer had failed in its efforts to quash several IRS third-party summonses issued to the taxpayer’s banks. See Bible Study Time, Inc. v. United States, 240 F.Supp.3d 409 (D.S.C. 2017).] Under § 7611, the IRS must navigate certain procedural and notice rules prior to conducting a church tax inquiry or examination. One such rule requires an “appropriate high-level Treasury official” to sign off before a church tax inquiry or examination can begin. See § 7611(a). Furthermore, § 7611(e) provides that “any proceeding to compel compliance with respect to any church tax inquiry or examination shall be stayed until the court finds that all practicable steps to correct the noncompliance have been taken.” Due largely to the IRS’s reorganization begun in 1998 and Congress’s failure to update § 7611 thereafter (as well as Treasury’s failure to update interpreting regulations), the law is unclear as to who is an “appropriate high-level Treasury official” within the meaning of § 7611. See generally United States v. Living Word Christian
C. Litigation Costs

1. After the monks lose their patience, a good deed by the IRS gets punished; however, the monks and their blood-sucking attorneys get no award of administrative or litigation costs under § 7430 due to the IRS’s concession. **Friends of the Benedictines in the Holy Land, Inc. v. Commissioner**, 150 T.C. No. 5 (2/21/18). As required by § 508, the taxpayer applied for tax-exempt status under § 501(c)(3) by filing a Form 1023 (Application for Recognition of Exemption) on July 2, 2012. After receiving no response from the IRS (other than a perfunctory acknowledgment letter) for over a year, the taxpayer filed a declaratory judgment action in Tax Court on September 20, 2013, as allowed by § 7428. Generally, § 7428 allows such declaratory judgment actions if the IRS does not issue a determination letter within 270 days from the date the organization files a properly-completed Form 1023. On September 22, 2013, two days after the taxpayer filed the § 7428 declaratory judgment action, the IRS issued a determination letter granting § 501(c)(3) status to the taxpayer retroactive to March 14, 2012. Next, on October 1, 2013, IRS counsel contacted the taxpayer’s counsel about filing a motion to dismiss the pending declaratory judgment action in Tax Court; however, the taxpayer’s counsel preferred to resolve the litigation by preparing a joint decision and stipulation to which the IRS would agree and the Tax Court would adopt. *(Perhaps taxpayer’s counsel was laying a trap?)* Over the next month and one-half, IRS counsel and the taxpayer’s counsel crafted a joint decision and stipulation stating that the taxpayer was indeed tax-exempt under § 501(c)(3). The Tax Court adopted and entered the joint decision and stipulation on December 31, 2013. Then *(perhaps closing the trap?)* on January 30, 2014, the taxpayer filed a motion for an award of reasonable administrative and litigation costs under § 7430. Generally, § 7430 permits taxpayers to recover reasonable administrative and litigation costs incurred in any administrative or court proceeding brought by or against the United States with respect to the “determination, collection, or refund of any tax, interest, or penalty” under the Code, including declaratory judgment actions filed under § 7428. To recover under § 7430, the taxpayer must establish that (1) it is the prevailing party, (2) it did not unreasonably protract the proceedings, (3) the amount of the costs requested is reasonable, and (4) it exhausted the administrative remedies available. Regardless, if the position of the United States in the administrative or court proceeding is “substantially justified,” the taxpayer is not entitled to an award of costs under § 7430.

The taxpayer’s and the IRS’s arguments. Taxpayer’s counsel originally had agreed to assist the taxpayer with the filing of the Form 1023 on a pro bono basis. Nevertheless, citing the determination letter as well as the joint decision and stipulation, the taxpayer’s counsel argued (1) that it was the “prevailing party” in both the administrative proceedings and the § 7428 declaratory judgment action and (2) that it thus should be awarded administrative and litigation costs totaling $69,000. *(Assuming the best, perhaps taxpayer’s counsel was going to donate the $69,000 to the taxpayer?)* The IRS
countered that, although the taxpayer did not unreasonably protract the proceedings or fail to exhaust administrative remedies, the taxpayer was not the “prevailing party” and the asserted costs were unreasonable.

The Tax Court’s analysis. The Tax Court (Judge Wells) initially noted with respect to the taxpayer’s arguments and the IRS’s response that § 7430 requires a bifurcated analysis whereby an award of administrative costs is determined separately from an award of litigation costs. The taxpayer had asserted that its administrative costs were roughly $8,500 and that its litigation costs were roughly $60,500. The IRS first argued that no administrative costs should be awarded under § 7430 because a request for a § 501(c)(3) determination letter is tantamount to a request for a private letter ruling, and the regulations under § 7430 provide an exception to the recovery of administrative costs in connection with a request for a private letter ruling or “similar determination.” See Reg. § 301.7430-3(a). Judge Wells ruled with respect to this initial argument by the IRS that because an organization is required by § 508 to seek a determination letter in order to be classified as exempt under § 501(c)(3), the exception in the regulations for private letter rulings or “similar determinations” did not apply. Next, with respect to the IRS’s argument that the taxpayer was not the “prevailing party” for administrative purposes under § 7430, the IRS asserted that its issuance of the determination letter on September 22, 2013, granting the taxpayer’s exempt status under § 501(c)(3) meant the taxpayer did not “prevail” over any contrary position asserted by the IRS. Judge Wells ruled that the Tax Court did not need to decide whether the issuance of a determination letter meant the taxpayer “prevailed” administratively because the taxpayer had not adequately proven its administrative costs, but rather only litigation costs. Finally, with respect to litigation costs, the IRS argued that no award should be granted under § 7430 because the IRS’s position in the declaratory judgment action, albeit a complete concession, was substantially justified. With respect to this argument by the IRS, Judge Wells determined that a complete concession by the IRS was reasonable under the circumstances and therefore the IRS’s position was substantially justified. Accordingly, Judge Wells held that the taxpayer was not a prevailing party within the meaning of § 7430 and was not entitled to an award of litigation costs either.

Although Judge Wells awarded neither administrative nor litigation costs, his opinion notes that the Tax Court was sympathetic to the taxpayer’s plight, stating:

Petitioner waited well over 14 months after it applied, and even then the IRS declined to give petitioner any assurance that a ruling would be forthcoming. We cannot criticize petitioner for then filing a petition; and the IRS’ almost immediate issuance of a determination and concession indicates that petitioner should not have been put to the trouble and expense of doing so.

D. Statutory Notice of Deficiency

E. Statute of Limitations

1. The time period for the IRS to return wrongfully levied funds, and for taxpayers to bring suit for wrongful levy, is now two years. The 2017 Tax Cuts and Jobs Act, § 11071, amended Code § 6343(b) to increase from nine months to two years the period of time within which the IRS can return to a taxpayer money (or monetary proceeds from the sale of property) upon which the IRS has wrongfully levied. The legislation also amended Code § 6532(c) to increase from nine months to two years the period of time within which a taxpayer can bring an action for wrongful levy. Under both Code provisions, the two-year period runs from the date of levy. These amendments are effective with respect to (1) levies made after the date of enactment, which is December 22, 2017, and (2) levies made on or before December 22, 2017 provided that the nine-month period had not expired as of the date of enactment.

2. “‘When I use a word,’ Humpty Dumpty said in rather a scornful tone, ‘it means just what I choose it to mean—neither more nor less.’” And when Congress says that a six-year limitations period on assessment applies when a taxpayer omits income from specified foreign financial assets “with respect to which information is required to be reported under section 6038D,” it means just that. Rafizadeh v. Commissioner, 150 T.C. No. 1 (1/2/18). The taxpayer did not report income earned on a foreign financial account with respect to the years 2006 through 2009. The IRS issued a notice of deficiency with respect to these years on December 8, 2014,
after the expiration of the normal three-year limitations period on assessment specified by § 6501(a). The IRS argued that the six-year limitations period on assessment set forth in § 6501(e)(1)(A)(ii) applied. Section 6501(e)(1)(A)(ii) provides that the limitations period is six years from the date the return is filed if two conditions are met: (1) the taxpayer omits an amount properly includible in gross income that “is attributable to one or more assets with respect to which information is required to be reported under section 6038D … .” and (2) the amount omitted exceeds $5,000. Section 6038D requires an individual who holds an interest in a “specified foreign financial asset” to report on the individual’s income tax return certain information if the aggregate value of all the individual’s specified foreign financial assets exceeds $50,000. (This $50,000 threshold does not apply in determining whether the six-year limitations period of § 6501(e)(1)(A)(ii) applies.) The reporting requirement of § 6038D, which was added to the Code by the Hiring Incentives to Restore Employment Act of 2010 (HIRE Act), Pub. L. No. 111-147, applies to taxable years beginning after March 18, 2010. Because all of the taxable years involved began before March 18, 2010, the taxpayer was not required by § 6038D to report the foreign accounts in question. The Tax Court (Judge Pugh) held in favor of the taxpayer. The court focused on the language of § 6501(e)(1)(A)(ii), which refers to omitted income that “is attributable to one or more assets with respect to which information is required to be reported under section 6038D.” This statutory language, the court noted, refers not just to assets specified in § 6038D, but to assets with respect to which § 6038D requires reporting. The court concluded that “the most natural reading of this phrase is that the six-year statute of limitations applies only when there is a section 6038D reporting requirement (or would be barring an exception that is to be disregarded).” In reaching this conclusion, the court rejected the IRS’s arguments to the contrary, which appear to be based on the effective date of § 6501(e)(1)(A)(ii). Section 6501(e)(1)(A)(ii), also added to the Code by the HIRE Act, applies to returns filed after March 18, 2010, and also to returns filed before that date if the limitations period on assessment was open on March 18, 2010, which the taxpayer conceded (for purposes of his motion for summary judgment) was true. Because the normal three-year limitations period on assessment had expired before the IRS issued the notice of deficiency, and because the six-year limitations period of § 6501(e)(1)(A)(ii) did not apply, the court granted summary judgment in favor of the taxpayer.

3. Maybe the IRS thought that “Island Time” applied to determine the limitations period on assessment? *Coffey v. Commissioner*, 150 T.C. No. 4 (1/29/18). Even though the taxpayer may not have been a bona fide resident of the U.S. Virgin Islands and therefore improperly failed to file a U.S. tax return herself, the IRS duly received copies of the taxpayer’s USVI returns for 2003 and 2004 from the U.S. Virgin Islands Bureau of Internal Revenue (“BIR”) and entered the taxpayer’s return information into the taxpayer’s IRS transcript no later than March 2006. According to the Tax Court, because that process and the provided information equated to receipt by the IRS of an adequate “return” to calculate U.S. federal income tax liability under the test of *Beard v. Commissioner*, 82 T.C. 766 (1984), aff’d, 793 F.2d 139 (6th Cir. 1986), the IRS was barred by the three-year limitations period of § 6501(a) from assessing tax when it issued a notice of deficiency to the taxpayer in September 2009.

*Background:* As a possession of the United States, the U.S. Virgin Islands has a so-called “mirror tax system.” Essentially, under this system, U.S. Virgin Island residents are taxed similar to U.S. residents by virtue of a fiction treating the U.S. Internal Revenue Code as if it referred to the USVI everywhere it actually refers to the United States. Thus, *bona fide residents* of the U.S. Virgin Islands with only USVI-source income generally complete and file IRS forms solely with the USVI BIR (not the IRS) to report and pay income taxes pursuant to § 932(d). Then, pursuant to § 7654(a), in the case of a taxpayer that has had income taxes withheld and remitted to the U.S. Treasury for a particular tax year, a Tax Implementation Agreement (“TIA”) between the IRS and the BIR requires return information to be transmitted to the IRS (and vice versa from the IRS to the BIR) allowing any taxes so withheld and paid to the U.S. Treasury to be “covered over” to the USVI Treasury. (Nonresidents of the USVI with both US- and VI-sourced income must file with both the IRS and the USVI Bureau of Internal Revenue and pay taxes accordingly.)

*The Taxpayer:* Claiming to be a bona fide resident of the USVI (a fact which the IRS vigorously disputed), the taxpayer filed her income tax returns for 2003 and 2004 solely with the BIR. A copy of the taxpayer’s returns then were duly transmitted by the BIR to the IRS pursuant to the TIA and entered
into the taxpayer’s IRS transcript no later than March of 2006. The taxpayer was claiming to be a bona fide resident of the USVI to obtain the benefits of reduced income tax rates under a USVI economic development program. The IRS commenced audits of the taxpayer’s 2003 USVI return in August of 2005 and the taxpayer’s 2004 USVI return in May of 2006; however, the IRS never requested that the taxpayer sign a waiver extending the three-year limitations period on assessment under §6501(a). Accordingly, upon a motion for summary judgment, the taxpayer argued that, regardless of whether she was a bona fide resident of the USVI for tax years 2003 and 2004, and regardless of whether she herself filed a return with the IRS for those years, because the IRS received sufficient information via the TIA to calculate her U.S. tax liability by March of 2006, the IRS was precluded from issuing a notice of deficiency in September of 2009 because the three-year limitations period on assessment of §6501(a) already had expired. This limitations period generally is three years from the time the taxpayer files a return. The IRS argued that the limitations period of §6501(a) had not begun to run at all because the taxpayer had not filed a return with the IRS showing $0 income.

The Tax Court: In a reviewed opinion (5-7-4) by Judge Holmes, the Tax Court agreed with the taxpayer’s position that the three-year limitations period of §6501(a) barred the IRS from assessing the tax. According to Judge Holmes’s opinion, the Beard test requires that an adequate return for purposes of §6501(a) must (1) contain sufficient data to permit calculation of tax liability, (2) purport to be a return, (3) be an honest and reasonable attempt to satisfy the requirements of tax law, and (4) be executed under penalties of perjury. Judge Holmes and four other judges (Foley, Vasquez, Gustafson, and Buch) reasoned that transmittal from the BIR to the IRS under the TIA of copies of the first two pages of taxpayer’s 2003 and 2004 income tax returns as well as related W-2 wage statements met that test. Seven judges (Thornton, Gale, Goeke, Paris, Kerrigan, Pugh, and Ashford) concurred only in the result, reasoning more broadly that the taxpayer’s filing of a return with the BIR pursuant to §932(d) should be sufficient in and of itself to start the statute of limitations under §6501 regardless of the Beard test. The four dissenting judges (Marvel, Morrison, Lauber, and Nega) would have held in favor of the IRS, reasoning that because the taxpayer’s return information was transmitted to the IRS by the BIR, but neither the taxpayer nor someone authorized to act for them had filed a return with the IRS, the statute of limitations never began to run and therefore the assessment was not be time-barred.

4. Gains from the sale of PFIC stock allocated to years other than the year of disposition are not counted as gross income for purposes of the six-year limitations provision of §6501(e)(1)(A)(i). Tosso v. Commissioner, 151 T.C. No. 4 (9/4/18). Under §6501(a), the IRS generally can assess tax within three years from the time the return for the year is filed. This period is extended to six years by §6501(e)(1)(A)(i) if a taxpayer omits from gross income an amount properly includible in gross income that exceeds 25 percent of the amount of gross income stated in the return. The taxpayer in this case failed to report for 2006 through 2008 gains from the sale of stock in passive foreign investment companies (PFICs). The IRS noticed a deficiency on January 6, 2015. The taxpayer asserted that the IRS was precluded from assessing tax for the years in question by the three-year limitations period of §6501(a). The parties stipulated that, if the six-year limitations period of §6501(e)(1)(A)(i) applied, then the IRS was not precluded from assessing tax. The issue before the court was whether gains from the sale of PFIC stock are counted as gross income for purposes of §6501(e)(1)(A)(i). The Tax Court (Judge Thornton) held that only gains from the sale of PFIC stock allocated to the year of disposition (current-year PFIC gain) is included in gross income for purposes of §6501(e)(1)(A)(i), and that gain allocated to years other than the year of disposition (non-current-year PFIC gain) is not so included. There are three regimes that potentially apply to PFIC stock: (1) the default regime in §1291(a)(1)-(2); (2) the elective treatment as a qualified electing fund authorized by §1295 and set forth in §1293; and (3) the elective mark-to-market treatment authorized by §1296. The taxpayer had not made either of the latter two elections and therefore the default regime applied. Under the default regime, a United States person who owns stock in a PFIC is permitted to defer U.S. tax on the PFIC’s earning, but upon a disposition of the PFIC stock (or receipt of an excess distribution) the United States person must pay both U.S. tax and interest on the deferred U.S. tax liability. This is accomplished by (1) allocating the gain from the disposition of the PFIC stock over the post-1986 years the shareholder held the stock; (2) applying the highest rate of tax on ordinary income in each year (other than the current year) to the amount of gain allocated to that year; (3) computing interest on the tax liability for each year as if the shareholder had failed to pay the tax liability when it was due; and (4) taking the sum of the amounts in steps 2 and 3. This sum is the “deferred tax amount.” The court
reasoned that, under this default regime, § 1291(a)(I)(B) provides that gross income includes only current-year PFIC gain. In contrast, non-current-year PFIC gain is not included in gross income. Instead, the taxpayer’s tax liability for the current year is increased by the “deferred tax amount.” Under this approach, the amounts the taxpayer had excluded from gross income for 2006 (not including non-current-year PFIC gains) exceeded 25 percent of the amount of gross income stated in the return, and therefore the IRS was not precluded from assessing tax, but the limitations periods for assessing tax for 2007 and 2008 had expired. The court rejected the taxpayer’s argument with respect to 2006 that the taxpayer could net losses from the sale of PFIC stock against gains from such sales and that only net gain is allocated to the taxpayer’s holding period for the stock.

F. Liens and Collections

1. Does the date on the notice or the date on the envelope control when the period for responding begins to run? Weiss v. Commissioner, 147 T.C. 179 (8/17/16). In this collection due process case the taxpayer sought review of the IRS’s determination to uphold a notice of intent to levy. Before the IRS may levy against a taxpayer’s property, it must provide written notice of the proposed levy and inform the taxpayer of his right to a CDP hearing. Section 6330(a)(2) requires that a levy notice must be sent or delivered to the taxpayer “not less than 30 days before the day of the first levy,” and § 6330(a)(3)(B) requires the notice to inform the taxpayer in simple and nontechnical terms of his right “to request a hearing during the 30-day period” specified in § 6330(a)(2). An IRS Revenue Officer attempted to deliver to the taxpayer in person a Final Notice of Intent to Levy, but was deterred by a dog blocking the driveway. The Revenue Officer chose instead to mail the notice by certified mail two days later without generating a new notice. The taxpayer argued that the period of limitations on collection of these liabilities expired in July 2009 based on the contention that he intentionally filed his request for a CDP hearing one day late, and thus was entitled only to an “equivalent hearing” rather than to the CDP hearing that the IRS afforded him. If the taxpayer’s contentions were correct, the period of limitations on collection would not have been suspended during the CDP process, and his tax liabilities would appear to have been uncollectible. The Tax Court (Judge Lauber) held that when the date appearing on a levy notice is earlier than the date of mailing, the 30-day period prescribed by § 6330(a)(2) and (3)(B) is calculated by reference to the date of mailing. The statutory directive that levy and lien notices should be drafted “in simple and nontechnical terms” does not require invalidation of a levy notice when there is a mismatch between the letter date and the mailing date. On the facts of the case, the taxpayer’s request for a CDP hearing was timely because he mailed his Form 12153 to the IRS, and under §§ 7502 and 7503 it was deemed received by the IRS, within 30 days of the IRS’s mailing of the levy notice, even though it was mailed more than 30 days after the date on the notice itself. Accordingly, the period of limitations on collection was suspended pursuant to § 6330(e)(1) when the taxpayer timely requested a CDP hearing.

a. The D.C. Circuit agrees. The take-away: keep the envelope in which the final notice of intent to levy is mailed! Weiss v. Commissioner, 121 A.F.T.R.2d ¶ 2018-1853 (D.C. Cir. 5/22/18). In a per curiam, unpublished opinion, the U.S. Court of Appeals for the D.C. Circuit has affirmed the Tax Court’s decision. According to the court, when the date appearing on a levy notice is earlier than the date of mailing, the 30-day period prescribed by § 6330(a)(2) and (3)(B) is calculated by reference to the date of mailing. Although the taxpayer mailed his request for a CDP hearing more than 30 days after the date of the notice of levy, he mailed it within 30 days of the date on which the IRS mailed the notice. (The court’s opinion notes that the taxpayer’s wife opened the IRS notice and discarded the envelope, so that the taxpayer apparently was not aware of the later date of mailing.) Because his request for a CDP hearing was timely, it had the effect of suspending the running of the ten-year limitations period on collection, and therefore the IRS could exercise its collection powers. The court expressed its dissatisfaction with its ruling as follows:

Nonetheless, in spite of the unappealing proposition that we must side either with a taxpayer deliberately attempting to manipulate the Code to prevent paying his own taxes or a government agency that seems not to care whether it provides the citizenry with notice of their rights and liabilities, we must decide whether the date on the notice or the date of mailing governs. The taxpayer's position has the advantage of common sense. But the government’s position has the insurmountable advantage of compliance with the language of the statute.
2. The fees for installment agreements are going up! T.D. 9798, User Fees for Installment Agreements, 81 F.R. 86955 (12/2/16). The Treasury Department and the IRS have finalized without change proposed regulations (REG-108792-16, User Fees for Installment Agreements, 81 F.R. 56543 (8/22/16)) that significantly increase the user fees for entering into an installment agreement. Prior to the effective date of these regulations: (1) the general user fee for an installment agreement is $120, which is reduced to $52 for a direct debit installment agreement that permits the IRS to withdraw the installment payments from the taxpayer’s bank account; (2) the user fee is $43 for a low income taxpayer, defined as a taxpayer who has income at or below 250 percent of the federal poverty guidelines; and (3) the fee for restructuring or reinstating an installment agreement is $50. Under the final regulations, the fee for low income taxpayers remains the same, but the general fee increases to $225, the direct debit fee increases to $107, and the fee for restructuring or reinstating an installment agreement increases to $89. In addition, the regulations establish two new user fees for online payment agreements. The general user fee for a taxpayer who sets up an installment agreement online is $149, and the fee for a direct debit online payment agreement is $31. These regulations apply to installment agreements entered into, restructured, or reinstated on or after January 1, 2017.

   a. Low-income taxpayers can pay no fee for installment agreements, and the user fees for installment agreements for other taxpayers will never go up again. Wait, really? The Bipartisan Budget Act of 2018, § 41105, amended Code § 6159 by redesignating subsection (f) as subsection (g) and adding new subsection (f). New § 6159(f) provides that any fee imposed by the IRS for entering into an installment agreement cannot exceed the fee in effect on February 9, 2018, the date of enactment of the legislation. Section 6159(f) as amended also provides that a taxpayer whose adjusted gross income does not exceed 250 percent of the federal poverty guidelines will either (1) pay no fee for a direct debit installment agreement that permits the IRS to withdraw the installment payments from the taxpayer’s bank account, or (2) pay the applicable fee up front if the agreement does not provide for direct debit and then obtain a refund of the fee upon completion of the installment agreement. This provision applies to installment agreements entered into on or after the date which is 60 days after the date of the enactment. Because the date of enactment is February 9, 2018, the provision should apply to agreements entered into on or after April 10, 2018.

3. Economic hardship relief from a levy is not available to a corporate taxpayer. Lindsay Manor Nursing Home, Inc. v. Commissioner, 148 T.C. No. 9 (3/23/17). The taxpayer, a corporation that operated a nursing home in rural Oklahoma, failed to pay its federal withholding and employment taxes for the fourth quarter of 2013. In response to the IRS’s final notice of intent to levy, the taxpayer requested a CDP hearing and submitted a letter to the IRS settlement officer challenging the appropriateness of the levy on the grounds of economic hardship. The taxpayer argued that it was operating at a loss and could not “survive or provide essential care services to its patients if the IRS is able to file a levy against every available source of income.” The IRS settlement officer declined to consider the economic hardship argument because, under the relevant regulation, Reg. § 301.6343-1(b)(4)(i), relief is available only on account of economic hardship of an individual taxpayer. The regulation provides that the IRS must release a levy if one of several conditions is satisfied, including the following:

   The levy is creating an economic hardship due to the financial condition of an individual taxpayer. This condition applies if satisfaction of the levy in whole or in part will cause an individual taxpayer to be unable to pay his or her reasonable basic living expenses.

   The IRS settlement officer issued a notice of determination upholding the collection action. The taxpayer filed a petition in the Tax Court and moved for summary judgment on the grounds that the regulation’s limitation of economic hardship relief to individuals is contrary to the statute (§ 6343(a)(1)(D)) and therefore invalid and that the settlement officer had abused her discretion by failing to consider its request for economic hardship relief. The Tax Court (Judge Paris) upheld the validity of the regulation and concluded that the settlement officer had not abused her discretion. The court assessed the validity of the regulation by applying the two-step analysis of Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984). The court concluded in Chevron step one that the statute, § 6343(a)(1)(D), is ambiguous, and in step two that Reg. § 301.6343-1(b)(4)(i) is a permissible construction of the statute. In its analysis of Chevron step one, the court examined not
only the plain language of the statute but also its legislative history. (The U.S. Supreme Court’s decision in *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120 (2000), suggests that courts should consider legislative history in connection with *Chevron* step one rather than step two, but there is some uncertainty on this point. The Tax Court previously has noted this ambiguity. *Square D Co. v. Commissioner*, 118 T.C. 299, 310 & n.6 (2002), aff’d, 438 F.3d 739 (7th Cir. 2006).) Accordingly, the court denied the taxpayer’s motion for summary judgment.

- Although the court concluded that economic hardship relief from a levy is not available to a corporate taxpayer, it noted that taxpayers other than individuals are entitled to the protection of § 6330(c)(3)(C), which requires an appeals officer conducting a CDP hearing to consider “whether any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary.” The court stated:

  This conclusion [regarding the lack of economic hardship relief under § 6343(a)(1)(D)], however, does not foreclose nonindividual taxpayers from relief in circumstances where the proposed collection action, if sustained, could result in some form of economic difficulty. These economic realities and consequences of the Commissioner’s proposed collection action are properly considered for all taxpayers as part of the intrusiveness analysis within the section 6330(c)(3)(C) balancing test—namely whether the intrusiveness caused by sustaining the proposed collection action outweighs the Government’s need for the efficient collection of taxes.

  a. With economic hardship relief out of the way, the government succeeds in its quest to levy. *Lindsay Manor Nursing Home, Inc. v. Commissioner*, T.C. Memo. 2017-50 (3/23/17). In a separate, memorandum opinion, Judge Paris addressed the taxpayer’s remaining grounds for its motion for summary judgment and the government’s motion for summary judgment. The court rejected the taxpayer’s arguments that the IRS settlement officer (1) abused her discretion in rejecting the taxpayer’s request for an installment agreement, (2) failed adequately to consider whether the proposed collection action balances the need for the efficient collection of taxes with the taxpayer’s legitimate concern that the collection action be no more intrusive than necessary, as required by § 6330(c)(3)(C), and (3) was not impartial. The court denied the taxpayer’s motion for summary judgment and granted the government’s motion.

  b. Vacated as moot. Well, at least we know what the Tax Court thinks about the issue. *Lindsay Manor Nursing Home, Inc. v. Commissioner*, 121 A.F.T.R.2d 2018-1164 (10th Cir. 3/27/18). The taxpayer in this case requested economic hardship relief from a levy on the ground that the levy would leave it unable to care for its patients. During the course of this litigation, however, the taxpayer ceased operating nursing homes. Accordingly, the U.S. Court of Appeals for the Tenth Circuit dismissed the taxpayers’ appeal as moot and vacated the Tax Court’s decision.

4. If the IRS wrongfully levies on assets in a retirement account, the taxpayer can reconvert the assets plus interest in a tax-free rollover. The Bipartisan Budget Act of 2018, § 41104, amended Code § 6343 by adding § 6343(f). Section 6343(f) provides that, if the IRS determines that an individual’s account or benefit under an eligible retirement plan (as defined in § 402(c)(8)(B)) was levied upon wrongfully or otherwise not in accordance with administrative procedures and property or an amount of money is to be returned to the individual, then the individual can contribute the money (plus any interest paid by the IRS) or property into the same retirement plan (if permitted by the plan) or another eligible plan or IRA without regard to the normal limits on contributions or rollovers. When this provision applies, the distribution resulting from the levy and the subsequent contribution are treated as a tax-free rollover. The contribution is treated as having been made for the same taxable year in which the distribution resulting from the levy occurred. Any interest paid by the IRS is treated as earnings within the plan after the contribution and is not included in the taxpayer’s gross income. The rollover does not count towards the one-rollover-per-twelve-months limitation of § 408(d)(3)(B). A taxpayer who already included the amount of the distribution in gross income in an earlier year and has had tax assessed is entitled to have the assessment abated and to obtain a refund of any tax paid. The provision applies to amounts paid by the IRS in taxable years beginning after 2017.
5. The 30-day period for requesting review in the Tax Court of a notice of determination following a CDP hearing is jurisdictional and not subject to equitable tolling. Duggan v. Commissioner, 879 F.3d 1029 (9th Cir. 1/12/18), aff’g Duggan v. Commissioner, No. 4100-15L (U.S. Tax Court (6/26/15)). Following a collection due process hearing, the IRS issued two notices of determination upholding proposed collection action. The notices informed the taxpayer that, if he wished to contest the determinations, he could do so “by ‘fil[ing] a petition with the United States Tax Court within a 30-day period beginning the day after the date of this letter.’” The notices were dated January 7, 2015. The taxpayer mailed his petition to the Tax Court on February 7, 2015, which was 31 days after the date of the notices of determination. The Tax Court (Judge Thornton) granted the IRS’s motion to dismiss for lack of subject matter jurisdiction. On appeal, the taxpayer argued that he had been misled by the notices of determination, which caused him to believe that the day after the letter’s date was day zero, the following day was day one etc., and that his attempts to comply had been reasonable. In an opinion by Judge Christen, the U.S. Court of Appeals for the Ninth Circuit affirmed the Tax Court’s decision. The court held that the 30-day period specified in § 6330(d)(1) is jurisdictional and therefore is not subject to equitable tolling. In reaching this conclusion, the court relied on the plain language of § 6330(d)(1), which provides:

A person may, within 30 days of a determination under this section, petition the Tax Court for review of such determination (and the Tax Court shall have jurisdiction with respect to such matter).

This provision, the court reasoned, “expressly contemplates the Tax Court’s jurisdiction.” The court also reasoned that § 6330(d)(1) was similar to statutory provisions establishing similar filing deadlines, such as the 90-day period specified by § 6015(e)(1)(A) for seeking review in the Tax Court of an IRS determination denying innocent spouse relief, which the Second Circuit concluded is jurisdictional. See Matuszek v. Commissioner, 862 F.3d 192 (2d Cir. 7/5/17). Because the 30-day period specified in § 6330(d)(1) is jurisdictional, the court concluded, the taxpayer’s “failure to meet this deadline divested the Tax Court of the power to hear his case and foreclosed any argument for equitable tolling.”

- In Guralnik v. Commissioner, 146 T.C. 230 (6/2/16), the Tax Court previously had held that the 30-day period specified in § 6330(d)(1) for seeking review in the Tax Court of an IRS notice of determination following a CDP hearing is jurisdictional and not subject to equitable tolling.

a. Assuming without deciding that the 30-day period for seeking review in the Tax Court of an IRS determination following a CDP hearing is subject to equitable tolling, this taxpayer failed to establish circumstances that would justify doing so, says the Fourth Circuit. Cunningham v. Commissioner, 716 Fed. Appx. 182 (4th Cir. 1/18/18), aff’g Cunningham v. Commissioner, No. 14090-16 L (U.S. Tax Court (12/7/16)). The IRS issued a final notice of intent to levy, in response to which the taxpayer requested a collection due process hearing. Following the CDP hearing, the IRS issued a notice of determination upholding the proposed collection action. The notice of determination advised the taxpayer that, if she wished to contest the determination in the Tax Court, she must do so within the 30-day period prescribed by § 6330(d)(1), and that the 30-day period began to run on the day after the date of the letter. The letter was dated May 16, 2016. The taxpayer mailed her petition to the Tax Court on June 16, 2016, which was 31 days after the date of the letter. The Tax Court granted the IRS’s motion to dismiss for lack of subject matter jurisdiction. On appeal, the taxpayer argued that the 30-day period for seeking review in the Tax Court was subject to equitable tolling. In an unpublished opinion by Judge Diaz, the U.S. Court of Appeals for the Fourth Circuit affirmed the Tax Court’s decision. According to the Fourth Circuit, the taxpayer had to clear three hurdles in order for equitable tolling to apply: (1) the 30-day period specified by § 6330(d)(1) must be a mandatory claim-processing rule rather than a jurisdictional rule, (2) equitable tolling must be available for untimely actions under the statute, and (3) the circumstances must warrant equitable tolling. In connection with the second “hurdle,” the court noted that “it is uncertain whether the presumption established by Irwin v. Department of Veterans Affairs, 498 U.S. 89 (1990), that equitable tolling is available to litigants applies at all outside the context of Article III courts.” But the court rested its decision on the third condition. In the court’s view, circumstances warranting equitable tolling were “wholly absent here.” The taxpayer argued that she had been misled by the notice of determination, which caused her to believe that the day after the letter’s date was day zero, the
following day was day one etc. The court rejected this interpretation as contrary not only to Tax Court Rule 25(a), but also to the plain language of the letter and common sense. Equitable tolling, the court emphasized, is available only in rare instances in which it would be unconscionable to enforce a limitations period due to circumstances other than the party’s own conduct. In this case, the court stated, the error resulted from the taxpayer’s own mistake.

G. Innocent Spouse

1. Never, ever, never rely upon IRS correspondence concerning the law, and school your students and junior colleagues about the harsh reality that there is no equitable relief in tax from jurisdictional requirements. Rubel v. Commissioner, 856 F.3d 301 (3d Cir. 5/9/17), aff’g Rubel v. Commissioner, No. 9183-16 (U.S. Tax Court 7/11/16). In a case that went all the way to the U.S. Court of Appeals for the Third Circuit, the taxpayer, admirably represented by the Federal Tax Clinic at the Harvard Legal Services Center, claimed innocent spouse relief under § 6015 for the years 2005 through 2008. The IRS had denied the taxpayer’s requests for each year via four separate notices of determination issued in January 2016. Section 6015(e)(1)(A) provides that a taxpayer who seeks innocent spouse relief may petition the Tax Court and that the Tax Court “shall have jurisdiction” if the petition is filed within specified time limits and no later than 90 days after the date the IRS mails the notice of determination. For the years 2006 through 2008, the taxpayer’s petition in Tax Court was due by April 4, 2016. For 2005, the taxpayer’s petition was due by April 12, 2016. Meanwhile, after receiving the notices, the taxpayer submitted additional information to the IRS concerning her claim for innocent spouse relief. The IRS again denied the taxpayer’s claim via letter dated March 3, 2016; however, the letter misrepresented the due date for filing a petition in the Tax Court stating: “Please be advised this correspondence doesn’t extend the time to file a petition with the U.S. Tax Court.” The taxpayer subsequently filed a petition in the Tax Court on April 19, 2016, and the IRS moved the Tax Court to dismiss the taxpayer’s claim for lack of jurisdiction (because the petition was outside the 90-day period). The Tax Court agreed with the IRS and dismissed the petition. The taxpayer appealed to the Third Circuit arguing for equitable tolling and estoppel against the IRS due to the misrepresentation in the March 3, 2016, IRS letter. The Third Circuit affirmed the Tax Court’s dismissal of the case stating: “[T]he ninety-day deadline is jurisdictional and cannot be altered ‘regardless of the equities’ of the case.”

a. Another case confirming that you cannot rely on what the IRS tells you about the filing deadline! The 90-day period for filing a Tax Court petition seeking review of an IRS determination denying innocent spouse relief is jurisdictional and not subject to equitable tolling. Matuszak v. Commissioner, 862 F.3d 192 (2d Cir. 7/5/17), aff’g Matuszak v. Commissioner, No. 471-15 (U.S. Tax Court 12/29/15). The IRS issued a notice of determination denying the taxpayer’s request for innocent spouse relief. Under § 6015(e)(1)(A), the taxpayer then had 90 days from the date of mailing of the notice of determination to file a petition in the Tax Court. The taxpayer filed her petition in the Tax Court one day late. The Tax Court (Judge Marvel) granted the government’s motion to dismiss the petition. The Tax Court subsequently denied the taxpayer’s motion to vacate. See Matuszak v. Commissioner, No. 471-15 (7/29/16). In doing so, the Tax Court rejected the taxpayer’s argument that the 90-day period for filing the petition could and should be equitably tolled because she had relied on erroneous verbal advice from IRS agents concerning the deadline for filing the petition. The taxpayer argued that recent developments in jurisdictional jurisprudence warranted overruling Pollock v. Commissioner, 132 T.C. 21 (2009), in which the court had concluded that the 90-day period of § 6015(e)(1)(A) is jurisdictional and not subject to equitable tolling. The Tax Court, however, declined to do so. The Tax Court noted that, in Guralnik v. Commissioner, 146 T.C. 230 (6/2/16), it had recently rejected a similar argument for changing its view on the jurisdictional nature of the 30-day period in § 6330(d)(1) for seeking review in the Tax Court of an IRS notice of determination following a CDP hearing. In a per curiam opinion, the U.S. Court of Appeals for the Second Circuit affirmed the Tax Court’s decision. The Second Circuit acknowledged that recent decisions from the U.S. Supreme Court have distinguished between jurisdictional rules, which are not subject to equitable tolling, and non-jurisdictional claim-processing rules, which are. Nevertheless, the Second Circuit concluded that the 90-day period specified in § 6015(e)(1)(A) is jurisdictional. The court emphasized
that the language of the statute provides that “the Tax Court shall have jurisdiction” if the petition is filed within the 90-day period. The court also noted that, in Maier v. Commissioner, 360 F.3d 61 (2d Cir. 2004), it had previously recognized the jurisdictional nature of § 6015 by concluding that the statute did not confer jurisdiction on the Tax Court over petitions seeking review of innocent spouse determinations filed by the non-electing spouse.

- The taxpayer was represented on the appeal by the Federal Tax Clinic at the Harvard Legal Services Center.

b. Things really are not looking good for those seeking to toll the 90-day period for filing a Tax Court petition to seek review of an IRS determination denying innocent spouse relief. The Fourth Circuit has agreed with the Second and Third Circuits. Nauflett v. Commissioner, 892 F.3d 649 (4th Cir. 6/14/18), aff’g Nauflett v. Commissioner, No. 24427-15 (U.S. Tax Court 8/9/16). The taxpayer in this case sought innocent spouse protection with respect to four years for which she had filed joint returns with her husband. The IRS denied the taxpayer’s requested relief in multiple notices of determination dated July 17, 2015. The notices of determination informed the taxpayer of the rule set forth in § 6015(e)(1)(A), which provides that a taxpayer has 90 days from the date of mailing of the notice of determination to file a petition in the Tax Court. The taxpayer asserted that she had contacted both the IRS contact person listed on the notices and an employee at the IRS Taxpayer Advocate Service for assistance, and that they both incorrectly had informed her that she had until September 22, 2015, to file her petition. The taxpayer’s petition to the Tax Court was postmarked September 22. However, the last day of the 90-day period specified by § 6015(e)(1)(A) was September 15, 2015. The Tax Court (Judge Marvel) granted the IRS’s motion to dismiss the petition. The Tax Court subsequently denied the taxpayer’s motion to vacate or revise. See Nauflett v. Commissioner, No. 24427-15 (U.S. Tax Court 5/25/17). In an opinion by Judge Agee, the U.S. Court of Appeals for the Fourth Circuit affirmed the Tax Court’s decision. The court emphasized that the language of § 6015(e)(1)(A) provides that “the Tax Court shall have jurisdiction” if the petition is filed within the 90-day period. “We need not look beyond that mandate because Congress has, in fact, uttered ‘magic words,’ expressly conditioning the Tax Court’s power on the timely filing of a petition.” The court also relied on the “broader context of subsection (e)(1)(A) within § 6015.” Because § 6015(e)(1)(A) is jurisdictional, the court concluded, courts do not have discretion to waive compliance based on equitable considerations.

H. Miscellaneous

1. The D.C. Circuit found that registered (?) tax return preparers were entitled to be unqualified. The IRS had de gall to require character, competence, and continuing education for “independent” tax return preparers who only needed PTINs to continue preparing error-laden tax returns for their unsophisticated clientele. Loving v. IRS, 742 F.3d 1013 (D.C. Cir. 2/11/14), aff’g 920 F. Supp. 2d 108 (D. D.C. 2/11/13). The D.C. Circuit (Judge Kavanaugh) held that regulations issued in 2011 under 31 U.S.C. § 330 that imposed new character, competence, and continuing education requirements on tax return preparers were “foreclose[d] and render[ed] unreasonable” by the statute, and thus failed at the Chevron step 1 standard. They would have also failed at the Chevron step 2 standard because they were “unreasonable in light of the statute’s text, history, structure, and context.”

- Judge Kavanaugh’s opinion found six problems with the 2011 regulations: (1) tax return preparers were not “representatives” because they are not “agents” and, thus, lack “legal authority to act on the taxpayer’s behalf”; (2) the preparation and filing of a tax return did not constitute “practice … before the Department of the Treasury” because that term implies “an investigation, adversarial hearing, or other adjudicative proceeding”; (3) the history of the statutory language originally enacted in 1884 “indicated that the statute contemplated representation in a contested proceeding”; (4) the regulation was inconsistent with the “broader statutory framework,” (?) in which Congress had enacted a number of statutes specifically directed at tax-return preparers and imposing civil penalties, which would not have been necessary if the IRS had authority to regulate tax-return preparers; (5) the statute would have been clearer had it granted power “for the first time to regulate hundreds of thousands of individuals in the multi-billion dollar tax-preparation industry” [“the enacting Congress did not intend to grow such a large elephant in such a small mousehole”]; and (6) the IRS’s past approach showed that until 2011 it never maintained that it had authority to regulate tax return preparers.
• Judge Kavanaugh concluded: “The IRS may not unilaterally expand its authority through such an expansive, atextual, and ahistorical reading of Section 330.”

a. In light of the IRS loss in Loving v. IRS, a new, voluntary Annual Filing Season Program to give tax return preparers the ability to claim they hold “a valid Annual Filing Season Program Record of Completion” and that they have “complied with the IRS requirements for receiving the Record of Completion.” Rev. Proc. 2014-42, 2014-29 I.R.B. 192 (6/30/14). In order to encourage unenrolled tax return preparers, i.e., those who are not attorneys, CPAs or EAs, to complete continuing education courses in order to get a better understanding of federal tax law, the carrot of being able to claim superiority to the ordinary run-of-the-mill slob tax return preparers is offered. The requirements for this voluntary program include a six-hour refresher course, with a 100-question test at the end, plus other continuing education of two hours of ethics and ten hours of federal tax law topics. Holders of the Record of Completion may not use the terms “certified,” “enrolled,” or “licensed” to describe the designation.

b. The AICPA’s challenge to the Annual Filing Season Program fails, but the court signals that others might successfully challenge it. American Institute of Certified Public Accountants vs. Internal Revenue Service, 199 F. Supp. 3d 55 (D.D.C. 8/3/16). The AICPA challenged as unlawful the voluntary Annual Filing Season Program established by the IRS in Rev. Proc. 2014-42, 2014-29 I.R.B. 192 (6/30/14), and the U.S. Court of Appeals for the District of Columbia ruled that the AICPA had standing to bring the challenge. American Institute of Certified Public Accountants vs. Internal Revenue Service, 804 F.3d 1193 (D.C. Cir. 10/30/15). In that opinion, the D.C. Circuit declined to address an issue raised by the IRS for the first time on appeal: that the AICPA’s grievance does not “fall within the zone of interests protected or regulated by the statutory provision it invokes.” On remand, the District Court (Judge Boasberg) held that the AICPA failed the zone of interests test because its grievance (which the court characterized as the grievance of the AICPA’s members) is neither regulated nor protected by the relevant statute. Accordingly, the court granted the IRS’s motion to dismiss. The court characterized the grievance of the AICPA and its members as competitive injury from brand dilution, i.e., that the AFS Program would dilute the credentials of the AICPA’s members by introducing a government-backed credential and government-sponsored public listing. The relevant statute, the court concluded, is 31 U.S.C. § 330(a), which authorizes the Secretary of the Treasury to regulate the practice of representatives of persons before the Treasury Department and to require that certain conditions be satisfied, such as good character, before admitting a person to practice. The AICPA is not a representative of persons within the zone of interests regulated by the statute, the court concluded, because to satisfy this requirement the party must be regulated by the particular regulatory action being challenged. To demonstrate that it is in the zone of interests protected by the statute, the AICPA would have to demonstrate either that it is an intended beneficiary of the statute or that it is a “suitable challenger” to enforce the statute. The AICPA did not contend that it was an intended beneficiary of the statute, and the court concluded that the AICPA was not a suitable challenger. The court reasoned that the purpose of 31 U.S.C. § 330(a) is consumer protection, and that the AICPA’s interest in avoiding intensified competition as a result of the AFS Program was not congruent with that purpose. “On the contrary, AICPA members’ competitive interests are on a collision course with Congress’s interest in safeguarding consumers.”

• Although it dismissed the AICPA’s challenge, the court added:

    A final word. While AICPA does not have a cause of action under the APA to bring this suit, the Court has little reason to doubt that there may be other challengers who could satisfy the rather undemanding strictures of the zone-of-interests test.

c. The D.C. Circuit had good news and bad news for the AICPA. The good news: the AICPA had standing to challenge the IRS’s Annual Filing Season Program. The bad news: on the merits, the IRS had authority to adopt the program and the program does not violate the Administrative Procedure Act. American Institute of Certified Public Accountants vs. Internal Revenue Service, 122 A.F.T.R.2d ¶2018-5507 (D.C. Cir. 8/14/18). The AICPA appealed the decision of the U.S. District Court for the District of Columbia that the AICPA lacked standing to challenge the IRS’s Annual Filing Season (AFS) Program and the court’s dismissal of the AICPA’s challenge. In an opinion by Judge Ginsburg (with Judge Griffith concurring in part and dissenting in
part), the U.S. Court of Appeals for the District of Columbia Circuit reversed the District Court on the issue of standing and, reaching the merits of the AICPA’s challenge, held that the IRS had statutory authority to create the AFS Program and had not violated the Administrative Procedure Act in doing so. The court addressed three issues: (1) whether the AICPA had standing to challenge the AFS Program, (2) whether the IRS had statutory authority to adopt the AFS Program, and (3) whether the IRS followed the requisite procedures in creating the AFS Program.

Standing. With respect to standing, the court concluded that the AICPA had both constitutional and statutory standing to bring the challenge. The AICPA had constitutional standing, the court held, because its members who employ unenrolled return preparers are injured by the AFS Program, which applies Circular 230 to a new class of employees (the unenrolled preparers) and therefore imposes new supervisory responsibility requirements on those who employ them. On the issue of statutory standing, the court agreed with the District Court that the relevant statute is 31 U.S.C. § 330(a), which authorizes the Secretary of the Treasury to regulate the practice of representatives of persons before the Treasury Department and to require that certain conditions—such as good character—be satisfied before admitting a person to practice. In contrast to the District Court, however, the court held that the AICPA is a representative of persons within the zone of interests regulated by the statute. The relevant zone of interests regulated or protected by the statute, the court reasoned, is consumer protection and regulation of those who practice before the IRS. According to the court, the AICPA’s injury fell within this zone of interests because its members who employ unenrolled agents are injured by the AFS Program, which imposes new supervisory responsibility requirements on them. In other words, the additional supervisory responsibilities of which the AICPA complained established both constitutional and statutory standing.

Statutory Authority for the AFS Program. The court recognized that, when it reverses a District Court’s dismissal of a case for lack of standing, its normal practice is to remand to allow the District Court to address the merits. Nevertheless, the court chose to reach the merits of the AICPA’s challenge because it presented purely legal issues that the parties had fully briefed. The court considered whether two statutes provided the IRS with authority to implement the AFS Program. First, the court considered 31 U.S.C. § 330(a), which authorizes the Secretary of the Treasury to regulate the practice of representatives of persons before the Treasury Department. The court rejected the AICPA’s argument that the AFS Program relies on this statute to regulate the business of tax return preparation, contrary to the court’s decision in Loving v. IRS, 742 F.3d 1013 (D.C. Cir. 2014). To the contrary, the court reasoned, unenrolled preparers who participate in the AFS Program do not consent to be subject to Circular 230 in connection with their preparation of tax returns, but rather in connection with their limited right to represent clients before the IRS. The court held that the AFS Program is thus within the IRS’s statutory authority to regulate those who practice before the IRS. Second, the court analyzed Code § 7803(a)(2)(A), which authorizes the IRS to “administer … the execution and application of the internal revenue laws or related statutes.” This provision, the court concluded, does not provide any additional substantive authority for the AFS Program, but does authorize the IRS to publish the public directory of those who hold a “Record of Completion” of the AFS Program. “In sum, § 330(a) authorizes the IRS to establish and operate the Program, and § 7803(a)(2)(A) authorizes the agency to publish the results of the Program.”

Procedural Requirements. The court also considered the AICPA’s argument that the IRS had violated the Administrative Procedure Act by issuing Rev. Proc. 2014-42, 2014-29 I.R.B. 192 (6/30/14), to create the AFS Program. The revenue procedure, the AICPA argued, was a legislative rule that could be adopted only by following a notice-and-comment process, which the IRS had failed to do. The court rejected this argument for two reasons. First, the court explained, agency action constitutes a legislative rule only if it binds private parties or the agency with the force of law, which the AFS Program does not do because it “merely provides an opportunity for those unenrolled preparers who choose to participate and satisfy its requirements.” Second, the court reasoned, Revenue Procedure 2014-42 did not withdraw a benefit that had been created through a notice-and-comment process and therefore could not be regarded as a legislative rule on that basis. Prior to 2011, when the IRS issued the regulations that ultimately were held invalid in Loving, all unenrolled tax return preparers had the ability to represent a taxpayer during an examination if the preparer had prepared and signed the return under examination. Revenue Procedure 2014-42 limits this right to unenrolled preparers who have a
Record of Completion under the AFS Program. Nevertheless, the court held, the pre-2011 right of unenrolled preparers to represent taxpayers “was the product of Revenue Procedure 81-38, which—like Revenue Procedure 2014-42—was issued without notice and comment.”

Dissenting Opinion. Judge Griffith concurred with the majority on the first two issues (standing of the AICPA and statutory authority for the AFS Program). In a lengthy dissenting opinion, however, he dissented on the issue whether Revenue Procedure 2014-42 was a legislative rule that could be issued only following a notice-and-comment process. In Judge Griffith’s view, the revenue procedure is a legislative rule because it binds private parties with the force of law. Specifically, he emphasized, although it is voluntary for those unenrolled preparers who participate, it (1) imposes new supervisory responsibility requirements on enrolled practitioners who employ unenrolled preparers with a Record of Completion, and (2) precludes unenrolled preparers who do not hold a Record of Completion from representing taxpayers before the IRS as they formerly could. In addition, Judge Griffith reasoned, the revenue procedure is a legislative rule because it modifies a rule that had been created following a notice-and-comment process. Contrary to the majority, Judge Griffith expressed the view that the limited practice right of unenrolled preparers had been created not by Rev. Proc. 81-38, but rather by a 1959 regulation, which was subject to notice and comment. See Appearance of Unenrolled Preparers of Returns, 24 Fed. Reg. 1157 (2/14/59). Because Judge Griffith viewed Revenue Procedure 2014-42 as a legislative rule that had not been issued following a notice-and-comment process, the AFS Program, he concluded, is unlawful and should be vacated.

2. Planning to travel overseas? You might need to cancel that vacation if you are seriously delinquent on your taxes. The Fixing America’s Surface Transportation (FAST) Act, § 32101, Pub. L. No. 114-94, signed by the President on 12/4/15, adds new Code § 7345, which provides that having a “seriously delinquent tax debt” is grounds for denial, revocation, or limitation of a passport. A “seriously delinquent tax debt” is generally defined as an unpaid, legally enforceable federal tax liability of an individual that has been assessed and exceeds $50,000 (to be adjusted in future years for inflation) for which a notice of lien has been filed in public records pursuant to § 6323 or a notice of levy has been filed pursuant to § 6331. Debts that are being paid on a timely basis pursuant to an installment agreement or an offer in compromise are excluded from the category of seriously delinquent tax debts, as are debts with respect to which collection is suspended because a collection due process hearing or innocent spouse relief has been requested or is pending. The IRS will certify to the Secretary of the Treasury that an individual has a seriously delinquent tax debt, and Treasury will transmit the certifications to the Secretary of State for action. The IRS must contemporaneously notify the taxpayer of the certification. The taxpayer is permitted to challenge the certification as erroneous by bringing an action in a United States District Court or the Tax Court. The new provision is effective on the date of enactment, 12/4/15.

a. The IRS prepares to implement passport denial and revocation procedures. On June 2, 2017 the IRS updated its website with information about upcoming implementation procedures for Code § 7345, added by the FAST Act, which provides that having a “seriously delinquent tax debt” is grounds for denial, revocation, or limitation of a passport: https://perma.cc/YBB2-H73Y. The IRS also added a generic paragraph about passport revocation to its Notice of Intent to Levy, both CP 90 and CP 504 (the CDP and non-CDP notices, respectively). On June 7 and June 14, the National Taxpayer Advocate (NTA) published blog posts in which she criticized the IRS’s approach. See https://perma.cc/6GSE-GSHQ and https://perma.cc/3DFP-HCRQ. More formal guidance should be forthcoming, but practitioners should review the IRS website and the NTA’s blog posts so affected clients can be alerted. Under the IRS’s planned approach, the IRS will certify taxpayers with a “seriously delinquent debt” to the State Department automatically when certain criteria are met and the total amount owed passes $50,000. Taxpayers will not receive a warning letter immediately prior to certification. For many taxpayers the Notice of Intent to Levy will arrive long before a passport certification, perhaps years before. Once certification has happened, the taxpayer cannot get it reversed by simply paying down the balance to under the threshold.2

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2 We thank Christine Speidel, Director of the Low-Income Taxpayer Clinic at Villanova University School of Law, for alerting us to this development and for writing the summary of it.
b. The IRS has explained what you need to do to take that overseas trip if you have a seriously delinquent tax debt. Notice 2018-1, 2018-3 I.R.B. 299 (1/12/18). This notice provides information about the implementation of Code § 7345. The notice provides detailed background information on § 7345 and provides guidance to taxpayers on when the IRS will notify the State Department of a seriously delinquent tax debt and steps that can be taken to have a certification reversed. The notice provides that the State Department will not be notified that a taxpayer has a seriously delinquent tax debt if one of the exceptions listed in § 7345(b)(2) applies. Therefore, the State Department will not be notified if the debt (1) is being timely paid pursuant to an installment agreement, (2) is being timely paid under an offer in compromise accepted by the IRS, (3) is being timely paid under the terms of a settlement agreement with the Department of Justice, (4) has collection action suspended because of a request for a due process hearing (or because such a request is pending), or (5) has collection action suspended because the individual made an innocent spouse election (§ 6015(b) or (c)) or the individual requested innocent spouse relief (§ 6015(f)). If the IRS has notified the State Department that an individual has a seriously delinquent tax debt, the IRS will notify the State Department (in accordance with § 7345(c)) that the certification has been reversed if the IRS determines that the tax debt should not have been certified (for example, because one of the exceptions just listed applies or a circumstance set forth in the Internal Revenue Manual applies). Once the State Department receives notification that the certification has been reversed, it is required to remove the certification from the individual’s record. Therefore, the notice suggests,

taxpayers notified that certification of their seriously delinquent tax debt has been transmitted to the State Department should consider paying the tax owed in full, or entering into an installment agreement under section 6159 or an offer in compromise under section 7122 with respect to the debt.

The notice provides that, when a taxpayer who has been certified as having a seriously delinquent tax debt applies for a passport, the State Department will provide the applicant with 90 days to resolve their tax delinquency before denying the application. The notice advises that, if a taxpayer needs a passport to travel within those 90 days, the taxpayer must contact the IRS and resolve the matter within 45 days from the date of the passport application so that the IRS has adequate time to notify the State Department. Ways of resolving the matter include making full payment, entering into an installment agreement, or having the IRS accept an offer in compromise. Finally, the notice reminds taxpayers that the sole remedy for a taxpayer who believes that a certification is erroneous (or that the IRS has incorrectly failed to reverse a certification) is to bring an action in a United States District Court or in the Tax Court. Nevertheless, the notice suggests, “the taxpayer may contact the phone number in the Notice CP508C to request reversal of the certification if the taxpayer believes that the certification is erroneous.”

• The IRS began sending certifications of unpaid tax debt to the State Department in February 2018.

3. The IRS has provided extensions of filing and payment due dates for those affected by California wildfires, flooding, mudflows and debris flows. In news release CA-2018-1 (1/17/18), the IRS has extended to April 30, 2018, several filing and payment due dates for those affected by the wildfires, flooding, mudflows and debris flows that took place beginning on December 4, 2017, in parts of California. The relief is available to individuals and businesses in the counties of Los Angeles, San Diego, Santa Barbara, and Ventura. The due dates extended include the January 16, 2018, due date for quarterly estimated tax payments and the April 17, 2018, due date for 2017 individual returns. More generally, taxpayers have until April 30, 2018, to file most tax returns (including individual, corporate, and estate and trust income tax returns; partnership returns, S corporation returns, and trust returns; estate, gift, and generation-skipping transfer tax returns; and employment and certain excise tax returns; annual information returns of tax-exempt organizations; and employment and certain excise tax returns), that have either an original or extended due date occurring on or after December 4, 2017, and before April 30, 2018. The IRS will automatically provide filing and penalty relief to any taxpayer with an address of record in one of these disaster areas. Taxpayers in one of these areas who receive a notice from the IRS regarding a late-filing or late-payment penalty should contact the IRS at the number listed on the notice to have the penalty abated.
Affected taxpayers who reside or have a business located outside the covered disaster area must call the IRS disaster hotline at 866-562-5227 to request this tax relief.

a. The IRS has extended several filing and payment deadlines for those affected by wildfires and high winds that began July 23, 2018, in parts of California. In news release CA-2018-11 (8/6/18), the IRS has extended to November 30, 2018, several filing and payment due dates that occurred beginning on July 23, 2018, for those in areas affected by wildfires and high winds that began July 23, 2018 in parts of California. The relief is available to individuals and businesses in Lake and Shasta Counties, to relief workers who live elsewhere who are affiliated with a recognized government or philanthropic organization assisting in relief efforts in the covered areas, and to those visiting the areas who are killed or injured as a result of the disaster. The due dates extended include (1) the September 17, 2018, due date for quarterly estimated tax payments; (2) the September 17, 2018, due date for certain returns, such as those for calendar-year partnerships that filed timely extension requests for 2017; (3) the October 15, 2018, due date for 2017 individual returns for individuals who filed timely extension requests; (4) the October 31, 2018, due date for quarterly payroll and excise tax returns; (5) the November 15, 2018, due date for 2017 returns of calendar-year tax-exempt organizations that filed timely extension requests, and (6) due dates on or after after July 23, 2018, and before November 30, 2018 for the filing of Form 5500 series returns. The IRS will automatically provide filing and penalty relief to any taxpayer with an address of record in one of these disaster areas. Taxpayers in one of these areas who receive a notice from the IRS regarding a late filing or late-payment penalty should contact the IRS at the number listed on the notice to have the penalty abated.

b. The IRS has provided extensions of filing and payment due dates for those in areas affected by Hurricane Florence. In news releases IR-2018-187 (9/15/18) and SC-2018-01 (9/24/18), the IRS has provided relief from several filing and payment deadlines to those in areas affected by Hurricane Florence. The relief is available to individuals and businesses in parts of North Carolina and South Carolina, to relief workers affiliated with a recognized government or philanthropic organization assisting in relief efforts in the covered areas, and to those visiting the areas who are killed or injured as a result of the disaster.

Deadlines extended to January 31, 2019. For those in affected areas, the following due dates have been extended to January 31, 2019: (1) the September 17, 2018, and January 15, 2019, due dates for quarterly estimated tax payments; (2) the September 17, 2018, due date for certain returns, such as those for calendar-year partnerships that filed timely extension requests for 2017; (3) the October 15, 2018, due date for 2017 individual returns for individuals who filed timely extension requests; (4) the October 31, 2018, due date for quarterly payroll and excise tax returns; (5) the November 15, 2018, due date for 2017 returns of calendar-year tax-exempt organizations that filed timely extension requests, and (6) due dates after September 7, 2018, and before January 31, 2019 for the filing of Form 5500 series returns. Note: individuals who filed a timely request for an extension of time to file their 2017 returns do not obtain any relief for tax payments related to the 2017 return because those payments were due on April 18, 2018.

Waiver of late-deposit penalties for federal payroll and excise taxes. For those in affected areas, the IRS has waived late-deposit penalties for federal payroll and excise taxes due on or after September 7, 2018, and before September 24, 2018, as long as the deposits are made by September 24, 2018.

Relief provided automatically. The IRS will automatically provide filing and penalty relief to any taxpayer with an address of record in one of the designated disaster areas. Taxpayers in one of these areas who receive a notice from the IRS regarding a late-filing or late-payment penalty should contact the IRS at the number listed on the notice to have the penalty abated. In contrast, affected taxpayers who reside or have a business outside the covered disaster area must call the IRS to request relief.

4. When the Tax Court reviews an IRS determination regarding a whistleblower award, the court will limit its review to the administrative record and the appropriate standard of review is for abuse of discretion. Kasper v. Commissioner, 150 T.C. No. 2 (1/9/18). The petitioner sought a whistleblower award of more than $11 million pursuant to § 7623 by informing the IRS that his former employer had failed to pay overtime wages to its employees and therefore had failed to pay
FICA and FUTA taxes on the unpaid wages. The IRS determined that the petitioner’s claim raised an issue for the Department of Labor rather than the IRS and denied his claim. In the employer’s bankruptcy proceedings, the IRS filed a proof of claim and ultimately entered into a closing agreement with the employer pursuant to which the IRS received $37.5 million in settlement of all of the employer’s tax liabilities. The petitioner asserted that the IRS made use of his information “to keep ‘held open’ its bankruptcy claim ….” The petitioner sought review of the IRS’s determination in the Tax Court pursuant to § 7623(b)(4), which provides:

Any determination regarding an award … may, within 30 days of such determination, be appealed to the Tax Court (and the Tax Court shall have jurisdiction with respect to such matter).

In a unanimous reviewed opinion by Judge Holmes (with Judge Paris not participating in the court’s consideration of the opinion), the Tax Court held that the IRS did not abuse its discretion in rejecting the petitioner’s whistleblower award claim. The court first considered the appropriate scope of review in a whistleblower award case and held that the court will limit its review to the administrative record but will permit the record to be supplemented if one of the recognized exceptions to the record rule applies. These exceptions are summarized in Esch v. Yeutter, 876 F.2d 976, 991 (D.C. Cir. 1989). The court reached this conclusion regarding the scope of review after considering, among other things, the language in § 7623(b)(4) and comparing it to the language in statutes that give the court jurisdiction to review IRS other determinations, such as those in innocent spouse cases and collection due process hearings. The court next held that the appropriate standard of review in a whistleblower award case is for abuse of discretion. The court reasoned in part that the underlying tax liability on which the whistleblower’s claim is based is never at issue when the court reviews an IRS determination regarding a whistleblower award. Therefore, the court reasoned, applying an abuse of discretion standard is consistent with the court’s approach in reviewing IRS determinations in CDP hearings, for which the court applies a de novo standard if the taxpayer’s underlying tax liability is at issue and an abuse of discretion standard if it is not. Finally, the court applied the doctrine of Securities and Exchange Commission v. Chenery Corp., 332 U.S. 194 (1947), 318 U.S. 80 (1943), which it described as “an administrative-law principle that says ‘a reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency.’” In this case, the court held, the IRS’s letter denying the petitioner’s claim was “a completely inadequate explanation—it has no reasoning specific to Kasper’s claim, recites only boilerplate, and then states a conclusion.” The court further held that, although it would not consider post hoc rationalizations for an agency’s action, it could consider contemporaneous explanations by the agency for its decision. In this case, the records of the IRS Whistleblower Office reflected the reason for the IRS’s denial of an award, i.e., that the petitioner’s claim raised an issue for the Department of Labor rather than the IRS. Although the court viewed as an error the IRS’s failure to consider certain evidence in considering the petitioner’s claim, “the error was harmless because the rest of the record shows that the IRS did not proceed with any action resulting in the collection of proceeds using [the petitioner’s] information.”

5. Trust but verify—taxpayers need to check the amount of taxes being withheld from their paychecks. The IRS has issued revised withholding tables that take into account changes made by the 2017 Tax Cuts and Jobs Act. Notice 1036 (1/11/18) and IRS News Release IR-2018-05 (1/11/18). Among other changes, the 2017 Tax Cuts and Jobs Act reduced tax rates, significantly increased the standard deduction, and eliminated personal exemption deductions. The overall effect of the legislation is to reduce the amount of tax owed by most taxpayers. In light of these changes, the IRS has issued new withholding tables for use by employers. The new withholding tables generally direct employers to withhold less in taxes from the paychecks of employees compared to the former tables. The IRS has directed employers to begin using the new tables as soon as possible, but no later than February 15, 2018. The new withholding tables are designed not to require employees to file a new Form W-4 with their employers.

a. The IRS has updated its online withholding calculator and issued a revised Form W-4. IRS News Release IR-2018-36 (2/28/18). The IRS has released an updated withholding calculator on its website to help taxpayers check their 2018 withholding in light of the changes made by the 2017 Tax Cuts and Jobs Act. Simultaneously, the IRS issued a revised Form W-
4 that eliminates references to dependents and reflects certain other changes enacted by the legislation.

6. “All explanations tend to be self-serving.” And that’s okay, says the Eleventh Circuit. An affidavit that satisfies FRCP 56 can create an issue of material fact and preclude summary judgment even if it is self-serving and uncorroborated. United States v. Stein, 881 F.3d 853 (11th Cir. 1/31/18) (en banc). The government brought this action against the taxpayer to collect assessed but unpaid taxes, penalties, and interest with respect to several years. In the District Court, the government moved for summary judgment and submitted copies of the taxpayer’s returns, transcripts of her accounts, and an affidavit from an IRS officer. The taxpayer responded by submitting an affidavit in which she stated that, after her husband’s death, she had retained an accounting firm to prepare and file joint returns for the relevant years and that, “to the best of [her] recollection,” she had paid the amounts in question. Her affidavit specified, for each year, when she had filed the return, the amount she had paid, and whether the IRS had a record of that payment. Her affidavit also stated that she no longer had bank records for the years in question and could not obtain them. The District Court granted the government’s motion for summary judgment on the ground that the taxpayer had the burden to overcome the presumption of correctness that is attributed to the government’s documentation, that the taxpayer had failed to meet that burden, and therefore there was no genuine issue of material fact and the government was entitled to judgment as a matter of law. On appeal, a panel of the United States Court of Appeals for the Eleventh Circuit affirmed and cited its previous opinion in May v. United States, 763 F.2d 1295 (11th Cir. 1985), for the proposition that “general and self-serving assertions that [the taxpayer] paid the taxes owed and related late penalties for [the relevant] tax years failed to rebut the presumption established by the [IRS’s] assessments. The Eleventh Circuit subsequently vacated the panel’s opinion and granted rehearing en banc. In a unanimous opinion by Judge Jordan, the Eleventh Circuit held that, if an affidavit satisfies Rule 56 of the Federal Rules of Civil Procedure, it can create an issue of material fact and preclude summary judgment even if the affidavit is self-serving and uncorroborated. The court overruled May v. United States, 763 F.2d 1295 (11th Cir. 1985), “to the extent it holds or suggests that self-serving and uncorroborated statements in a taxpayer’s affidavit cannot create an issue of material fact with respect to the correctness of the government’s assessments.” The court reasoned that, if an affidavit is otherwise admissible, nothing in Rule 56 prohibits it from being self-serving or imposes a corroboration requirement. An affidavit cannot be conclusory, the court emphasized, but most of its prior decisions had concluded that a litigant’s self-serviny statements based on personal knowledge or observation can defeat summary judgment. Tax cases, the court explained, are no different. The court also explained that it was not holding that a self-serving or uncorroborated affidavit always is sufficient to defeat a motion for summary judgment; rather, the court held only that the self-serving and/or uncorroborated nature of an affidavit cannot prevent it from creating an issue of material fact. The court remanded to the panel to determine the impact of the taxpayer’s affidavit.

a. The Eleventh Circuit panel remanded to the District Court. United States v. Stein, 889 F.3d 1200 (11th Cir. 5/9/18). After remand to the original Eleventh Circuit panel, the court, in a per curiam opinion, vacated the summary judgment entered by the District Court and remanded for further consideration. In doing so, the Eleventh Circuit panel declined to address arguments that the parties had not presented to the District Court, such as the government’s argument that, to defeat summary judgment, the taxpayer had to “show that funds were actually delivered to the [Internal Revenue Service].”

7. Seniors now will benefit not only from the early-bird special, but also from a simplified return on Form 1040SR. The Bipartisan Budget Act of 2018, § 41106, directs the Secretary of the Treasury to make available an individual federal income tax return, to be known as “Form 1040SR,” for use by individuals who have attained age 65 by the close of the taxable year. Form 1040SR is to be as similar as practicable to Form 1040EZ, except that it will be available regardless of the taxpayer’s level of income and regardless of whether the taxpayer’s income includes social security benefits, distributions from qualified retirement plans or annuities, interest and dividends, or capital gains and losses taken into account in determining adjusted net capital gain. Congress has directed that Form 1040SR be available for taxable years beginning after February 9, 2018, the date of enactment.
8. Whistleblowers benefit under the Bipartisan Budget Act of 2018, including those whistling to the SEC, CFTC, and SSA. The Bipartisan Budget Act of 2018, §§ 41107 and 41108, make changes that benefit IRS whistleblowers as well as whistleblowers to the Securities and Exchange Commission ("SEC"), the Commodity Futures Trading Commission ("CFTC"), and to the Social Security Administration ("SSA") pursuant to qualifying state false claims acts. Section 41107 amends § 62(a)(21) to permit not only IRS whistleblowers, but also SEC, CFTC, and SSA whistleblowers who receive an award, to deduct their attorneys’ fees in determining adjusted gross income. Previously, § 62(a)(21) allowed an above-the-line deduction for attorneys’ fees paid or incurred in connection with only an IRS (not other government agencies) whistleblower award. Further, § 41108 of the Bipartisan Budget Act amends Code § 7623 (governing IRS whistleblower awards) to expand the definition of the “proceeds” that count toward the $2 million threshold to be eligible for an IRS whistleblower award. Previously, eligible proceeds to determine qualification for an IRS whistleblower award under § 7623 included only “penalties, interest, additions to tax, and additional amounts provided under the internal revenue laws.” As amended, however, revised § 7623 expands the definition of eligible proceeds to include the foregoing as well as “any proceeds arising from laws for which the Internal Revenue Service is authorized to administer, enforce, or investigate, including criminal fines and civil forfeitures, and violations of reporting requirements.” The amendment made to § 62(a)(21) is effective for taxable years beginning after December 31, 2017. The amendment made to § 7623 applies to “information provided before, on, or after the date of enactment [February 9, 2018] with respect to which a final determination for an award has not been made before such date of enactment [February 9, 2018].”

- The expanded § 7623 definition of eligible proceeds presumably is meant to avoid controversies like the one that arose in Whistleblower 21276-13W v. Commissioner, 147 T.C. No. 4 (8/3/16). Following the Tax Court’s prior order that the parties attempt to resolve their differences (144 T.C. 290 (6/2/15)), the IRS and the petitioners, a married couple, agreed that the petitioners were eligible for a whistleblower award of 24 percent of the collected proceeds (i.e., the proceeds eligible for an award), but disagreed as to the amount of the collected proceeds. The targeted taxpayer paid to the government approximately $74 million, which consisted of tax restitution ($20 million), a criminal fine ($22 million), and civil forfeitures representing fees received from U.S. clients ($32 million). The parties agreed that the tax restitution payment constituted collected proceeds, but disagreed as to whether payments of the criminal fine and civil forfeitures constituted collected proceeds. Section 7623(b)(1) provides that a whistleblower award is:

  at least 15 percent but not more than 30 percent of the collected proceeds (including penalties, interest, additions to tax, and additional amounts) resulting from the action (including any related actions) or from any settlement in response to such action.

The IRS argued that the plain language of § 7623 dictates that only proceeds assessed and collected under a provision of title 26 may be used to determine the amount of a whistleblower award because § 7623 relates solely to violations of federal tax laws, and therefore criminal fines and civil forfeitures (which are not assessed under title 26) are not “collected proceeds” within the meaning of § 7623(b)(1). The IRS also argued that, if forfeitures could be used for payment of the whistleblower award, an irreconcilable conflict would be created between the whistleblower statute in title 26 and the provisions of title 42 regarding criminal fines and those of title 31 regarding civil forfeitures that specify the purposes for which moneys collected in this case under title 18 may be used. In a very thorough opinion, the Tax Court (Judge Jacobs) held that § 7623(b)(1), which “is straightforward and written in expansive terms,” does not limit “collected proceeds” to amounts assessed and collected under title 26. The court similarly rejected the IRS’s second argument, which the court characterized as arising “from a fundamental misinterpretation of the plain language of the statute.” According to the court, § 7623(b)(1) “does not refer to, or require, the availability of funds to be used in making an award.”

9. Successive motions to vacate or revise a Tax Court decision that raise substantially the same grounds as prior motions do not affect the 90-day period for filing a notice of appeal. Annamalai v. Commissioner, 884 F.3d 530 (5th Cir. 3/8/18). Addressing an issue of first impression, the U.S. Court of Appeals for the Fifth Circuit has held that successive motions to vacate or revise a Tax Court decision that raise substantially the same grounds as a prior motion do not affect the time period in which a party may appeal the Tax Court’s decision. Under Federal Rule of Appellate
Procedure 13(a), a party who wishes to appeal a decision of the Tax Court must file a notice of appeal within ninety days. The 90-day period runs from either (1) the entry of the Tax Court’s decision, or (2) if a party moves to vacate or revise the Tax Court’s decision, from the entry of the Tax Court’s ruling on that motion. In this case, the Tax Court entered its decision on June 23, 2016. On July 13, 2016, the taxpayers filed motions to vacate the Tax Court’s decision. The Tax Court denied those motions on November 18, 2016. On December 12, 2016, the taxpayers jointly filed a motion to vacate that did not raise any substantially new grounds or arguments. The Tax Court denied this second motion on December 22, 2016. On March 15, 2017, the taxpayers filed a notice of appeal with the clerk of the Tax Court. In a per curiam opinion, the Fifth Circuit held that the taxpayers’ second motion to vacate, which raised substantially the same grounds as their first, had no effect on the period within which they could appeal the Tax Court’s decision. The court found support for its conclusion in its prior decisions concluding that a successive motion for reconsideration based on substantially the same grounds as a prior motion does not toll the running of the thirty-day period provided by Federal Rule of Appellate Procedure 4(a) for appealing decisions in civil cases. The court also noted that its conclusion was consistent with that of the Tenth Circuit, which similarly had held that a taxpayer’s “renewed” motion to vacate a decision of the Tax Court did not affect the running of the 90-day period for appeal. See Okon v. Commissioner, 26 F.3d 1025 (10th Cir. 1994); see also Dean v. Commissioner, 2017 WL 4232520 (D.C. Cir. 9/13/17) (unpublished opinion); Robertson v. Commissioner, 22 Fed. Appx. 215 (4th Cir. 2001). Because the taxpayers had filed their notice of appeal more than ninety days after November 18, 2016, the date on which the Tax Court denied their initial motions to vacate, the Fifth Circuit dismissed their appeal as untimely.

10. Like Attorney General Jeff Sessions, the Tenth Circuit, the Tax Court, the IRS, and Code § 280E continue to be buzz killers for the marijuana industry. Section 280E disallows any deduction or credit otherwise allowable if such amount is paid or incurred in connection with a trade or business consisting of trafficking in controlled substances. Marijuana remains a controlled substance under federal law (the “Controlled Substances Act”) even though it has been legalized for medical or recreational use (or both) in a majority of states. Unlike some other federal agencies under the prior administration, the IRS has not turned a blind eye to taxpayers engaging in the domestic production and sale of marijuana, even where such activities are permitted under state law. Instead, relying upon § 280E, the IRS has audited such taxpayers, disallowed deductions, and asserted corresponding deficiencies and penalties. In general, the courts have upheld the IRS’s position in these cases, as summarized below.

a. The taxpayer may have the “green solution,” but the IRS gets the “green light” to continue its audit of this Colorado marijuana dispensary. The Green Solution Retail, Inc. v. United States, 855 F.3d 1111 (10th Cir. 5/2/17). The United States Court of Appeals for the Tenth Circuit, in an opinion by Judge McHugh, held that the Anti-Injunction Act (“AIA”) and the Declaratory Judgment Act (“DJA”) bar a marijuana dispensary’s suit to enjoin the IRS from auditing its business records. The IRS’s examination of the taxpayer, a Colorado-based marijuana dispensary, sought to determine if § 280E applies to disallow certain of the taxpayer’s claimed deductions and credits. The taxpayer argued that the AIA and DJA do not apply and the IRS thus should be prohibited from examining the taxpayer’s business records on three grounds. One, the taxpayer argued that the Tenth Circuit’s prior decision in Lowrie v. United States, 824 F.2d 827, 830 (10th Cir. 1987), which held that the AIA bars actions seeking to enjoin “activities leading up to, and culminating in, ... assessment” (such as an IRS audit) was implicitly overruled by the Supreme Court of the United States in Direct Marketing Ass’n v. Brohl, ___ U.S. ___, 135 S.Ct. 1124 (2015). Direct Marketing involved a suit by taxpayers seeking to enjoin Colorado taxing authorities from obtaining information from online retailers about the retailers’ customers. The Supreme Court held in Direct Marketing that the Tax Injunction Act (“TIA”), which generally prohibits federal injunctions against state tax assessment and collection actions, did not bar a federal suit seeking to enjoin Colorado from demanding information about customers from the online retailers. After a detailed examination of the language of the AIA as compared to the TIA, the Tenth Circuit determined that its decision in Lowrie was not implicitly overruled by Direct Marketing. Further, the Tenth Circuit determined that if the AIA bars the taxpayer’s suit, then the DJA — which bars declaratory judgments in certain federal tax cases — similarly bars the taxpayer’s suit because the acts are “coterminous.” Therefore, at least in the Tenth Circuit, the AIA and DJA continue to bar taxpayer suits seeking to enjoin the IRS from “activities
leading up to, and culminating in, ... assessment” (such as an IRS audit). **Two**, the taxpayer argued that, by seeking to determine in an audit whether the taxpayer was engaged in a federal crime under the Controlled Substances Act, the IRS was acting outside of its administrative authority. The Tenth Circuit was unconvinced. **Three**, the taxpayer argued that § 280E imposes a “penalty,” not a “tax,” and that the AIA and DJA prohibit only actions seeking to enjoin the assessment or collection of a federal “tax.” The Tenth Circuit dispensed of this latter argument by the taxpayer as well and upheld the District Court’s dismissal of the taxpayer’s suit to enjoin the IRS’s audit.

**b. The Tenth Circuit sniffs out this marijuana business’s refund claim.** *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187 (10th Cir. 7/3/18). In this case before the U.S. Court of Appeals for the Tenth Circuit, the taxpayers (who were the member-partners of Alpenglow Botanicals, LLC) sought a refund from the IRS arguing that, by disallowing Alpenglow’s deductions under § 280E and assessing a deficiency against the taxpayers, the IRS exceeded its administrative authority. Specifically, the taxpayers argued that the IRS lacked authority to investigate and deny tax deductions under § 280E without a criminal conviction having been established first and that, even if it had such authority, the IRS had insufficient evidence of “trafficking” to apply § 280E to the taxpayers LLC. The taxpayers further argued that Congress has not expressly delegated to the IRS the authority to investigate violations of federal drug laws and therefore the IRS cannot make a predicate finding of “trafficking” necessary to deny deductions under § 280E. The taxpayers’ arguments primarily stemmed (**no pun intended**) from the IRS’s notice of deficiency which contained conclusory language that the taxpayer had “committed the crime of trafficking in controlled substances.” Basically, the IRS argued in response that regardless of the conclusory language in the notice of deficiency, the taxpayer’s argument was misplaced as it related to the IRS’s authority to disallow deductions under § 280E. The Tenth Circuit agreed with the IRS, relying in part upon *Green Solution Retail* (discussed above). The court, with Judge McHugh writing for the three-judge panel, held that the IRS acted within its statutory authority by determining, as a matter of civil tax law, whether the taxpayers had trafficked in controlled substances for purposes of § 280E. Thus, the court denied the taxpayer’s refund claim.

**c. You must be high! Marijuana business conducted via an S corporation subjects taxpayer-shareholders to “double taxation” due to the application of § 280E.** *Loughman v. Commissioner*, T.C. Memo. 2018-85 (6/18/18). The taxpayers were the sole owners of a Colorado-based S corporation licensed to grow and sell medical marijuana. For the years in question, the taxpayers’ S corporation claimed deductions under § 162 for items such as compensation, repairs and maintenance, rents, state and local taxes, licenses, interest, depreciation, advertising, and employee benefits. The IRS disallowed most of these deductions under § 280E, but permitted the taxpayer to take into account certain expenses attributable to costs of goods sold for purposes of § 471 and inventory accounting. *See Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173, 180 (2007). The primary deduction disallowed by the IRS under § 280E consisted of wages paid to the taxpayer-shareholders. Of course, this disallowance resulted in the taxpayers being taxed not only on their allocable shares of the S corporation’s income (without deduction for wages), but also for the amount of the wages actually paid to the taxpayer-shareholders. In effect, then, the taxpayer-shareholders were taxed twice on the same revenue even though the business was conducted via an S corporation. The taxpayers argued that this result was “discriminatory in violation of subchapter S.” The Tax Court, Judge Kerrigan, dismissed this argument on the basis that the determination of taxable income is a function of statutory provisions in the Code and is not “discriminatory.” In particular, § 1366 determines a shareholder’s allocable share of income (after allowable deductions) from an S corporation, while § 61(a)(1) separately includes compensation in income. Judge Kerrigan acknowledged the taxpayers’ “double taxation” hardship as a result of § 280E, but also pointed out that the harsh result was the product of the taxpayers’ choice of entity, not a “discriminatory” violation of the principles of subchapter S.

11. You say “FBAR.” We say “FUBAR.” Treasury fails to update FBAR regulations resulting in FUBAR law, so the penalty for willful violations could be capped at $100,000 per account unless and until amended regulations are adopted. Some taxpayers successfully have argued in U.S. District Court that substantial foreign bank account reporting (“FBAR”) penalties assessed by the IRS must be reduced. To understand the significance of these
cases, some background is necessary. Under 31 U.S.C. § 5321(a)(5)(A), the Secretary of the Treasury “may impose” a penalty for FBAR violations, and pursuant to administrative orders, the authority to impose FBAR penalties has been delegated by the Secretary to the IRS. Further, under the current version of 31 U.S.C. § 5321(a)(5)(B)(i), the normal penalty for an FBAR violation is $10,000 per offending account; however, the penalty for a willful FBAR violation “shall be increased to the greater of” $100,000 or 50 percent of the balance in the offending account at the time of the violation. See 31 U.S.C. § 5321(a)(5)(C). These minimum and maximum penalties for willful FBAR violations were changed by the American Jobs Creation Act of 2004 (“AJCA”), Pub. L. No. 108-357, § 821, 118 Stat. 1418 (2004). The prior version of 31 U.S.C. § 5321(a)(5) provided that the penalty for willful FBAR violations was the greater of $25,000 or the balance of the unreported account up to $100,000. Treasury regulations issued under the pre-AJCA version of 31 U.S.C. § 5321(a)(5), reflecting the law at the time, capped the penalty for willful FBAR violations to $100,000 per account. See 31 C.F.R. § 1010.820(g). Unfortunately for the IRS in the cases summarized below, those pre-AJCA regulations have not been updated to reflect the change in the statute itself.

a. First taxpayer victory in the FBAR-FUBAR war. United States v. Colliot, 121 A.F.T.R.2d 2018-1834 (W.D. Tex. 5/16/18). The IRS had assessed multiple FBAR penalties totaling over $745,000 against the taxpayer for willful violations across the years 2007 through 2010. The bulk of the penalties were for violations in 2007 ($548,773) and in 2008 ($196,082). Contesting the IRS’s assessment, the taxpayer argued that the “may impose” language of 31 U.S.C. § 5321(a)(5)(A) leaves the amount of assessable FBAR penalties to the discretion of the Secretary of the Treasury. Further, because the (albeit outdated) Treasury regulations had not been amended to reflect the AJCA’s increase in the minimum and maximum FBAR penalties, the IRS’s authority was limited to the amount prescribed by the existing regulations. As noted above, the existing regulations limit the FBAR penalty for willful violations to $100,000 per unreported account. The IRS argued that notwithstanding Treasury’s failure to update the regulations, the amended statute “implicitly superseded or invalidated” the out-of-date regulations. The District Court for the Western District of Texas, Judge Sparks, disagreed with the IRS and sided with the taxpayer. Judge Sparks reasoned that, although amended 31 U.S.C. § 5321(a)(5)(C) allows greater penalties for willful FBAR violations than the outdated regulations, the “may impose” language of the statute clearly leaves the Secretary of Treasury with the discretion to do so. Accordingly, because the Secretary of the Treasury has not exercised his discretion to update the regulations, the IRS’s authority to assert penalties for willful FBAR violations, the court held, is capped at the greater of $25,000 or the balance of the unreported account up to $100,000 until the regulations are amended. Judge Sparks concluded his opinion by ordering the taxpayer and the IRS to brief the court on the appropriate remedy that should be granted, so the exact amount of the FBAR penalties (if any) to be imposed upon the taxpayer in Colliot was not determined by the court.

b. Second taxpayer victory in the FBAR-FUBAR war. United States v. Wadhan, 325 F. Supp. 3d 1136 (D. Colo. 7/18/18). In a very similar case, the U.S. District Court for the District of Colorado (Judge Krieger) held that penalties totaling over $2 million assessed against a taxpayer for willful FBAR violations across the years 2008 through 2010 must be reduced and capped at $100,000 per unreported account. Judge Krieger reiterated that although the current version of 31 U.S.C. § 5321(a)(5) permits a higher amount, existing (albeit outdated) Treasury regulations (31 C.F.R. § 1010.820(g)) limit the IRS’s authority to assess penalties to the greater of $25,000 or the balance of the unreported account up to $100,000. Judge Krieger cited the court’s decision in United States v. Colliot 121 A.F.T.R.2d 2018-1834 (W.D. Tex. 5/16/18), as support for her decision. Judge Krieger further reasoned that, although Treasury has updated other regulations since 2004 to increase FBAR penalties for inflation (see, e.g., 31 C.F.R. § 1010.821), Treasury has not updated the regulations to reflect the increased penalties allowed by amended 31 U.S.C. § 5321(a)(5)(C). Like the court in United States v. Colliot, Judge Krieger did not determine the ultimate amount of penalties to be
imposed upon the taxpayer other than to hold that the amount should not exceed $100,000 per unreported account.

c. But wait! A government victory in the FBAR-FUBAR war. **Norman v. United States**, 138 Fed. Cl. 189 (7/31/18). The government assessed a penalty of $803,500 for failure to file an FBAR in 2007 with respect to a Swiss Bank account. The taxpayer, relying on **United States v. Colliot**, 121 A.F.T.R.2d 2018-1834 (W.D. Tex. 5/16/18), argued that the relevant statute, 31 U.S.C. § 5321(a)(5), provides the Secretary of the Treasury with discretion to determine the amount of assessable FBAR penalties and that, because the outdated Treasury regulations had not been amended to reflect the AJCA’s increase in the minimum and maximum FBAR penalties, the IRS’s authority was limited to the amount prescribed by the existing regulations. The Court of Federal Claims (Judge Damich) rejected this argument. Judge Damich reasoned that the amended statute, which provides that the amount of penalties for willful FBAR violations shall be increased to the greater of $100,000 or 50 percent of the account value, is mandatory and removed Treasury’s discretion to provide for a smaller penalty by regulation. Accordingly, the court held, the relevant regulation that provides for a smaller penalty, 31 C.F.R. § 1010.820(g), is invalid.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. The IRS wins three battles but loses the war in this withholding trust fund tax case; a CPA firm may have been the taxpayers’ salvation. **Byrne v. United States**, 857 F.3d 319 (6th Cir. 5/15/17). The two taxpayers were CEO and President of a manufacturing company that they, the company’s controller, and other investors purchased in October 1998. Early in 1999, the taxpayers became aware that the company’s controller had mishandled payroll tax payments (i.e., making biweekly instead of semiweekly payments) for several months resulting in a large penalty assessment by the IRS. As a result of the controller’s continued mishandling of the company’s finances, in April and July of 2000 the taxpayers hired two new employees to assist the controller. In October 2000, the IRS sent the company a notice of a penalty for $98,622.32 for unpaid trust-fund taxes for the first quarter of 2000. These unpaid taxes plus interest were paid in November 2000. In December 2000, the company’s independent CPA firm issued a “clean” audit letter regarding the company’s financial statements through September 30, 2000; however, the letter noted that the company had “flaws” in its accounting practices. Subsequently, in January of 2001, the company’s lender discovered that not only had the company missed payroll tax payments for the last three quarters of 2000, but the controller had falsely overstated accounts receivable records to hide the company’s financial difficulties. In April 2001, the company filed for bankruptcy protection and ultimately was liquidated. Then, in July 2005, the IRS assessed $855,668.35 responsible person penalty taxes against the taxpayers under § 6672. The taxpayers subsequently paid a portion of the penalty taxes and filed refund claims instituting this action. The U.S. Court of Appeals for the Sixth Circuit previously had affirmed the District Court’s ruling that the taxpayers were responsible persons for purposes of § 6672(a), but remanded the case to the District Court to determine if the taxpayers had acted willfully as required by the statute. **Byrne v. United States**, 498 Fed. Appx. 555 (6th Cir. 2012). After a bench trial, the District Court held that the taxpayers had acted willfully because they recklessly disregarded the risk that the trust fund taxes were not being paid. In an opinion by Judge Batchelder, a three-judge panel of the Sixth Circuit reversed the District Court and held as a matter of first impression that (i) a determination of “willfulness” under § 6672 is a question of “ultimate fact” subject to de novo review on appeal, and (ii) even if the taxpayers were negligent, and possibly even reckless, in their failure to determine whether trust fund taxes were being paid, their belief that the trust fund taxes had been paid was reasonable under the circumstances and therefore they had not acted willfully within the meaning of § 6672. In particular, the Sixth Circuit pointed to the hiring of two employees to assist the controller in 2000 and the taxpayers’ reliance upon the “clean” audit letter issued by the company’s CPA firm in December 2000.

In reaching its decision, the Sixth Circuit apparently aligns itself with a similar “reasonable belief” exception adopted by the Second Circuit, noting:

In many circuits, “[r]eckless disregard includes failure to investigate or correct mismanagement after being notified that withholding taxes have not been paid.” **Morgan v. United States**, 937 F.2d 281, 286 (5th Cir. 1991) (per curiam); see also
a. Unlike the taxpayer in Byrne who had a reasonable basis to believe the company was meeting its payroll tax obligations, this taxpayer found out that the ostrich defense will not “fly” (pun intended). United States v. Hartman, 896 F.3d 759 (6th Cir. 7/25/18). In a case somewhat similar to Byrne v. United States, 857 F.3d 319 (6th Cir. 5/15/17), the Sixth Circuit (in an opinion by Judge Sutton) upheld a federal district court decision imposing liability on the taxpayer under § 6672 for an amount equal to the business’s unpaid withholding taxes. The taxpayer and another individual had founded the company, and the taxpayer had placed the other individual in charge of payroll. Unfortunately, though, the other individual did not do well in this role, and eventually the taxpayer discovered that the company had not paid payroll taxes to the IRS. After both founders met with the IRS, the taxpayer directed the other individual founder to pay all delinquencies as well as future payroll taxes on a timely basis; however, the taxpayer did not follow up and subsequently became aware (finding a number of unmailed checks to the IRS as well as learning other clues) that payroll taxes were not being paid. The District Court held on a motion for summary judgment that the taxpayer “recklessly” disregarded the company’s payroll obligations, which was tantamount to willfulness, even if the taxpayer did not have actual knowledge that payroll taxes were not being paid to the IRS. The Sixth Circuit upheld the District Court’s ruling, holding that although neither negligence nor gross negligence constitutes willfulness, reckless disregard is tantamount to willfulness. The Sixth Circuit concluded that the taxpayer was reckless because he had actual knowledge of the other individual founder’s “extensive track record of misconduct.” Coupled with other facts of which the taxpayer was aware and which indicated payroll taxes had not been paid, the Sixth Circuit determined that the taxpayer “had no plausible basis” for believing that the company’s payroll tax obligations were being met. Yet, despite this knowledge, the taxpayer did nothing to correct the situation. These facts, the Sixth Circuit wrote, distinguished this case from Byrne where the taxpayers took meaningful steps (by hiring an accounting firm and in-house accountant) to address unpaid payroll taxes.

B. Self-employment Taxes

1. In this employment tax refund case concerning non-qualified stock options, Judge Posner tells railroads to take a hike, but Judge Manion dissents because “money remuneration” and “stock” were different in 1934; however, both apparently agree that “wampum” and “sheep” can be money (and no, we are not making this up)! Wisconsin Central Ltd. v. United States, 856 F.3d 490 (7th Cir. 5/8/17). Beginning in 1996, the taxpayer railroad companies began including non-qualified stock options in the compensation plans for their employees. The taxpayers previously had withheld and paid employment taxes (under the Railroad Retirement Tax Act, § 3231) when employees exercised non-qualified stock options, but subsequently the taxpayers filed claims for refunds with the IRS, which were denied. The United States District Court for the Northern District of Illinois (Judge Feinerman) also denied the taxpayers’ refund claim, and the taxpayers appealed to the Seventh Circuit. The taxpayers argued that stock options are not “compensation” because they are not “money remuneration” within the meaning of § 3231. Section 3231(e)(1) defines taxable compensation as “any form of money remuneration paid to an individual for services rendered as an employee to one or more employers.” Based upon this language, Judge Posner, writing for the majority, explained that even though the term “money remuneration” may not have commonly been understood to include stock when the Railroad Retirement Tax Act was passed in 1937, today stock and stock options are well-accepted forms of compensation and hence taxable under § 3231. Judge Posner wrote, “The dictionary definition of money may remain constant while the
instruments that comprise it change over time: sheep may have once been a form of money; now stock is.” In short, Judge Posner interprets the term “money remuneration” in § 3231 to be an evolving concept that changes with the times. Judge Manion, however, dissented, arguing that the 1934 edition of Webster’s Dictionary defined money as “[a]nything customarily used as a medium of exchange and measure of value, as sheep, wampum, copper rings, quills of salt or of gold dust, shovel blades, etc.” Thus, in Judge Manion’s view, non-qualified stock options are not “money remuneration” and hence not subject to tax under § 3231. We presume, somewhat sarcastically, that Judge Posner and Judge Manion would agree that “wampum” and “sheep” were taxable in 1937 under § 3231 and would be taxable today as well, although according to their opinions the law is unsettled on this point.

a. The U.S. Supreme Court has reversed the Seventh Circuit and held that non-qualified stock options are not “money remuneration” and therefore are not taxable compensation for purposes of the Railroad Retirement Tax Act. Wisconsin Central Ltd. v. United States, ___ U.S. ___, 138 S. Ct. 2067 (6/21/18). In an opinion by Justice Gorsuch (joined by Justices Roberts, Kennedy, Thomas, and Alito), the U.S. Supreme Court reversed the decision of the Seventh Circuit and held that non-qualified stock options are not “compensation” within the meaning of § 3221 and therefore are not subject to taxation under the Railroad Retirement Tax Act. The Court focused on the definition of the term “compensation” in § 3231(e)(1), which defines compensation as “any form of money remuneration paid to an individual for services rendered as an employee to one or more employers.” The Court looked for guidance to several dictionary definitions of the term “money” that existed contemporaneously with Congress’s 1937 enactment of the Railroad Retirement Tax Act. These definitions generally defined money as currency issued by a recognized authority and used as a medium of exchange. Stock options, the court reasoned, do not fall within that definition. While stock can be bought or sold for money, few of us buy groceries or pay rent or value goods and services in terms of stock. When was the last time you heard a friend say his new car cost “2,450 shares of Microsoft”? Good luck, too, trying to convince the IRS to treat your stock options as a medium of exchange at tax time.

The Court also noted the difference in the language used in the Railroad Retirement Tax Act and in the Federal Insurance Contributions Act (FICA), both of which were enacted by the same Congress. The Railroad Retirement Tax Act taxes “money remuneration.” In contrast, FICA taxes “all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash.” According to the Court, “[t]he Congress that enacted both of these pension schemes knew well the difference between ‘money’ and ‘all’ forms of remuneration.” The Court declined to give Chevron deference to Reg. § 31.3231(e)-1, which provides, “except as specifically limited by the Railroad Retirement Tax Act,” that the term “compensation” in the Railroad Retirement Tax Act has the same meaning as the term “wages” in FICA. The statutory definition of “compensation,” the Court held, is clear and leaves no room for agency interpretation.

• Justice Breyer, joined by Justices Ginsburg, Sotomayor, and Kagan, dissented. Justice Breyer characterized the railroads as “engaging in (and winning) a war of 1930’s dictionaries.” In Justice Breyer’s view, the statutory definition of “money remuneration” is ambiguous, and therefore the Court should have deferred to the Treasury Department’s interpretation of the statute. The Treasury Department, Justice Breyer argued, has consistently interpreted the term “money remuneration” in a manner that supports treating stock options as a form of money remuneration.

C. Excise Taxes

XII. TAX LEGISLATION

A. Enacted

1. Congress couldn’t even get the name right in this legislation. Nevertheless, this is significant legislation that affects virtually all areas of federal taxation. An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, was signed by the President on December 22, 2017. This legislation is colloquially referred to as the Tax Cuts and Jobs Act (“TCJA”). (The legislation included the short title “Tax Cuts and Jobs Act,” but the name was stricken by the Senate Parliamentarian immediately prior to the
Senate’s passage of the final bill.) The TCJA makes significant amendments to the Internal Revenue Code of 1986 that are too numerous to list. The Conference Report accompanying the TCJA may be found here. The legislation generally applies to tax years beginning after 2017. Many of the TCJA changes affecting individual taxpayers are temporary and sunset for taxable years beginning after 2025. Some provisions, such as certain amendments of the rules for depreciation, apply prior to 2018.

2. Congress has retroactively extended a number of provisions designed to act as taxpayer incentives and made other changes. Wait, retroactive incentives? The Bipartisan Budget Act of 2018, Pub. L. No. 115-123, was signed by the President on February 9, 2018. This legislation retroactively extends a number of provisions through 2017, such as § 163(h)(3)(E)’s treatment of mortgage insurance premiums as deductible mortgage interest, the § 222 above-the-line deduction for qualified tuition and related expenses, the § 108(a)(1)(E) exclusion for cancellation of qualified principal residence indebtedness, favorable recovery periods for certain depreciable property, and various credits related to energy efficiency. The legislation also makes certain other changes to the Internal Revenue Code, such as a provision that precludes any increase in the current user fees for installment agreements.

3. Congress has enacted technical corrections to the centralized partnership audit regime. The Consolidated Appropriations Act, 2018, Public Law No: 115-141, was signed by the President on March 23, 2018. Part of the Act makes much-needed technical corrections to the new centralized partnership audit regime. These amendments to the centralized partnership audit regime are effective for taxable years beginning after December 31, 2017, as if enacted as part of The Bipartisan Budget Act of 2015.

XIII. TRUSTS, ESTATES & GIFTS

A. Gross Estate

B. Deductions

1. “The difference between death and taxes is death doesn’t get worse every time Congress meets.” Well, estate and gift taxes actually just got a little better. Congress has doubled the basic exclusion amount. The 2017 Tax Cuts and Jobs Act, § 11061, amended Code § 2010(c)(3) by adding § 2010(c)(3)(C), which increases the basic exclusion amount from $5 million to $10 million for decedents dying after 2017 and before 2026. Pursuant to § 2010(c)(3)(B), the $10 million amount is adjusted for inflation for calendar years after 2011. Accordingly, for 2018, the basic exclusion amount is $11.2 million. The legislation also directs the Treasury Department to issue regulations to carry out the new rule with respect to any difference between the exclusion amount in effect at the time of the decedent’s death and the amount in effect at the time of any gifts the decedent made.

C. Gifts

D. Trusts