RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

Bruce A. McGovern
Professor of Law and Director, Tax Clinic
South Texas College of Law Houston
Houston, Texas 77002
Tele: 713-646-2920
e-mail: bmcgovern@stcl.edu

State Bar of Texas Tax Section
First Wednesday Tax Update
November 1, 2017

Note: This outline was prepared jointly with Professor Cassady V. ("Cass") Brewer of the Georgia State University College of Law, Atlanta, GA. Martin J. McMahon, Jr., James J. Freeland Eminent Scholar in Taxation and Professor of Law Emeritus, University of Florida Levin College of Law, Gainesville, FL, also contributed to this outline.

I. ACCOUNTING 2
II. BUSINESS INCOME AND DEDUCTIONS 2
A. Income 2
B. Deductible Expenses versus Capitalization 2
C. Reasonable Compensation 2
D. Miscellaneous Deductions 2
E. Depreciation & Amortization 2
F. Credits 2
G. Natural Resources Deductions & Credits 3
H. Loss Transactions, Bad Debts, and NOLs 3
I. At-Risk and Passive Activity Losses 3
III. INVESTMENT GAIN 3
IV. COMPENSATION ISSUES 3
A. Fringe Benefits 3
B. Qualified Deferred Compensation Plans 3
C. Nonqualified Deferred Compensation, Section 83, and Stock Options 5
D. Individual Retirement Accounts 6
V. PERSONAL AND INDIVIDUAL INCOME AND DEDUCTIONS 6
A. Rates 6
B. Miscellaneous Income 6
C. Hobby Losses and § 280A Home Office and Vacation Homes 6
D. Deductions and Credits for Personal Expenses 6
E. Divorce Tax Issues 7
F. Education 7
G. Alternative Minimum Tax 7
VI. CORPORATIONS 7
A. Entity and Formation 7
B. Distributions and Redemptions 7
C. Liquidations 7

D. S Corporations 7
E. Mergers, Acquisitions and Reorganizations 8
F. Corporate Divisions 8
G. Affiliated Corporations and Consolidated Returns 8
H. Miscellaneous Corporate Issues 8

VII. PARTNERSHIPS 10
A. Formation and Taxable Years 10
B. Allocations of Distributive Share, Debt, and Outside Basis 10
C. Distributions and Transactions Between the Partnership and Partners 10
D. Sales of Partnership Interests, Liquidations and Mergers 12
E. Inside Basis Adjustments 12
F. Partnership Audit Rules 12
G. Miscellaneous 12

VIII. TAX SHELTERS 12

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING 12
A. Exempt Organizations 12
B. Charitable Giving 13

X. TAX PROCEDURE 14
A. Interest, Penalties and Prosecutions 14
B. Discovery: Summons and FOIA 14
C. Litigation Costs 16
D. StatutoryNotice of Deficiency 16
E. Statute of Limitations 16
F. Liens and Collections 16
G. Innocent Spouse 16
H. Miscellaneous 16

XI. WITHHOLDING AND EXCISE TAXES 17

XII. TAX LEGISLATION 17

XIII. TRUSTS, ESTATES & GIFTS 17

I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

E. Depreciation & Amortization

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, Huricane 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 September 21, 2017. 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.

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

I. At-Risk and Passive Activity Losses

III. INVESTMENT GAIN

IV. COMPENSATION ISSUES

A. Fringe Benefits

B. Qualified Deferred Compensation Plans

1. Retirement plans can make loans and hardship distributions to victims of Hurricanes Harvey and Irma. 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). Section 401(k) plans and similar employer-sponsored retirement plans can make loans and hardship distributions to victims of Hurricanes Harvey and Irma. Participants in § 401(k) plans, employees of public schools and tax-exempt organizations with § 403(b) tax-sheltered annuities, as well as state and local government employees with § 457(b) deferred-compensation plans, may be eligible to take advantage of these streamlined loan procedures and liberalized hardship distribution rules. IRA participants are barred from taking out loans, but may be eligible to receive distributions under liberalized procedures. Pursuant to this relief, an eligible plan will not be treated as failing to satisfy any requirement under the Code or regulations merely because the plan makes a loan, or a hardship distribution for a need arising from Hurricanes Harvey or Irma, to an employee, former employee, or certain family members of employees whose principal residence or place of employment was in one of the Texas counties (as of August 23, 2017) or Florida counties (as of September 4, 2017) identified for individual assistance by the Federal Emergency Management Agency (FEMA) because of the devastation caused by Hurricanes Harvey or Irma. Similar relief applies with respect to additional areas identified by FEMA for individual assistance after August 23, 2017 (in the case of Harvey) or September 4, 2017

(in the case of Irma). To qualify for this relief, hardship withdrawals must be made by January 31, 2018. To facilitate access to plan loans and distributions, the IRS will not treat a plan as failing to follow procedural requirements imposed by the terms of the plan for plan loans or distributions merely because those requirements are disregarded for any period beginning on or after August 23, 2017 (in the case of Harvey) or September 4, 2017 (in the case of Irma) and continuing through January 31, 2018, provided the plan administrator (or financial institution in the case of IRAs) makes a good-faith diligent effort under the circumstances to comply with those requirements. As soon as practicable, the plan administrator (or financial institution in the case of IRAs) must make a reasonable attempt to assemble any forgone documentation.

- This relief means that a retirement plan can allow a victim of Hurricanes Harvey or Irma to take a hardship distribution or borrow up to the specified statutory limits from the victim's retirement plan. It also means that a person who lives outside the disaster area can take out a retirement plan loan or hardship distribution and use it to assist a son, daughter, parent, grandparent or other dependent who lived or worked in the disaster area.

- A plan is allowed to make loans or hardship distributions before the plan is formally amended to provide for such features. Plan amendments to provide for loans or hardship distributions must be made no later than the end of the first plan year beginning after December 31, 2017. In addition, the plan can ignore the reasons that normally apply to hardship distributions, thus allowing them, for example, to be used for food and shelter.

- Except to the extent the distribution consists of already-taxed amounts, a hardship distribution made pursuant to this relief will be includible in gross income and generally subject to the 10-percent additional tax of § 72(t).

a. **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. 115-63, 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 recontributed within the required period. Because the recontribution might 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 recontribution. **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 recontributed 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 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 September 21, 2017.

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

1. Classic but likely avoidable mistake made by pro se taxpayer participating in IPO: ordinary income coupled with short-term capital loss. Hann v. United States, 120 A.F.T.R.2d 2017-5518 (Fed. Cl. 8/17/17). The taxpayer previously had been granted nonqualified stock options in a closely-held corporation of which he was the CFO. The primary shareholders of the corporation arranged to sell a substantial portion of their stock in an initial public offering ("IPO"). The taxpayer, along with other management employees, was invited to exercise a portion of his nonqualified stock options and sell stock in the IPO alongside the primary shareholders. Accordingly, the taxpayer engaged in a so-called cashless exercise of a portion of his nonqualified stock options. The cashless exercise resulted in roughly $776,000 of § 83 compensation income (equating to the $8.71 per share spread between the fair market value and the strike price of

the stock received) to the taxpayer, which his employer reported on Form W-2. (In this case, the cashless exercise of the nonqualified stock options allowed the taxpayer to acquire stock of his employer without actually paying the strike price in cash. Instead, the amount of the strike price reduced the proceeds the taxpayer received from the immediate sale in the IPO of the shares he had purchased. The taxpayer acquired a basis in the stock received equal to the stock's fair market value, i.e., the sum of the amount of the strike price and the spread included in the taxpayer's gross income under § 83.) Next, working with the underwriters, the taxpayer's stock was sold in the IPO for $15 per share, which generated gross proceeds from the sale of approximately $1.34 million. The strike price of roughly $561,000 was subtracted, leaving the taxpayer with net sale proceeds of $776,000. However, the underwriters deducted a commission of approximately $77,000 from the taxpayer's $776,000 gross proceeds received in the IPO. Therefore, the taxpayer was left with about only $700,000 of cash after the IPO. The taxpayer and his wife originally filed a joint return reporting $776,000 in compensation income (from the cashless exercise) and a $77,000 short-term capital loss (from the sale of the stock). Subsequently, though, the taxpayer filed a refund claim asserting that the $77,000 commission should have been a deductible expense offsetting a portion of the taxpayer's $776,000 of compensation income. The IRS denied the refund claim, asserting that the underwriter's commission of $77,000 was a reduction in the sales proceeds from the sale of the stock, which meant that the taxpayer had sold the stock for less than his basis, resulting in a short-term capital loss. The Court of Claims (Judge Williams) agreed with the IRS and denied the taxpayer's refund claim. The court upheld the IRS's position notwithstanding substance-over-form and step transaction arguments by the taxpayer, who contended that the cashless exercise and the sale of stock in the IPO should be collapsed into one transaction for tax purposes. Judge Williams, however, refused to recast the taxpayer's chosen form of the transaction, thereby resulting in unfavorable tax consequences for the taxpayer.

- *Planning Pointer:* A better way to structure this transaction from a tax standpoint might have been to allow the corporation, not the taxpayer, to sell additional stock in the IPO for $15 per share. The net $700,000 in sale proceeds realized by the corporation (as opposed to the taxpayer) in the IPO would have been nontaxable under § 1032. Then, to complete the transaction, the corporation could have paid $700,000 in compensation income to the taxpayer to terminate the taxpayer's nonqualified stock options.

D. Individual Retirement Accounts

V. PERSONAL AND INDIVIDUAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

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. 115-63, 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 September 21, 2017.

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 September 21, 2017. 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.

E. Divorce Tax Issues

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

C. Liquidations

D. S Corporations

E. Mergers, Acquisitions and Reorganizations

1. Treasury and the IRS have withdrawn the 2005 proposed regulations on transactions involving the transfer of no net value. REG-139633-08, Transactions Involving the Transfer of No Net Value, 82 F.R. 32281 (7/13/17). In 2005, Treasury and the IRS issued proposed regulations that addressed the net value requirement for tax-free transactions under subchapter C and provided that exchanges under §§ 351, 332 and 368 do not qualify for tax-free treatment where there is no net value in the property transferred or received, with exceptions for E, F and some D reorganizations. Transactions Involving the Transfer of No Net Value, 70 F.R. 11903 (3/10/05). The proposed regulations provided that the requirements of § 332 are satisfied only if the recipient corporation receives at least partial payment for each class of stock that it owns in the liquidating corporation. Finally, the proposed regulations provided guidance on the treatment of creditors of an insolvent corporation as proprietors to determine whether continuity of interest is preserved. This last portion of the proposed regulations became final in 2008. *See* Creditor Continuity of Interest, 73 F.R. 75566 (12/12/08). The Treasury Department and the IRS have now withdrawn the remaining portions of the 2005 proposed regulations because "current law is sufficient to ensure that the reorganization provisions and section 351 are used to accomplish readjustments of continuing interests in property held in modified corporate form." With respect to § 332, the preamble refers to several existing authorities as reflecting the position of the Treasury Department and the IRS, including *Spaulding Bakeries v. Commissioner*, 252 F.2d 693 (2d Cir. 1963), *aff'g* 27 T.C. 684 (1957), and *H. K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986).

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

1. If you lie down with dogs, you get up with fleas (even if you are not a "villian"). Kardash v. Commissioner, 866 F.3d 1249 (11th Cir. 8/4/17), *aff'g Kardash v. Commissioner*, T.C. Memo 2015-197 (10/6/15). The taxpayer was one of two minority shareholders in a C corporation controlled by two majority shareholders. The corporation manufactured concrete lintels and sills for residential construction, especially in Florida. The taxpayer, who joined the company in 1979, had worked his way up to president of manufacturing and operations and had retired in January 2014. Over the residential construction boom years 2000 to 2007, the corporation was very profitable with revenues most years of over $100 million. Unbeknowst to the taxpayer, however, the two majority shareholders had siphoned off almost $120 million of cash from the corporation during this time, and the corporation did not pay federal income taxes. By the time the Great Recession hit in 2007-2008, the corporation had become insolvent due to dividends and other amounts paid to shareholders in years 2005, 2006, and 2007. When the IRS came calling in 2009, the corporation had only $3 to $8 million in assets—there was a dispute as to the assets' fair market value—but owed back taxes of over $129 million. The IRS entered into an installment settlement agreement with the corporation for the full amount of the back tax liability, but it was clear the liability would never be paid in full by the corporation. The IRS also pursued the two controlling-shareholders (one of whom was in jail and the other dead) and reached settlements for some additional amount of the back taxes. The IRS then began looking to other sources of repayment, one of which was the taxpayer. Due to dividends he had received in 2005, 2006, and 2007, the IRS asserted § 6901 transferee liability against the taxpayer for roughly $3.4 million. The Tax Court (Judge Goeke) had held the taxpayer liable as a transferee under § 6901, and the taxpayer appealed making several arguments essentially stating that the payments to the taxpayer, although reported as dividends, were in reality compensation for services rendered not subject to transferee liability. Furthermore, the taxpayer argued that the IRS had to exhaust other remedies against the corporation before pursuing the taxpayer for transferee liability. In an opinion by Judge Boggs, the Eleventh Circuit upheld the Tax Court's decision and imposed transferee liability on the taxpayer. The Eleventh Circuit's holding depended in part upon Florida fraudulent conveyance law, which did not require exhaustion of remedies before pursuing a fraudulent transferee. The Eleventh Circuit summarized the law as follows:

> Stated another way, the existence of an exhaustion requirement in a transferee-liability claim depends upon the legal theory under which the Commissioner brings his claim. If brought under federal equity, then exhaustion is required. If brought under state or federal statute, then the substantive law of the statute governs. [Section] 6901, as a purely procedural statute, permits both. Because the state substantive law in this case does not require exhaustion for liability to exist, we hold that the Commissioner was not required to exhaust remedies against [the corporation] before proceeding against [the taxpayer] as a transferee.

The Eleventh Circuit was not unsympathetic to the taxpayer's situation, further stating in its opinion: "[The taxpayer] was not a villain. By all accounts, he was a victim of the fraud conducted by [the two controlling shareholders]. In perpetrating that fraud, however, they transferred funds from [the corporation] to [the taxpayer] that rightly belonged to the IRS, and the law of Florida requires that [the taxpayer] pay those funds back." We suspect that this statement by the Eleventh Circuit, although nice, did not make the taxpayer feel much better about the outcome.

2. The taxpayers didn't name their captive insurance company "Tax Dodge Insurance Company, Ltd.," but that's about the most we can say in their favor. The Tax Court has sent a torpedo through the hull of many micro-captive insurance arrangements. Avrahami v. Commissioner, 149 T.C. No. 7 (8/21/2017). The taxpayers, a married couple, were shareholders of a subchapter S corporation, American Findings Corporation, that operated three jewelry stores. They also owned several commercial real estate companies. In 2006, the taxpayers paid approximately $150,000 for commercial insurance for these operations. At the suggestion of their CPA, the taxpayers, with the assistance of two attorneys, established a captive insurance company, Feedback Insurance Company, Ltd., which was organized under the laws of St. Kitts. Feedback was wholly owned by Mrs. Avrahami. Feedback made the election provided by § 953(d) to be treated as a domestic corporation for U.S. federal tax purposes and also made the election under § 831(b) to be taxed as a small insurance company. (Generally speaking, the § 831(b) election allows the insurance company to be subject to tax only on its investment income and not be subject to tax on its underwriting income.) For the years in issue, 2009 and 2010, Feedback issued property and casualty policies to the entities owned by the taxpayers providing the following types of coverage: business income, employee fidelity, litigation expense, loss of key employee, tax indemnity, business risk indemnity, and administrative actions. Feedback also reinsured terrorism insurance for other small captive insurance companies through a risk distribution pool established by one of the attorneys exclusively for clients of her firm. During these two years, the entities owned by the taxpayers paid premiums directly to Feedback ranging from $710,000 to $830,000. In addition, the taxpayers' entities paid indirectly to Feedback, as the reinsurer of terrorism insurance, premiums of $360,000 per year. In total, the premiums paid came close to the "target premium" of $1.2 million, which was (during the years in issue) the maximum amount of premiums an insurance company could receive and still qualify for the § 831(b) election. Despite the purchase of insurance coverage through Feedback, the entities owned by the taxpayers continued to maintain without change their insurance coverage purchased from third-party commercial carriers. Feedback paid no claims and therefore accumulated a large surplus. It used this surplus to transfer funds to the taxpayers. For example, in March 2010, Feedback transferred $1.5 million to Belly Button, LLC, a limited liability company whose members ostensibly were the taxpayers' children (who knew nothing about their ownership). Mr. Avrahami, acting on behalf of Belly Button, executed a promissory note to Feedback for $1.5 million, and the taxpayers then transferred the $1.5 million into their personal bank account. In December 2010, Feedback transferred $200,000 directly to Mrs. Avrahami. The IRS challenged the arrangement on the basis that it failed to meet all four of the criteria derived from *Helvering v. Le Gierse*, 312 U.S. 531 (1941), necessary to be considered "insurance": (1) risk-shifting, (2) risk distribution, (3) involve insurance risk, and (4) meet commonly accepted notions of insurance. The IRS also asserted that the amounts Feedback transferred to the taxpayers were ordinary income. The Tax Court (Judge Homes) held that the amounts paid by the taxpayers' entities to Feedback were not insurance premiums and therefore not deductible as business expenses. The court held that the arrangement did not involve risk distribution (factor 1) because Feedback did not have a sufficient number of risk exposures, even taking into account its reinsurance of terrorism policies. The court also held that the arrangement did not meet commonly accepted notions of insurance (factor 4)

because Feedback "was not operated like an insurance company, it issued policies with unclear and contradictory terms, and it charged wholly unreasonable premiums." Because the amounts that Feedback received were not insurance premiums, it failed to qualify as an insurance company, and therefore its elections under § 831(b) and § 953(d) were both invalid. The taxpayers partially prevailed on the tax treatment of amounts that Feedback transferred to them (directly or through Belly Button, LLC): the court held that, of the $1.7 million transferred in 2010, $1.2 million was a nontaxable loan repayment and only $500,000 ($300,000 in March and $200,000 in December) was included in their gross income. Finally, the court held that the taxpayers were not subject to accuracy-related penalties because of their reliance on the advice of an attorney, except with respect to the penalties attributable to the $500,000 transferred by Feedback that was included in their gross income.

- It appears to us that the changes Congress made to Code § 831(b) in the Protecting Americans from Tax Hikes (PATH) Act of 2015 (§ 333), would have precluded the captive insurance company in this case from making the § 831(b) election, and therefore effectively would have precluded the arrangement. The PATH Act added a new diversification requirement that must be met to be eligible to make the § 831(b) election. To be eligible, an insurance company must not have more than 20 percent of its net premiums (or, if greater, direct premiums written) received for the taxable year be attributable to any one policyholder. For this purpose, all policyholders who are related (within the meaning of §§ 267(b) or 707(b)) or who are members of the same controlled group will be treated as one policyholder. In *Avrahami*, by virtue of the related party rules, there would have been only one policyholder who paid more than 20 percent of net premiums. Alternatively, the diversification requirement will be met if no "specified holder" has an interest in the insurance company that is more than a de minimis percentage higher than the percentage of interests in the "specified assets" with respect to the insurance company held (directly or indirectly) by the specified holder. A "specified holder" is any individual who holds (directly or indirectly) an interest in the insurance company and who is a spouse or lineal descendant of an individual who holds an interest (directly or indirectly) in the specified assets with respect to the insurance company. "Specified assets" are the trades or businesses, rights, or assets with respect to which the net written premiums (or direct written premiums) of the insurance company are paid. (An indirect interest is any interest held through a trust, estate, partnership, or corporation.) Except as otherwise provided in regulations or other IRS guidance, 2 percent or less is treated as de minimis. The alternative test also would not have been met in *Avrahami* because Mrs. Avrahami held 100 percent of the captive insurance company's stock and held a much lower percentage (apparently ranging from zero percent to 50 percent) in the insured businesses.

VII. PARTNERSHIPS

A. Formation and Taxable Years

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

C. Distributions and Transactions Between the Partnership and Partners

1. **Even in their wildest dreams the taxpayers couldn't have thought they had a chance of winning this one.** Bosque Canyon Ranch, L.P. v. Commissioner, T.C. Memo. 2015-130 (7/14/15). Bosque Canyon Ranch, L.P. (BCR) developed a tract of several thousand acres known as Bosque Canyon Ranch into home sites and constructed various amenities. Upon completion of development, it marketed limited partnership units at $350,000 per unit. Each purchaser would become a limited partner of BCR, and the partnership would subsequently distribute to that limited partner a fee simple interest in an undeveloped five-acre parcel of property. Parcels were distributed within five months of the cash contribution by a limited partner. The distribution of the parcels was conditioned on BCR granting the North American Land Trust a conservation easement relating to 1,750 acres of Bosque Canyon Ranch. The conservation deed provided that portions of the area subject to the easement included habitat of the golden-cheeked warbler, an endangered species of bird endemic to, and nesting only in, Texas. Property subject to the 2005 easement could not be used for residential, commercial, institutional, industrial, or agricultural purposes. BCR retained various rights relating to the property, including rights to raise livestock; hunt; fish; trap; cut down trees; and construct buildings, recreational facilities, skeet shooting

stations, deer hunting stands, wildlife viewing towers, fences, ponds, roads, trails, and wells. The home site parcel owners and the NALT could, by mutual agreement, modify the boundaries of the home site parcels, provided that any such modification could not "in the Trust's reasonable judgment, directly or indirectly result in any material adverse effect on any of the Conservation Purposes" and "[t]he area of each Homesite parcel *** [could] not be increased." The partnership (1) claimed a deduction for the conservation easement, and (2) reported the $350,000 received form each partner as a capital contribution. The Tax Court (Judge Foley) upheld the IRS's (1) disallowance of the charitable contribution deduction and (2) treatment of the transactions with the limited partners as disguised sales under § 707(a)(2)(B) and Reg. § 1.707-3. With respect to the conservation easement, as a result of the boundary modification provisions, property protected by the easement, at the time it was granted, could subsequently lose this protection. Thus, the restrictions on the use of the property were not granted in perpetuity. I.R.C. § 170(h)(2)(C); *Belk v. Commissioner*, 140 T.C. 1 (2013), *aff'd*, 774 F.3d 221 (4th Cir. 2014). Furthermore, the "baseline documentation was unreliable, incomplete, and insufficient to establish the condition of the relevant property on the date the respective easements were granted." With respect to the contributions and distributions, the facts and circumstances established that the property transfers at issue were disguised sales: "the timing and amount of the distributions to the limited partners were determinable with reasonable certainty at the time the partnerships accepted the limited partners' payments; the limited partners had legally enforceable rights, pursuant to the LP agreements, to receive their Homesite parcels and the appurtenant rights; the transactions effectuated exchanges of the benefits and burdens of ownership relating to the Homesite parcels; the distributions to the partners were disproportionately large in relation to the limited partners' interests in partnership profits; and the limited partners received their Homesite parcels in fee simple without an obligation to return them to the partnerships." The limited partners' payments were not at risk, even though pursuant to the terms of the LP agreements the distributions would not have been made if the easements were not granted. The easements had been granted before the partnership agreement was executed. Furthermore, the partnerships would have refunded the amounts paid by the limited partners if the easements were not granted. Thus, the distributions to the limited partners were made in exchange for the limited partners' payments and were not subject to the entrepreneurial risks of the partnerships' operations. A § 6662(h) gross valuation misstatement penalty was upheld with respect to the claimed charitable contribution deduction.

a. The Fifth Circuit: where tax dreams come true! Well, almost. B.C. Ranch II, L.P. v. Commissioner, 867 F.3d 547 (5th Cir. 8/11/17), *vacat'g and remand'g* T.C. Memo. 2015-130 (7/14/15). In an opinion by Judge Wiener, the Fifth Circuit vacated and remanded the Tax Court's decision. The Fifth Circuit disagreed with the Tax Court's conclusion that the property subject to the conservation easement was not protected in perpetuity as required by § 170(h)(2)(C). The facts of this case, the court reasoned, are distinguishable from those in *Belk v. Commissioner*, 140 T.C. 1 (2013), *aff'd*, 774 F.3d 221 (4th Cir. 2014). In this case, the easements allowed only the homesite parcels' boundaries to be changed within the tracts that are subject to the easements and without increasing the acreage of the homesite parcel in question. Because they did not allow any change in the exterior boundaries of the easements or in their acreagesneither the exterior boundaries nor the total acreage of the easements would ever change. In contrast, in *Belk*, the easement "could be moved, lock, stock, and barrel, to a tract or tracts of land entirely different and remote from the property originally covered by that easement." The easements in this cae, the court explained, more closely resemble the façade conservation easements in *Commissioner v. Simmons*, 646 F.3d 6 (D.C. Cir. 2011), and *Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012), which allowed the easement holder to consent to the partial lifting of the restrictions to allow repairs and changes to the façades of buildings. The court also disagreed with the Tax Court's conclusion that the partnerships' baseline documentation failed to satisfy the requirements of § 1.170A-14(g)(5)(i). The court remanded for the Tax Court to consider the other grounds on which the IRS disallowed the partnerships' charitable contribution deductions for the conservation easements. Although the partnerships did not challenge on appeal the Tax Court's conclusion that disguised sales had occurred, they did contest the amount contributed by each limited partner that should be taken into account as part of a disguised sale. The Fifth Circuit agreed. The homesite parcels were valued at $16,500 to $28,000, and each limited partner generally contibuted $350,000 for a partnership

interest. The Fifth Circuit remanded for the Tax Court to determine the correct amount of any taxable income resulting from the disguised sales. Finally, because the Tax Court's reliance on *United States v. Woods*, 134 S. Ct. 557 (2013), to support the gross valuation misstatement penalty was misplaced and the grounds relied on by the Tax Court to disallow the partnerships' charitable contribution deductions were incorrect, the Fifth Circuit vacated the Tax Court's ruling on this issue and remanded for further consideration.

- Judge Dennis concurred in part and dissented in part. He disagreed with the majority's conclusion that, despite the ability to modify the boundaries of the property subject to the easements, the property was protected in perpetuity:

> The majority opinion attempts to distinguish *Belk*. Respectfully, I find the attempted distinction unpersuasive. As the majority opinion correctly notes, "[t]he court in Belk reasoned that, because the donor of the easement could develop the same land that it had promised to protect, simply by lifting the easement and moving it elsewhere, it was not granted in perpetuity." Op. at 9–10. The majority opinion states that the same concern is not implicated in the present case because "[o]nly discrete five-acre residential parcels, entirely within the exterior boundaries of the easement property, could be moved." Id. at 9–10. I do not see how this distinction obviates the concern expressed by the Belk court: using the modification provision, the BCR Partnerships can lift the easement and swap the previously unprotected five-acre homesites for initially protected land, thereby converting conservation habitat into residential development.

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

G. Miscellaneous

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. The eleven-factor facts and circumstances test for political campaign activity by tax exempts is neither unconstitutionally vague nor overbroad, at least on its face. Freedom Path, Inc. v. Internal Revenue Service, 120 A.F.T.R. 2d 2017-5125 (N.D. Tex. 7/7/17). In this unreported decision from the U.S. District Court for the Northern District of Texas, Judge Fitzwater upheld Rev. Rul. 2004-6, 2004-1 C.B. 328, as being neither unconstitutionally vague nor overbroad on its face for purposes of determining impermissible political campaign activity by a § 501(c)(4) organization. Rev. Rul. 2004-6 sets forth an eleven-factor facts and circumstances test used by the IRS to determine whether certain activity by tax-exempt § 501(c)(3) or (c)(4) organizations is impermissible political campaign activity. The IRS preliminarily denied exempt § 501(c)(4) status to Freedom Path, Inc. on the basis that its proposed activities were primarily political in nature. Freedom Path then sued Lois Lerner and the IRS before the IRS even issued a final negative determination letter to Freedom Path. The opinion in this case is the fourth ruling issued by Judge Fitzwater in a series of claims made in this ongoing lawsuit against the IRS and former Exempt Organizations Director Lois Lerner alleging that conservative § 501(c)(4) groups had been targeted for denial of tax-exempt status during the 2011-2012 election cycle. The specific issue in this case was whether Rev. Rul. 2004-6 was unconstitutional on its face under either the First Amendment (free speech) or Fifth Amendment (due process) for being vague or overbroad. Judge Fitzwater held that it was not. The next and fifth ruling in this case almost certainly will be whether the eleven-factor test in Rev. Rul. 2004-6 was applied in an unconstitutional manner by the IRS to preliminarily deny § 501(c)(4) exempt status to Freedom Path, Inc. Stay tuned . . . .

B. Charitable Giving

1. The charitable contribution deduction taken by these hard-working farmers gets jerked up by the roots when the IRS and the Tax Court deny "qualified farmer" status. Rutkoske v. Commissioner, 149 T.C. No. 6 (8/7/17). The taxpayers were brothers, and each had at least 2,500 hours annually working as farmers within any normal sense of the word. As part of their farming enterprise, the taxpayers were 50/50 members of an LLC that leased 355 acres of farmland to a general partnership through which the taxpayers conducted most of their farming operations. In 2009, the LLC contributed to charity a conservation easement worth approximately $1.3 million on the 355 acres owned by the LLC. During the same year, the LLC sold its remaining rights in the 355 acres and reported capital gain of approximately $1.7 million. The taxpayers had operating gross income from their farming enterprise of only $16,800 each for 2009. The taxpayers took what they thought was the sensible position that, as "qualifed farmers," under § 170(b)(1)(E)(iv) they were not subject to the normal 50 percent "contribution base" (essentially, adjusted gross income) limit under § 170(b)(1)(G) on charitable contribution deductions. Therefore, the taxpayers claimed that for 2009 they were entitled to deduct the full $1.3 million charitable contribution (roughly $650,000 each) against their $1.7 million of capital gain income (roughly $850,000 each). The IRS, however, disagreed, and upon cross-motions for summary judgment, the Tax Court (Judge Jacobs) upheld the IRS's position. Specifically, the IRS contended that under § 170(b)(1)(E)(v), a "qualified farmer or rancher" is a taxpayer whose gross income from the trade or business of farming is greater than 50 percent of the taxpayer's total gross income for the year. Next, for purposes of determining "qualified farmer" status, the LLC should be ignored (pursuant to § 702(a)(4) and Reg. § 1.703-1(a)(2)(iv)) and each taxpayer-member of the LLC must be considered to have individually contributed the conservation easement. Then, gross income from the trade or business of farming (as defined in § 2032A(e)(5)) must be determined individually for each taxpayer and must exceed 50% of total gross income for the taxpayer to be considered a "qualified farmer." Because the taxpayers essentially had only capital gain gross income for 2009, the root question (pun intended) became whether the capital gain income realized and recognized by the LLC counted as gross income from the trade or business of farming. Relying upon the language of § 2032A(e)(5), which refers to "planting," "cultivating," "raising," "cutting," "harvesting," and "storing" but not sales of real estate as farming activities, Judge Jacobs determined that the taxpayers' $1.7 million of capital gain income from the LLC's sale of leased land was not farming income. Judge Jacobs wrote:

> For the contribution of the conservation easement to qualify for the special rule of section 170(b)(1)(E)(iv), we look to the income derived from the sale of the agricultural and/or horticultural products created when engaging in these activities, not from the sale of the land on which the agricultural and/or horticultural products are grown.

Alternatively, Judge Jacobs ruled that, under § 702(b), the character of partnership income is determined at the LLC level, not the partner-member level. The 355 acres were leased by the LLC, not farmed by it. Thus, because the taxpayers had essentially no other gross income for 2009, their income from farming activities ($16,800) did not exceed 50 percent of their total gross for 2009, and they were not "qualified farmers" for 2009. The Tax Court did not rule on the amount of the charitable contribution deduction to which the taxpayers would be entitled, however, because the valuation of the conservation easement also was in dispute, and the value was a fact issue to be determined in a subsequent trial.

- Judge Jacobs was sympathetic to the taxpayers' plight, but nevertheless ruled against them, summing up the result of the Tax Court's holding as follows:

> We recognize that the statute makes it difficult for a farmer to receive a maximum charitable contribution deduction by disposing of a portion of property in a year in which he/she donates a conservation easement, especially in a State with high land values. But it is not our task to rewrite a statute.

- *Practice pointer:* Query whether the taxpayers could have caused the LLC to terminate its lease of the 355 acres and either distribute the land to the taxpayers or

merge the LLC into the general partnership prior to the sale so that their capital gain income would have been considered gross income from the trade or business of farming. Judge Jacobs' primary rationale for the Tax Court's decision would seem to indicate this would not have mattered, but Judge Jacobs' alternative rationale (the LLC was in the leasing not farming business) might have been circumvented.

2. 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.

X. TAX PROCEDURE

A. Interest, Penalties and Prosecutions

B. Discovery: Summons and FOIA

1. In an effort to absolve itself of liability for withholding taxes pursuant to § 3402(d), an employer succeeded in getting access to IRS records of workers it classified as independent contractors. Mescalero Apache Tribe v. Commissioner, 148 T.C. No. 11 (4/5/17). During an audit, the IRS asserted that the Mescalero Apache Tribe (the Tribe) had improperly classified some of its several hundred workers as independent contractors and therefore was liable, pursuant to §§ 3402(a) and 3403, for the taxes that it should have withheld from their wages. Under § 3402(d), an employer is not liable for withholding taxes if, despite the lack of withholding, the taxes are actually paid. The Tribe attempted to ascertain whether the workers had paid the taxes by following the standard procedure required by the IRS, i.e., by asking the workers to complete IRS Form 4669, Statement of Payments Received. However, the Tribe was unable to find 70 of its workers. In the Tax Court, the Tribe moved to compel discovery of the IRS's records of these workers to ascertain whether they paid the taxes in question. The IRS argued that it was precluded from disclosing the information sought by the Tribe because it was return information, the disclosure of which is prohibited by § 6103(a). In a unanimous reviewed opinion by Judge Holmes, the Tax Court held that disclosure of the information sought by the Tribe was permitted by the exception in

§ 6103(h)(4)(C), which permits disclosure in a federal or state judicial or administrative proceeding pertaining to tax administration:

> if such return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding.

The court also rejected the government's argument that, even if the information was disclosable, it was not discoverable because § 3402(d) places the burden on the employer to prove the payment of taxes and requiring the IRS to disclose the information sought by the Tribe would amount to a shifting of the burden of proof. Under Tax Court Rule 70(b), the court noted, information is discoverable "regardless of the burden of proof involved."

- The Tax Court noted differing views among the U.S. Courts of Appeals on the issue of *to whom* return information can be disclosed under the exceptions in § 6103(h)(4). The Fifth Circuit has interpreted § 6103(h)(4) to authorize disclosure only to officials of the Treasury Department or the Department of Justice. *Chamberlain v. Kurtz*, 589 F.2d 827 (5th Cir. 1979). The Tenth Circuit has rejected this view. *First Western Government Securities, Inc. v. Commissioner*, 796 F.2d 356 (10th Cir. 1986). Because the Tax Court's decision in this case most likely will be heard by the Tenth Circuit, the court explained, it chose to follow the precedent set in *First Western*.

- The Tax Court declined to consider whether disclosure was authorized by § 6103(h)(4)(B), which authorizes disclosure "if the treatment of an item reflected on such return is directly related to the resolution of an issue in the proceeding." The term "return information" does not appear in this provision. The court noted that both the Federal and Sixth Circuits have concluded that § 6103(h)(4)(B) does not authorize disclosure of return information that is not reflected on a return, and that the Tenth Circuit seems to have reached a contrary conclusion. *United States v. NorCal Tea Party Patriots*, 817 F.3d 953, 961-62 (6th Cir. 2016); *In re United States*, 669 F.3d 1333, 1339-40 (Fed. Cir. 2012); *Tavery v. United States*, 32 F.3d 1423, 1427-28 (10th Cir. 1994). The Tax Court declined to address the issue on the grounds that it was unnecessary to do so in light of its conclusion that disclosure was authorized by § 6103(h)(4)(C).

a. **We're not going to provide this information during either the examination or appeals process, says the IRS. Looks to us like an incentive for Tax Court litigation.** Chief Counsel Advice 201723020 (5/5/17). The IRS Chief Counsel's Office has advised that the Tax Court's decision in *Mescalero Apache Tribe v. Commissioner*, 148 T.C. No. 11 (4/5/17) "does not stand for the proposition that taxpayers and/or their representatives are entitled to workers' return information during the conduct of an employment tax audit or at Appeals consideration level." Although § 6103(h)(4) authorizes disclosure of workers' return information in the context presented in *Mescalero*, the Chief Counsel Advice explains, the Service is not required to disclose it. As interpreted by this Chief Counsel Advice, "the *Mescalero* decision is limited to discovery requests made by a taxpayer during the pendency of a Tax Court proceeding, where the Tax Court has the ability to determine whether the requested information is disclosable pursuant to IRC 6103(h)(4) AND has balanced the relevancy of the requested information against the burden placed on the Service in accordance with Tax Court Rules 70(b) and 70(c)."

b. **The IRS position on *Mescalero* is "shabby tax administration."** The IRS's Position in *Mescalero Apache Tribe v. Commissioner* Raises Concerns About the IRS's Commitment to Taxpayer Rights (9/7/17). The National Taxpayer Advocate, Nina Olson, has harshly criticized the Chief Counsel's position in Chief Counsel Advice 201723020 (5/5/17). She has described the IRS's position as "a mockery of the Taxpayer Bill of Rights" and as "shabby tax administration." At her request, the NTA staff determined that it would take the IRS one or two hours to obtain the type of information requested by the taxpayer in *Mescalero* in a typical employment tax audit. Taking into account the number of audits and the number of years involved, this would require the IRS to devote about 2,200 hours per year to such requests. This figure pales, she said, in comparison to the significant resources the IRS will instead devote to litigation of the issue. "The waste of taxpayer, IRS, Chief Counsel, and Tax Court resources is astounding." She has encouraged

employers who are unable to obtain requested information from the IRS during an employment tax audit to contact their Local Taxpayer Advocate Office for assistance.

C. Litigation Costs

D. StatutoryNotice of Deficiency

E. Statute of Limitations

F. Liens and Collections

G. Innocent Spouse

H. Miscellaneous

1. Happy Holloween! Trump Executive Order results in death or minimal life support for eight sets of recent regulations. Notice 2017-38, 2017-30 I.R.B. 147 (7/7/17) and Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, Dep't of Treasury, Press Release (10/2/17). On April 21, 2017, President Trump issued Executive Order 13789 directing the Secretary of the Treasury (i) 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. One report was to be issued in 60 days to identify regulations that met any of the foregoing criteria, and a second report was to be issued by September 18, 2017, recommending actions to mitigate the burdens imposed by the identified regulations. In response to the President's Executive Order, the IRS issued as the first report Notice 2017-38, which merely identified eight sets of regulations that possibly met the above-mentioned criteria. (Not surprisingly, perhaps, none of the regulations were deemed to "exceed [the IRS's] statutory authority.") The second report, although originally due in September, was issued by Treasury Secretary Mnuchin on October 2, 2017. The second report recommends certain actions with respect to the eight sets of regulations identified in Notice 2017-38. Specifically, the eight sets of regulations and the actions recommended with respect thereto are summarized below:

Proposed Regulations to be Withdrawn Entirely

1. Proposed Regulations under § 2704 on Restrictions on Liquidation of an Interest for Estate, Gift and Generation-Skipping Transfer Taxes (REG-163113-02, 81 F.R. 51413 (8/4/16)). These regulations concern the determination of transfer-tax valuation discounts with respect to certain restricted interests in family-controlled entities (e.g., family limited partnerships). These regulations have been the subject of much criticism and debate. Accordingly, the second report states that these regulations will be withdrawn entirely and that a withdrawal notice will be published "shortly" in the Federal Register. There is no mention in the second report of further regulatory guidance in this area.
2. Proposed Regulations under § 103 on Definition of Political Subdivision (REG-129067-15, 81 F.R. 8870 (2/23/17)). These regulations define a "political subdivision" of a State (e.g., a city or county) that is eligible to issue tax-exempt bonds for governmental purposes under § 103. lthough the second report indicates that Treasury continues to study this area and may propose more targeted guidance in the future, these regulations also will be withdrawn by subsequent notice in the Federal Register.

Regulations to Consider Revoking in Part

1. Temporary Regulations under § 752 on Liabilities Recognized as Recourse Partnership Liabilities (T.D. 9788, 81 F.R. 69282 (10/5/16)). These regulations address the partnership liability-allocation rules for purposes of disguised sales under § 707 and "bottom-dollar" guarantees used to attract outside basis in partnerships. These regulations also have been the subject of significant criticism and debate. The second report states that, with respect to liability-allocation rules for purposes of disguised sales, Treasury and IRS are considering whether the regulations should be revoked and prior regulations reinstated. On the other hand, with respect to regulations relating to "bottom-dollar" guarantees, the second report

concludes that those regulations should be retained to prevent abuse, and Treasury and IRS do not plan to make any changes to those regulations.

2. Final and Temporary Regulations under § 385 on the Treatment of Certain Interests in Corporations as Stock or Indebtedness (T.D. 9790, 81 F.R. 72858 (10/21/16)). These regulations were meant to combat corporate inversion transactions by multinational corporate groups. The regulations also imposed onerous documentation rules for large corporate groups issuing intercompany debt. Implementation of the documentation rules already had been postponed until 2018 pursuant to Notice 2017-36, 2017-33 I.R.B. 208 (7/28/17). The second report takes things a step further by concluding that the documentation rules in the regulations may be revoked due to the associated increased compliance burden. On the other hand, the second report determines that the portion of the regulations targeting corporate inversion transactions should be retained pending enactment of future tax reform legislation.

3. Final Regulations under § 7602 on the Participation of a Person Described in § 6103(n) in a Summons Interview (T.D. 9778, 81 F.R. 45409 (7/14/16)). These regulations concern rules for allowing IRS-contracted service providers to participate in the interview of a witness under oath. Commentators particularly objected to these rules where the IRS hires outside attorneys to assist with taxpayer audits. Accordingly, the report provides that Treasury and the IRS are considering a prospective amendment that would narrow the ability of the IRS to engage outside attorneys, but still permit the IRS to engage other subject-matter experts such as economists, engineers, etc. (including, though, attorneys who are specialists in highly-technical fields).

Regulations to Consider Substantially Revising

1. Final Regulations under § 367 on the Treatment of Certain Transfers of Property to Foreign Corporations (T.D. 9803, 81 F.R. 91012 (12/16/16)). These regulations concern outbound transfers of foreign goodwill and going concern value that avoid U.S. income tax consequences. Although the second report indicates that these regulations will remain in place, the report also states that Treasury and IRS are developing a proposal that would create an active trade or business exception. The exception thus may permit outbound transfers of foreign goodwill and going concern value attributable to a foreign branch under those circumstances where there is a limited potential for taxpayer abuse.

2. Temporary Regulations under § 337(d) on Certain Transfers of Property to Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs) (T.D. 9770, 81 F.R. 36793 (6/8/16)). These regulations are the relatively new IRC § 355 spinoff rules for RICs and REITs. The second report provides that proposed revisions to these regulations are being considered by Treasury. The proposed revisions would narrow the application of the rules and protect taxpayers against over-recognition of gain in certain circumstances, particularly where a larger corporation makes a REIT election after acquiring a smaller corporation that previously was a party to a spin off.

3. Final Regulations under § 987 on Income and Currency Gain or Loss With Respect to a § 987 Qualified Business Unit (T.D. 9794, 81 F.R. 88806 (12/8/16)). These regulations concern deemed currency gains and losses relating to branch offices. The second report indicates that Treasury and the IRS expect to issue guidance with respect to these regulations that would defer application of the new rules until 2019.

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

XIII. TRUSTS, ESTATES & GIFTS