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TAX SECTION
STATE BAR OF TEXAS

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Dear Fellow Tax Section Members:

It's hard to believe that we are over halfway through our 2017-2018 fiscal year. We are entering spring already, although some parts of the world would consider our spring temperatures summer. There is much happening at the Tax Section! Below is my winter recap.

International Tax Symposium

The **20th Annual International Tax Symposium** took place November 2nd (Dallas) and November 3rd (Houston). The event continues to be a success each year. Between the two locations, there were over 60 attendees. For the first time the Symposium was recorded as a webcast that was broadcast on November 9. Also, on November 8 we presented a separate four hour webinar focused on the nuts and bolts of international tax. The Tax Section received positive comments from attendees on the quality of speakers and topics.

Tax Law in a Day

The Tax Section held its annual **Tax Law in a Day** program on Friday, February 9, 2018 in Houston. The CLE program this year focused on the effect of the new tax laws. This CLE program was started several years ago as a means of providing basic level tax continuing education and is available to both CPAs and attorneys. This year's event will take place at the Westin Oaks Galleria Hotel, Houston, Texas. Many thanks to **Lora Davis**, **Renesha Fountain**, and everyone else who helped make the program a continuing success.

First Wednesday Tax Update

The Tax Section is excited to announce a new **free** webcast series "**First Wednesday Tax Update**". These webcasts have been wildly popular. The webcasts will be offered the first Wednesday of each month and will always focus on Recent Developments in Federal Income Taxation, and be presented by **Bruce McGovern**, Professor of Law and Director, Tax Clinic, South Texas College of Law Houston (and may occasionally include other guest speakers). We hope you will make plans to watch the webcast each month, but if you miss it, check back after a few weeks in the Tax Section's 24/7 online library. Watch your email for sign up information! Special thanks to **Sara Giddings,** Co-Chair of the Solo and Small Firm Committee, for coming up with this idea for providing convenient and relevant continuing legal education for our members, and to **Bruce McGovern**, Chair of the General Tax Committee for bringing Sara's idea to life.

Federal Tax Workshop – 2018

Also new this year is an important new CLE program that is intended to focus in detail on one or two emerging developments in federal income tax law. Each program will strive to have governmental speakers who are involved in crafting the regulatory or sub-regulatory guidance and experienced practitioner speakers. The programs will not be taped so as to encourage open dialogue between the speakers and the audience. The primary goals of the programs are to foster compliance with tax laws through education and to improve tax laws by providing opportunities for day-long discussion by multiple minds about issues. Audience participation is encouraged throughout the program.

The first federal tax workshop program, "**New Partnership Audit Rules-In Depth**" was held at the Belo Mansion in Dallas, Texas on March 21, 2018 was a smash hit with attendees who rated it as "outstanding." The all-day event was co-sponsored by the Tax Section of the State Bar of Texas, the Texas Federal Tax Institute, and the Dallas Bar Association. The event featured government speakers from Washington who are writing the partnership audit regulations, **Rochelle Hodes**, U.S. Treasury, **Brendan O'Dell**, U.S. Treasury, and **Jennifer Black**, Chief Counsel, Internal Revenue Service. The event also featured prominent private practice speakers, including, course director **Dan Baucum**, of Munsch Hardt, **George Hani**, of Miller & Chevalier and **Terence Cuff** of Loeb & Loeb. The event also featured **Joel Crouch** of Meadows Collier, and the Chair and Vice Chair of the Partnership and Real Estate Section of the Tax Section of the State Bar of Texas, **Nate Smithson** and **Lee (Fearless) Meyercord**. Congratulations to **Dan Baucum**, Co-Chair of the CLE Committee of the Tax Section, who conceived of and organized this stellar event. This new CLE offering enables the Tax Section to provide our members an in depth review of a specific topic. Our Tax Section members who attended said they really appreciated the unique format, learned a lot (even if they were frequent speakers themselves on the topic area), and were engaged throughout the program. The attendees appreciated having the opportunity to hear from and engage with the governmental speakers and the prominent private practice speakers. After the event, the governmental speakers also complimented the audience, stating that the audience in Texas (which spoke from floor microphones) had some of the most intelligent comments and questions they had encountered in their speaking engagements, and that some of those comments and questions would make their list of items to consider further when they returned to Washington to draft the partnership audit regulations.

Special thanks to Dan Baucum's firm, **Munsch Hardt** for serving as a sponsor of the event. Thanks also to **Miller & Chevalier** for sponsoring the event. Thanks also to the **Tax Section of the Dallas Bar Association** for co-sponsoring the event. Finally, last but not least, thanks to the **Texas Federal Tax Institute** for co-sponsoring the event. We are very pleased to have worked with the Texas Federal Tax Institute again on a first class CLE event.

Leadership Academy

The Tax Section recently completed a promotional video for the Leadership Academy that is available on the Tax Section's website for future applicants. Check it out to see past participants, many of whom have assumed leadership roles in the State Bar of Texas Tax Section. The next Leadership Academy class will form in the spring of 2019.

Committee on Governmental Submissions

The Committee on Governmental Submissions continues to operate like a well-oiled machine! Already, COGS has completed 15 comment projects for the year with the State and Local Tax Committee at the lead. Included in this number were Comments on Proposed Amendments to 34 Tex. Admin. Code Section 3.287, concerning exemption certificates. Several other projects are currently underway as well.

Law School Outreach/Law School Scholarship Applications

The Tax Section's Law School Outreach initiative is well underway. The Tax Section has provided panel presentations to law students at Southern Methodist University, Texas Tech University, Texas A&M University, and Baylor University. Six more universities are being scheduled as well. Many thanks to **Abbey Garber** for his continued hard work and dedication to this program.

The application period for law school scholarships opened on January 16, 2018. Applications are available on our website. These scholarships are intended to assist students with their financial needs, facilitate and encourage students to enter the practice of tax law in Texas, and become active members of the State Bar Tax Section. **Applications must be postmarked or received by April 6, 2018 and can be emailed to Stephen Long at stephen.long@bakermckenzie.com**. The scholarships will be awarded at the State Bar Annual Meeting in June 2018 in Houston.

Section Representative to the State Bar of Texas Board of Directors

The Tax Section recently nominated **Elizabeth Copeland** to serve as the Large Section Representative to the State Bar Board of Directors. There was one opening for this position and each of the 5 Large Sections of the State Bar submitted their own nominees. Our very own **Elizabeth Copeland** won the nomination and will be serving as Large Section Representative to the State Bar Board of Directors for the 2017 to 2020 term. Congratulations Elizabeth!

Outstanding Texas Tax Lawyer Award

The nominations period for the annual Texas Tax Lawyer Award opened on January 8, 2018. Help us continue this long-standing tradition by nominating a qualified candidate. Nomination forms are available on the Tax Section website. Nominations should be submitted to **Charolette Noel**, Tax Section Secretary, at cfnoel@jonesday.com no later than April 1, 2018. The award will be presented at an awards dinner on Thursday, June 21 in Houston, Texas in conjunction with the 2018 Annual Meeting of the Tax Section.

Deadline for the Spring Edition of the *Texas Tax Lawyer*

The deadline for submitting articles for the Winter edition of the *Texas Tax Lawyer* is **April 15, 2018**. Any members interested in submitting articles should contact **Michelle Spiegel** at michelle.spiegel@nortonrosefulbright.com.

Sponsorships

We are very grateful to our many sponsors of the Tax Section and our events. If your organization would like to become a sponsor, please contact **Jim Roberts**, Sponsorship Chair, at jvroberts@gpm-law.com.

Join a Committee

We have an active set of committees, both substantive and procedural as in previous years. Our substantive committees include: Corporate Tax, Employee Benefits, Energy and Natural Resources, Estate and Gift Tax, General Tax Issues, International Tax, Partnership and Real Estate, Property Tax, Solo and Small Firm, State and Local Tax, Tax Controversy, Tax-Exempt Finance, and Tax-Exempt Organizations. In addition, our facilitator committees include: the Committee on Governmental Submissions, Annual Meeting Planning Committee, Continuing Legal Education Committee, Newsletter Committee, and Tax Law in a Day Committee.

Any members interested in joining a committee can do so by visiting our website at www.texastaxsection.org.

Contact Information

Below is my contact information as well as the contact information for our Tax Section Administrator, Kelly Rorschach, if anyone would like additional information:

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RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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State Bar of Texas Tax Section
First Wednesday Tax Update
October 4, 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

A. Accounting Methods

B. Inventories

C. Installment Method

1. Can an installment sale between related parties ever *not* have the proscribed tax avoidance purpose requisite for denying installment reporting? Vest v. Commissioner, T.C. Memo. 2016-187 (10/6/16). The taxpayers owned 85 percent of Truebeginnings, LLC, which was an accrual basis partnership for federal tax purposes. According to the reported opinion, Truebeginnings in turn owned 100 percent interests in two other partnerships, H.D. Vest Advanced Systems, LLC (VAS), and Metric, LLC (Metric). (We do not understand how a 100 percent owned LLC can be a partnership rather than a disregarded entity or a corporation, but the opinion says they were partnerships and the issue could not have arisen if they were disregarded entities.) In consideration of 10-year promissory notes, Truebeginnings sold computer equipment to VAS and Metric and sold zero-basis intangible assets with an appraised value of $2,885,175 to VAS. Truebeginnings reported over $3 million of gain on the § 453 installment method. The Tax Court

(Judge Lauber) upheld the IRS's conclusion that the sales did not qualify for installment sale treatment pursuant to § 453(g)(1), which disallows installment reporting for installment sales of depreciable property between related persons unless "it is established to the satisfaction of the Secretary that the disposition did not have as one of its principal purposes the avoidance of Federal income tax." I.R.C. § 453(g)(2). TB, VAS, and Metric were clearly "related persons," and the computer equipment and intangible assets that TB sold to VAS and Metric were "depreciable property." The taxpayer failed to carry the burden of proof that tax avoidance "was not among the principal purposes of the asset sale transaction." Judge Lauber reasoned that § 453(g)(2) "resembles other Code sections providing that certain tax treatment will be available only if the taxpayer establishes that the plan or transaction did not have 'as one of its principal purposes the avoidance of Federal income tax,' and that" Tax Court precedent establishes that "a taxpayer in such cases can satisfy his burden of proof only by submitting 'evidence [that] clearly negate[s] an income-tax-avoidance plan.'" *Tecumseh Corrugated Box Co. v. Commissioner*, 94 T.C. 360, 381-382 (1990) (addressing § 453(e)(7)), *aff'd*, 932 F.2d 526 (6th Cir. 1991). The taxpayer's burden in such cases is "a heavy one." *Pescosolido v. Commissioner*, 91 T.C. 52, 56 (1988) (addressing § 306(b)(4)), *aff'd*, 883 F.2d 187 (1st Cir. 1989). In ascertaining the true purpose of the transaction, Judge Lauber stated, the Tax Court accords "more weight to objective facts than to the taxpayer's 'mere denial of tax motivation.'" The enhanced depreciation deductions available to the related buyer is relevant in deciding whether the seller had a principal purpose of avoiding tax. *Guenther v. Commissioner*, T.C. Memo. 1995-280. In this case, the court stated, "[t]he substance of the transaction at issue clearly reveals a principal purpose of tax avoidance."

> Notwithstanding the asset sale, petitioner through TB retained full control over the ad-optimization business. By use of installment reporting, TB aimed to defer for 10 years virtually all the tax on its $3.2 million gain, while VAS and Metric would receive stepped-up bases in, and be able to claim correspondingly large depreciation or amortization deductions on, the assets transferred. ... This tax-avoidance purpose is particularly clear with respect to the intangible assets sold to VAS. Those assets had a zero cost basis in TB's hands, thus yielding zero amortization deductions to it. But VAS claimed a stepped-up basis in those assets of $2,885,175, yielding amortization deductions of $192,345 annually. The enhanced amortization deductions claimed by VAS and Metric, totaling $644,772 for 2008-2010 alone, dwarf the $29,798 gain that TB reported for 2008.

a. The Fifth Circuit affirms. Vest v. Commissioner, ___ Fed. Appx. ___ (5th Cir. 6/2/17). In a per curiam opinion, the U.S. Court of Appeals for the Fifth Circuit affirmed. In response to the taxpayer's argument that the sale of assets from Truebeginnings to the related partnerships had a business purpose, the court stated:

> Even if the sale was motivated by a business purpose, this fact would not necessarily mean that the sale did not also have a principal purpose of tax avoidance. Merely arguing that the sale had a business purpose is not inconsistent with it also having tax avoidance as one of its principal purposes. Accordingly, Vest has failed to demonstrate clear error on the Tax Court's part

D. Year of Inclusion or Deduction

1. Almost as rare as a total solar eclipse: a cash-method taxpayer is entitled to deduct estimated, future expenses. Gregory v. Commissioner, 149 T.C. No. 2 (7/11/17). The taxpayers, a married couple, held 80 percent of the stock of a cash-method S corporation that owned and operated a landfill in Texas. All landfills, regardless of size, must clean up and restore the site upon their inevitable closing. Closing a landfill and complying with federal, state, and local environmental regulations is an expensive endeavor. For this reason, § 468 generally permits a "taxpayer" owning and operating a landfill to deduct currently estimated "qualified reclamation or closing costs" anticipated in a future year or years. When the future costs actually are paid in a future year, § 468 disallows a deduction to the extent the costs do not exceed the taxpayer's previously established and annually calculated § 468 reserve. (Of course, § 468 is more complicated than the foregoing statements might lead one to believe, but the essence of the statute is to allow landfill owners like the taxpayers' S corporation to take a current deduction for future reclamation and clean-up costs.) From 1996 through 2007, the taxpayers' S corporation had utilized § 468 without challenge by the IRS. For tax years 2008 and 2009, however, the IRS contested the S corporation's § 468 deduction on the grounds that the term "taxpayer" in § 468 refers only to accrual-method taxpayers, not cash-method taxpayers. In a case of first impression, the Tax Court unanimously disagreed with the IRS. In a reviewed (and surprisingly long) opinion by Judge Holmes, the Tax Court held that the term "taxpayer" in § 468 does indeed refer to both accrual-method and cash-method taxpayers. The court relied primarily on the statutory language of § 468, which does not distinguish between cash-method and accrual-method taxpayers. The court also examined several other sources of guidance, including § 7701(a)(14), which defines the term "taxpayer" simply as "any person subject to any internal revenue tax," as well as the legislative history of § 468. Apparently, this was news to the IRS, which argued voluminously to the contrary, but to no avail. In a lengthy concurring opinion, Judge Lauber (joined by Judges Marvel, Gale, Nega, and Ashford) traced the legislative history of § 468 (and § 468A regarding nuclear decommissioning costs), which appeared in preliminary bills as exceptions to the § 461(h) economic performance requirement, and concluded that Congress likely had intended § 468 to be available only to accrual-method taxpayers. Judge Lauber also suggested that, if Treasury had issued regulations that defined "taxpayer" for purposes of § 468 as meaning an accrual-method taxpayer, the result in the case might have been different. In the absence of regulations, Judge Lauber concluded, the court "reasonably concludes that nothing in the text of section 468 necessitates giving the term "taxpayer" a meaning less comprehensive than the ordinary meaning it has elsewhere in the Code."

II. BUSINESS INCOME AND DEDUCTIONS

III. INVESTMENT GAIN

A. Gains and Losses

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

D. Section 121

E. Section 1031

1. The Tax Court confirms that § 1031 is an exception to the principle that substance controls over form. Estate of Bartell v. Commissioner, 147 T.C. No. 5 (8/10/16). This case involved a reverse like-kind exchange structured before the promulgation of Rev. Proc. 2000-37, 2000-2 C.B. 308 (effective for qualified exchange accommodation arrangements entered into by an exchange accommodation titleholder on or after September 15, 2000). In 1999, Bartell Drug (an S corporation) entered into an agreement to purchase a property (Property #2). To further structuring the disposition of another property already owned by Bartell Drug (Property #1) as a § 1031 like-kind exchange, Bartell Drug assigned its rights in the purchase agreement to a third-party exchange facilitator (EPC) and entered into an agreement with EPC that provided for EPC to purchase Property #2 and gave Bartell Drug a right to acquire Property #2 from EPC for a stated period and price. EPC purchased Property #2 on August 1, 2000, with bank financing guaranteed by Bartell Drug. Bartell Drug then supervised construction of a drugstore on Property #2 using proceeds of the EPC financing guaranteed by Bartell Drug. Upon substantial completion of the construction in June 2001, Bartell Drug leased the store from EPC until Bartell Drug acquired Property #2 on December 31, 2001. In late 2001, Bartell Drug contracted to sell Property #1 to another party. Bartell Drug thereupon entered an exchange agreement with intermediary SS and assigned to SS its rights under the sale agreement and under the earlier agreement with EPC. SS sold Property #1, applied the proceeds of that sale to the acquisition of Property #2 from EPC and transferred Property #2 to Bartell Drug on December 31, 2001. The Tax Court (Judge Gale) held that the transactions qualified as a § 1031 like-kind exchange of Property # 1 for Property #2. The Court rejected the IRS's argument that under a "benefits and burdens" analysis Bartell Drug was the owner of Property #2 long before the formal transfer of title on December 31, 2001 and treated EPC as the owner of Property #2 during the period it held title to the property. *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963), *rev'g* 38 T.C.

215 (1962), and *Biggs v. Commissioner*, 69 T.C. 905 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980), were cited as precedent for the proposition that § 1031 is formalistic, and that the exchange facilitator does not bear the benefits and burdens of ownership during the period it holds title to the property for the purpose of facilitating a like kind exchange on behalf of a taxpayer who contractually does bear the benefits and burdens of ownership does not preclude § 1031 nonrecognition for the deferred exchange. "[G]iven that the caselaw has countenanced a taxpayer's pre-exchange control and financing of the construction of improvements on the replacement property while an exchange facilitator held title to it, *see J.H. Baird Publ'g. Co. v. Commissioner*, 39 T.C. 608, 610-611 (1962), we see no reason why the taxpayer's pre-exchange, temporary possession of the replacement property pursuant to a lease from the exchange facilitator should produce a different result."

a. **If you wish to engage in a reverse like-kind exchange in which the exchange accommodation titleholder holds title to the replacement property for more than 180 days, proceed at your own peril, says the IRS.** A.O.D. 2017-06, 2017-33 I.R.B. 194 (8/23/17). The IRS has nonacquiesced in the Tax Court's decision in *Bartell*. In its nonacquiescence, the IRS emphasized Rev. Proc. 2000-37, 2000-2 C.B. 308, which provides a safe harbor for reverse like-kind exchanges in which replacement property is parked with an exchange accommodation titleholder if certain requirements are met. If all of the requirements are met, then the exchange accommodation titleholder is considered the owner of the property to which it holds title regardless of who bears the benefits and burdens of ownership. One requirement is that the exchange accommodation titleholder must not hold the property for more than 180 days. If the requirements of the revenue procedure are not met, then the determination whether the taxpayer or the exchange accommodation titleholder is the owner of the property is made without regard to the provisions of the revenue procedure. In *Bartell*, the exchange accommodation titleholder held title to the property for 17 months. In this action on decision, the IRS stated:

> [I]in determining whether a reverse exchange outside the scope of Rev. Proc. 2000-37 meets the requirements of § 1031, the Service will not follow the principle in the court opinions that an exchange facilitator may be treated as the owner of property regardless of whether it possesses the benefits and burdens of ownership. … Taxpayers that use accommodating parties outside the scope of Rev. Proc. 2000-37 have not engaged in an exchange if the taxpayer, rather than the accommodating party, acquires the benefits and burdens of ownership of the replacement property before the taxpayer transfers the relinquished property. The Service will not follow the Tax Court's opinion in *Bartell* to the extent the opinion provides otherwise.

F. Section 1033

G. Section 1035

H. Miscellaneous

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 minimus* 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.

2. There are no adverse tax consequences for employers or employees if employees forgo their vacation, sick, or personal leave in exchange for the employer's contributions to charitable organizations providing disaster relief for those affected by Hurricanes Harvey and Irma. Notice 2017-48, 2017-39 I.R.B. 254 (9/5/17) and Notice 2017-52, 2017-40 I.R.B. 262 (9/14/17). In these notices, the IRS has provided guidance on the tax treatment of cash payments that employers make pursuant to leave-based donation programs for the relief of victims of Hurricanes Harvey and Irma (as well as the Tropical Storm forms of these hurricanes). Under leave-based donation programs, employees can elect to forgo vacation, sick, or personal leave in exchange for cash payments that the employer makes to charitable organizations described in § 170(c). The notices provide that the IRS will not assert that: (1) cash payments an employer makes before January 1, 2019, to charitable organizations for the relief of victims of Hurricanes Harvey and Irma in exchange for vacation, sick, or personal leave that its employees elect to forgo constitute gross income or wages of the employees; (2) the opportunity to make such an election results in constructive receipt of gross income or wages for employees; or (3) an employer is permitted to deduct these cash payments exclusively under the rules of § 170 as a charitable contribution rather than the rules of § 162 as a business expense. Employees who make the election cannot claim a charitable contribution deduction under § 170 for the value of the forgone leave. The employer need not include cash payments made pursuant to the program in Box 1, 3 (if applicable), or 5 of the employee's Form W-2

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).

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

D. Individual Retirement Accounts

1. The form of the transaction was a mystery, but Judge Gustafson peers through the fog to find that the substance was what the taxpayer said it was. McGaugh v. Commissioner, T.C. Memo. 2016-28 (2/24/16). The taxpayer had a self-directed IRA of which Merrill Lynch was the custodian. Among its other assets, the IRA held stock in First Personal Financial Corp. The taxpayer asked Merrill Lynch to purchase additional stock in First Personal Financial Corp. for the IRA. Although the investment in First Personal Financial Corp. was not a prohibited investment for the IRA, Merrill Lynch, for reasons not reflected in the record, refused to purchase the stock directly. At the taxpayer's request, Merrill Lynch issued a wire transfer directly to First Personal Financial Corp., and more than 60 days thereafter, First Personal Financial Corp. issued the stock in the name of the taxpayer's IRA. Merrill Lynch attempted to deliver the stock certificate to the taxpayer, but at trial, the possession of the stock certificate issued in the name of the IRA was unclear. The record indicated that if the stock certificate had been received by Merrill Lynch within the 60-day period, it would have been accepted. Merrill Lynch reported the transaction on Form 1099-R as a taxable distribution because it had determined that the wire transfer was a distribution to the taxpayer that was not followed by a rollover investment within the 60-day period permitted under § 408(d)(3). The IRS determined that the wire transfer issued by Merrill Lynch constituted a "distribution" from the IRA and was includible in gross income under §§ 408(d) and 72 and that, because the taxpayer had not yet reached age 59-1/2, it was an "early distribution" subject to the § 72(t) 10 percent additional tax. The Tax Court (Judge Gustafson) held that there had not been a distribution from the IRA to the taxpayer and did not uphold the deficiency. The opinion noted that there was no evidence that the taxpayer requested an IRA distribution to himself. "No cash, check, or wire transfer ever passed through [the taxpayer's] hands, and he was therefore not a literal "payee or distributee" of any amount." The taxpayer "was, at most, a conduit of the IRA funds." The court distinguished *Dabney v. Commissioner*, T.C. Memo. 2014-108, which involved a similar wire transfer of self-directed IRA funds to purchase an asset and in which the court found a taxable distribution, on the basis that the asset purchased in *Dabney* (land) was one that the IRA custodian would not permit the IRA to hold. In contrast, the asset purchased in this case, stock of First Personal Financial Corp., was a permissible investment that the IRA already held.

a. The Seventh Circuit agrees. McGaugh v. Commissioner, 860 F.3d 1014 (7th Cir. 6/26/17), *aff'g* T.C. Memo. 2016-28 (2/24/16). In an opinion by U.S. District Judge DeGuilio (sitting by designation), the U.S. Court of Appeals for the Seventh Circuit affirmed the Tax Court's decision. The government argued on appeal that the taxpayer had constructively received the IRA proceeds and therefore had to include them in gross income. The court rejected this argument:

> McGaugh didn't direct a distribution to a third party; he bought stock. That is a prototypical, permissible IRA transaction. … Further, there is no indication that McGaugh orchestrated this purchase for the benefit of [First Personal Financial Corp.] or for any reason other than because he wished to obtain stock to be held by his IRA. Thus, there is no evidence that he constructively received funds, either in ordering Merrill Lynch to wire funds to [First Personal Financial Corp.], or in any other respect.

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. Final regulations provide guidance on eligibility for the § 36B premium tax credit of married taxpayers who are victims of domestic abuse or spousal abandonment and do not file a joint return, allocation rules for reconciliation of advance credit payments and the credit, and guidance on the deduction for health insurance costs of self-employed individuals. T.D. 9822, Health Insurance Premium Tax Credit, 82 F.R. 34601 (7/26/17). The Treasury Department and the IRS have finalized, with only a minor change, proposed and temporary regulations (T.D. 9683, Rules Regarding the Health Insurance Premium Tax Credit, 79 F.R. 43622 (7/28/14)) regarding the premium tax credit authorized by § 36B for individuals who meet certain eligibility requirements and purchase coverage under a qualified health plan through an Affordable Insurance Exchange. The regulations generally apply to taxable years beginning after December 31, 2013.

Eligibility for the Premium Tax Credit of Married Taxpayers Who Are Victims of Domestic Abuse or Spousal Abandonment—To be eligible for the premium tax credit, an individual who is married within the meaning of § 7703 must, among other requirements, file a joint return. See I.R.C. § 36B(c)(1)(C). Married individuals who live apart can be treated as not married if they meet the requirements of § 7703(b), but victims of domestic abuse or spousal abandonment might not meet those requirements. Accordingly, absent relief, victims of domestic abuse or spousal abandonment who are married and do not file a joint return (e.g., because of the risk of injury arising from contacting the other spouse, a restraining order that prohibits contact with the other spouse, or inability to locate the other spouse) would be precluded from claiming the premium tax credit. The final regulations provide that a married taxpayer will satisfy the joint filing requirement of § 36B(c)(1)(C) if he or she uses a filing status of married filing separately and meets three requirements: (1) at the time the individual files the return, the individual lives apart from his or her spouse, (2) the individual is unable to file a joint return because he or she is a victim of domestic abuse or spousal abandonment, and (3) the individual certifies on the return in accordance with instructions that he or she meets the first two requirements. Reg. § 1.36B-2(b)(2)(iii). A taxpayer ceases to be eligible for this relief from the joint filing requirement if he or she qualified for the relief for each of the three preceding taxable years. Reg. § 1.36B-2(b)(2)(v). The final regulations generally define domestic abuse as including "physical, psychological, sexual, or emotional abuse, including efforts to control, isolate, humiliate, and intimidate, or to undermine the victim's ability to reason independently." Reg. § 1.36B-2(b)(2)(iii). A taxpayer is considered a victim of spousal abandonment "if, taking into account all facts and circumstances, the taxpayer is unable to locate his or her spouse after reasonable diligence." Reg. § 1.36B-2(b)(2)(iv).

Allocation Rules for Reconciliation of Advance Credit Payments and Premium Tax Credit—An individual who enrolls in coverage through a health insurance exchange can seek advance payment of the premium tax credit authorized by § 36B. The exchange makes an advance determination of eligibility for the credit and, if approved, the credit is paid monthly to the health insurance issuer. An individual who receives advance credit payments is required by § 36B(f)(1) to reconcile the amount of the advance payments with the premium tax credit calculated on the individual's income tax return for the year. If the taxpayer's advance credit payments exceed the actual premium tax credit allowed, then the taxpayer owes the excess as a tax liability. A taxpayer must reconcile the advance credit payments for coverage of all members of the taxpayer's family (defined as the taxpayer, spouse, and dependents) with the premium tax credit the taxpayer is allowed for the taxable year. To compute the premium tax credit and perform the required reconciliation, a taxpayer must know the advance credit payments, the actual premiums paid, and the premiums for the second lowest cost silver plan (the benchmark plan) for all family members. The final regulations provide rules for allocating advance credit payments, premiums, and benchmark plan premiums among family members. This allocation is necessary when: (1) married individuals file separate returns, (2) married individuals become divorced or legally separated during the year, or (3) an individual such as a child is enrolled in a qualified health plan by one taxpayer but another taxpayer claims a personal exemption deduction for the individual. In the latter two situations, the taxpayers can agree on an allocation percentage and, if the taxpayers do not agree, a default allocation percentage is provided.

Deduction for Health Insurance Costs of Self-Employed Individuals—A self-employed individual who is enrolled in a qualified health plan and eligible for the premium tax credit may also be allowed a deduction under § 162(*l*) for premiums paid for health insurance covering the taxpayer, the taxpayer's spouse, the taxpayer's dependents, and any child of the taxpayer who has not attained age 27. The final regulations provide rules for taxpayers who claim a § 162(*l*) deduction and also may be eligible for a § 36B credit for the same qualified health plan or plans. Under the final regulations, a taxpayer is allowed a § 162(*l*) deduction for "specified premiums" not to exceed an amount equal to the lesser of (1) the specified premiums less the premium tax credit attributable to the specified premiums, and (2) the sum of the specified premiums not paid through advance credit payments and the additional tax imposed under § 36B(f)(2)(A) and Reg. § 1.36B-4(a)(1) with respect to the specified premiums after the application of the limitation on additional tax in § 36B(f)(2)(B) and Reg. § 1.36B-4(a)(3). See Reg. § 1.162(*l*)-1T(a)(1). The term "specified premiums" generally is defined as premiums for which the taxpayer can otherwise claim a deduction under § 162(*l*) for a qualified health plan covering the taxpayer or another member of the taxpayer's family for a month that a premium tax credit is allowed for the family member's coverage.

E. Divorce Tax Issues

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

A. Entity and Formation

1. The "Bell" did not save this taxpayer in a faulty attempt to convert ordinary income to capital gain. Bell v. Commissioner, 120 A.F.T.R.2d 2017-5152 (9th Cir. 7/12/17), *aff'g* T.C. Memo. 2015-111 (6/15/15). In this relatively easy case for the Ninth Circuit to affirm, the taxpayers, a married couple, attempted to sell contracts into which Mr. Bell had entered to their newly-formed S corporation. The contracts were between Mr. Bell and various lenders and entities and provided that Mr. Bell, a licensed real estate broker who operated as a sole proprietor, would assist them with real estate owned properties (properties acquired by the lenders through foreclosure). Mr. Bell sold these real estate owned contracts in exchange for the S corporation's contractual obligation to pay $10,000 per month plus 10 percent interest. Weeks after the purchase agreement, the S corporation's board of directors resolved to issue 250 shares to each of the taxpayers in exchange for $500. The S corporation had no equity capital and no operating history. Therefore, the IRS argued, and the Tax Court (Judge Haines) and the Ninth Circuit agreed, that the purported sale was in substance a contribution of the real estate owned contracts to the S corporation in a § 351 nonrecognition transaction. The taxpayer's right to payments of $10,000 per month plus 10 percent interest, the courts held, should be recharacterized as additional stock, not indebtedness, issued in the incorporation transaction.

- **Note:** You might be wondering, "*Why on earth would Bell have wanted the transfer of the real estate owned contracts to his S corporation to be taxable instead of being nontaxable under § 351?*" *Here's why:* Taxpayers occasionally structure sales of assets (land before subdividing into lots; apartments before converting to condominiums) to their newly-formed S corporations with the goal of converting what otherwise would be ordinary income into capital gain. Often, the newly-formed S corporation issues a promissory note to a shareholder-taxpayer for the fair market value of the taxpayer's capital asset or § 1231 asset. The taxpayer reports the capital gain or quasi-capital gain realized from the sale over time on the installment method. Meanwhile, the S corporation obtains a cost basis in the asset. The asset then will be subdivided (land into lots) or converted (apartments to condominiums) to ordinary income property to be sold by the S corporation. The sales of the ordinary income property by the S corporation are used to repay the note issued to the shareholder-taxpayer who reports capital or § 1231 gain on the repayments. Any residual ordinary income generated by the S corporation's sales is reported by the taxpayer as flow-through income from the S corporation. Hence, future ordinary income has been converted to capital gain. A variation of this strategy was employed successfully by the taxpayer in *Gyro Engineering Corp. v. United States*, 417 F.2d 437 (9th Cir. 1969). If, however, the newly-formed S corporation is thinly capitalized, the IRS challenges these transactions by asserting that the purported sale of the asset to the newly-formed S corporation is in substance a § 351 nonrecognition transaction. The promissory note issued to the shareholder-taxpayer is recharacterized as stock issued in the § 351 transaction. This is what happened in *Bell*. Had the taxpayer in *Bell* adequately capitalized his S corporation with other assets, his strategy might have had a better chance of success.

B. Distributions and Redemptions

C. Liquidations

D. S Corporations

1. A § 267 "looptrap" snares an accrual-method subchapter S corporation with an ESOP shareholder. Petersen v. Commissioner, 148 T.C. No. 22 (6/13/17). The taxpayers, a married couple, owned stock in an accrual-method S corporation with many employees. As permitted by § 1361(c)(7), an ESOP benefitting the employees also owned stock in the S corporation. The S corporation had accrued and deducted the following amounts with respect to its ESOP participants as of the end of its 2009 and 2010 tax years: for 2009, unpaid wages of $1,059,767 (paid by January 31, 2010) and vacation pay of $473,744 (paid by December 31, 2010); for 2010, unpaid wages of $825,185 (paid by January 31, 2011) and vacation pay of $503,896 (paid by December 31, 2011). Notwithstanding the fact that the S corporation was an accrual-method taxpayer, the IRS asserted under § 267(a)(2) (forced-matching) that the corporation was not entitled to deduct the foregoing accrued amounts until the year of actual payment and inclusion in gross income by the ESOP's employee-participants. In a case of first impression, the Tax Court (Judge Lauber) agreed with the IRS based upon a plain reading of §§ 67(a)(2), (b), and (e), as well as a determination that the S corporation's ESOP is a "trust" within the meaning of § 267(c). Specifically, § 267(a)(2) generally requires so-called "forced matching" of an accrual-method taxpayer's deductions with the gross income of a cash-method taxpayer to whom a payment is to be made if the taxpayer and the person to whom the payment is to be made are related persons as defined by § 267(b). For an S corporation, pursuant to § 267(e), all shareholders are considered related persons under § 267(b) regardless of how much or how little stock such shareholders actually *or constructively* own. Furthermore, under § 267(c) beneficiaries of a trust are deemed to own any stock held by the trust. Because the assets held by an ESOP are owned by a trust (as required by ERISA, *see* 29 U.S.C. § 1103(a)), the participating employees of the ESOP are treated as shareholders of the S corporation. Hence, the forced-matching rule of § 267(a)(2) applies to accrued but unpaid wages and vacation pay owed to the S corporation's ESOP participants at the end of the year. Judge Lauber noted that this odd situation probably was a "drafting oversight"—in our words, a *looptrap*—because § 318, which defines related parties for certain purposes under subchapter C, excepts tax-exempt employee trusts from its constructive ownership rules. Nevertheless, Judge Lauber wrote, the Tax Court is "not at liberty to revise section 267(c) to craft an exemption that Congress did not see fit to create." Mercifully, however, the Tax Court declined to impose § 6662 negligence or substantial understatement penalties on the taxpayers because the case was one where "the issue was one not previously considered by the Court and the statutory language was not clear" (even though the court obviously relied upon the plain language of § 267 to reach its decision).

E. Mergers, Acquisitions and Reorganizations

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

1. The Tax Court invokes a "common law" doctrine to disallow a double deduction for the same economic loss. Duquesne Light Holdings, Inc. v. Commissioner, T.C. Memo. 2013-216 (9/11/13). Duquesne Light Holdings, Inc. was the common parent of a consolidated group of corporations. Duquesne held 1.2 million shares of AquaSource, Inc., which until 2001 was a wholly-owned member of the group. In 2001, Duquesne sold 50,000 shares of AquaSource to Lehman Brothers—remember them—and claimed a capital loss of approximately $199 million ("2001 stock loss"). Duquesne filed an application for tentative refund, in which it carried back to 2000 a portion of the 2001 stock loss, and the IRS paid a tentative refund of $35 million. In 2002 and 2003, AquaSource, while still a member of the group, sold all of its assets (stock in its wholly-owned subsidiaries) and recognized aggregate capital losses of $252 million ("2002 and 2003 assets losses"), which were claimed on Duquesne's consolidated return, carried back to 2000, and resulted in the IRS paying a tentative refund of $52 million. The IRS determined that the 2001 stock loss on the disposition of 50,000 shares of AquaSource stock (approximately 4% of the stock) recognized by the common parent was a loss attributable to the fact that there was built-in loss in the underlying assets of AquaSource, and that the group was not permitted to take the duplicative portion ($199 million) of the 2002 and 2003 asset losses upon the subsequent sale of AquaSource's assets under the doctrine of *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934). The Tax Court (Judge Chiechi) upheld the IRS's determination, relying in part on its prior opinion in *Thrifty Oil v. Commissioner*, 139 T.C. 198 (2012). In doing so, the court rejected the taxpayer's argument that *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), which held invalid the loss disallowance rule of former Reg. § 1.1502-20, supported allowing deduction of the 2002 and 2003 assets losses, and that the disallowance of double deductions could be effected only through the promulgation of valid regulations. Although the court acknowledged that former Temp. Reg. § 1.1502-35T, which was in effect for the years in question, did not disallow the losses, the court concluded that nothing prohibited it from disallowing duplicate deductions for the same economic loss under *Charles Ilfeld Co.* Finally, the court held that even though the limitations period on assessment had expired for 2000–the year to which losses had been carried back–the period was still open pursuant to § 6501(h) and § 6501(k), thereby allowing the IRS to assess a deficiency attributable to the disallowance of the loss carryback.

a. The *Ilfeld* doctrine is alive and well in the Third Circuit, which concluded that the failure of the consolidated return regulations to disallow a loss is not clear authorization for the taxpayer to take a double deduction for the same economic loss. Duquesne Light Holdings, Inc. v. Commissioner, 861 F.3d 396 (3d Cir. 6/29/17), *aff'g* T.C. Memo. 2013-216 (9/11/13). In an opinion (2-1) by Judge Ambro, the Third Circuit affirmed the Tax Court's decision. The majority opinion construed *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934), as standing for the proposition that there is a presumption that statutes and regulations do not allow a double deduction for the same economic loss, and "[t]his presumption must be overcome by a clear declaration in statutory text or a properly authorized regulation." The majority acknowledged that there is some uncertainty whether the *Ilfeld* doctrine applies to taxpayers not filing consolidated returns, but concluded that it "remains good law in the consolidated-return context." The court held that neither the text of § 165, nor the combination of the statutory text with the applicable regulations, authorized the taxpayer to deduct the same economic loss twice. According to the court, the language of § 165(a), which authorizes a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise," is broad and does not meet the *Ilfeld* doctrine's "requirement of explicit approval for duplicating the underlying economic loss." The regulations in effect during the years in question did not preclude Duquesne from deducting the 2002 and 2003 asset losses. One regulation, Reg. § 1.1502-35T, precluded deduction of a loss recognized on the disposition of subsidiary stock to the extent of the duplicated loss if, immediately after the disposition, the subsidiary remained a member of the consolidated group. This regulation did not apply to the 2002 and 2003 asset losses because the subsidiaries that AquaSource sold were not members of the consolidated group after their disposition. Duquesne relied on Reg. § 1.337(d)-2T as authority for its deduction of the 2002 and 2003 asset losses. Paragraph (a)(1) of Reg. § 1.337(d)-2T provided a general rule that "[n]o deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary loss." Paragraph (c)(2) provided that a loss on the disposition of subsidiary stock "is not disallowed" by the general rule "to the extent the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain … on the disposition of an asset (including stock and securities)." Although Reg. § 1.337(d)-2T did not disallow Duquesne's 2002 and 2003 asset losses, the court held that the regulation was insufficient to overcome the presumption of *Ilfeld* because "there is no mention in the regulation of approval for a loss deduction that duplicates another already taken for the same underlying economic loss." The court emphasized that Reg. § 1.337(d)-2T "has nothing to do with loss duplication" because it was accompanied by Notice 2002-18, 2002-1 C.B. 644, which stated that "the IRS and Treasury believe that a consolidated group should not be able to benefit more than once from one economic loss" and would issue another regulation addressing that issue. That other regulation, issued in 2003 retroactive to 2002, was Reg. § 1.1502-35T which, as previously discussed, did not preclude the 2002 and 2003 asset losses. The majority also affirmed the Tax Court's ruling that the IRS's assessment of a deficiency attributable to the disallowance of the loss carryback was not barred by the limitations period on assessment.

- In a dissenting opinion, Judge Hardiman disagreed with several aspects of the majority's reasoning. He took issue with the majority's conclusion that *Ilfeld* requires an explicit authorization of a double deduction:

> That means even if the Code separately allows Deduction A and Deduction B, the taxpayer could not take both deductions unless a provision authorized them both to be taken simultaneously. This triple-authorization requirement, I believe, goes above and beyond any rule envisioned by the Supreme Court.

Judge Hardiman emphasized that *Ilfeld* requires only that a provision of the statute or regulations can "fairly be read to authorize" the double deduction. He concluded that Reg. § 1.337(d)-2T can fairly be read to authorize Duquesne's deduction. "When the IRS writes that a deduction is 'not disallowed,' we should accept that it is not. And without that ambiguity, it is not our place to investigate the structure and purpose of the scheme in order to restyle the language of the regulation." Regarding the interplay of the regulations and the *Ilfeld* doctrine, Judge Hardiman stated:

> [I]t seems unnatural for the IRS to write a regulation that literally authorizes a specific action, only to expect taxpayers to appreciate that the regulation is undermined by common-law doctrines lurking in the shadows.

2. Better be careful in drafting those tax allocation agreements! A subsidiary member of a consolidated group was entitled to a refund produced by the subsidiary's loss because the group's tax allocation agreement was ambiguous and provided that any ambiguity must be resolved in favor of the subsidiary. In re United Western Bancorp, Inc., ___ F. Supp. 3d ___, 2017 WL 2928031 (D. Colo. 7/10/17). United Western Bancorp, Inc. ("Holding Company") was the common parent of a consolidated group. One member of the consolidated group was a wholly-owned subsidiary, United Western Bank ("Bank"). The Holding Company received a refund of $4.8 million that was produced by carrying back a 2010 consolidated net operating loss (produced by the Bank's loss) to 2008, a year in which the consolidated group had paid tax on income of the Bank. According to the court, "[t]here is no dispute that, to whatever extent a refund was due, it was entirely the result of revenue generated by the Bank in 2008 and losses incurred by the Bank in 2010 …." In the same year the 2010 consolidated return was filed, the Bank was placed into receivership with the FDIC as its receiver. Subsequently, the Holding Company became a debtor in a chapter 7 bankruptcy proceeding. The bankruptcy trustee asserted that the refund was an asset of the bankruptcy estate, and the FDIC asserted that the refund was an asset of the Bank. In a thorough and thoughtful opinion, the District Court (Judge Martinez) held that the Bank was entitled to the refund. The court noted that, in *Barnes v. Harris*, 783 F.3d 1185 (10th Cir. 2015), the Tenth Circuit, relying on *In re Bob Richards Chrysler-Plymouth Corp., Inc.*, 473 F.2d 262 (9th Cir. 1973), had held that, in the absence of a contrary agreement, "a tax refund due from a joint return generally belongs to the company responsible for the losses that form the basis of the refund." In this case, however, the consolidated group members had entered into a tax allocation agreement. The District Court ultimately framed the issue as whether, under the tax allocation agreement, the Holding Company was acting as the agent of the Bank or instead had a standard commercial relationship with the Bank. If the former, then the Holding Company was acting as a fiduciary of the Bank and the refund would belong to the Bank; if the latter, then the Bank was a creditor of the Holding Company and the refund would be an asset of the Holding Company's bankruptcy estate. The court concluded that the tax allocation agreement was ambiguous on this point, which triggered a provision in the agreement that required any ambiguity in the agreement to be resolved in favor of the Bank. Accordingly, the court concluded, the Bank had equitable title to the refund. The Holding Company had only legal title to the refund and the refund was not part of the Holding Company's bankruptcy estate.

H. Miscellaneous Corporate Issues

1. Due date of corporate income tax returns: temporary and proposed regulations address the filing date chaos created by Congress. T.D. 9821, Return Due Date and Extended Due Date Changes, 82 F.R. 33441 (7/20/17). Treasury and the IRS have issued proposed, temporary, and final regulations regarding the due date and extended due date of corporate income tax returns. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(a), amended Code § 6072(b) to require C corporations to file their income tax returns by the 15th day of the fourth month after the close of their taxable year (by subjecting them to § 6702(a)), thus deferring the due date by one month. On the other hand, under amended § 6072(b), S corporations continue to be required to file their tax returns by the 15th day of the third month (March 15 for calendar year S corporations). Pursuant to this statutory directive, Temp. Reg. § 1.6072-2T(a)(1) provides that the income tax return of a C corporation is due on the 15th day of the fourth month following the close of its taxable year and that the income tax return of an S corporation is due on or before the 15th day of the third month following the close of its taxable year. However, pursuant to Temp. Reg. § 1.6072-2T(a)(2), the income tax return of a C corporation that has a taxable year that ends on June 30 is due on the 15th day of the *third* month following the close of its taxable year for taxable years beginning before January 1, 2026. (Yes, that's correct, a ten-year deferred effective date only for C corporations with a fiscal year ending on June 30.) For this purpose, a return for a short period ending on any day in June is treated as a return for a taxable year that ends on June 30. This special rule for C corporations using a June 30 taxable year implements the effective date rule enacted by § 2006(a)(3) of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015.

- The extended due dates for C corporation returns were changed by § 2006(c) of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 through amendments to Code § 6081(b). The temporary regulations reflect these changes. Pursuant to Temp. Reg. § 1.6081-3T, a C corporation is allowed an automatic six-month extension of the due date. However, for periods beginning before January 1, 2026, the automatic extension is 7 months for a C corporation with a taxable year that ends on June 30. Code § 6081(b), as amended by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, provides that the automatic extension is only 5 months for a calendar-year C corporation for periods ending before January 1, 2026. Nevertheless, the temporary regulations provide an automatic 6-month extension for calendar-year C corporations pursuant to § 6081(a), which authorizes the Secretary of the Treasury to grant reasonable extensions of not more than 6 months.

- The temporary regulations apply to corporate returns and extension requests filed on or after July 20, 2017, but the statutory amendments made by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 apply to returns for corporate taxable years that begin after December 31, 2015. Accordingly, the preamble to the temporary regulations provides that taxpayers can elect to apply the regulations to returns filed for periods beginning after December 31, 2015.

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

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 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 no need to carve out an exception to prevent U.S. real property interests from being swept into the indivisible capital asset treatment that section 741 otherwise prescribes.

The court noted that this conclusion is consistent with the court's prior decision in *Pollack v. Commissioner*, 69 T.C. 142 (1977).

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

- In reaching its conclusion that the taxpayer's gain was not effectively connected with the conduct of a U.S. trade or business, the court rejected the 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.

E. Inside Basis Adjustments

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 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).

Pre-2018 Election Into the New Regime. The reissued proposed regulations do not affect the ability of partnerships to elect into the new regime for tax years beginning before January 1, 2018, but after November 2, 2015. See T.D. 9780, Election into the Partnership Audit Regime Under the Bipartisan Budget Act of 2015, 81 F.R. 51795 (8/5/16).

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)-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-thu 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.

G. Miscellaneous

1. Due date for partnership income tax returns: temporary and proposed regulations reflect Congress's belief that some partners might not need filing extensions any more. T.D. 9821, Return Due Date and Extended Due Date Changes, 82 F.R. 33441 (7/20/17). Treasury and the IRS have issued proposed, temporary, and final regulations regarding the due date and extended due date of partnership income tax returns (Form 1065). The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(a), amended Code § 6072(b) to require partnerships to file their income tax returns by the 15th day of the third month following the close of the taxable year (March 15 for calendar year partnerships), thus accelerating the due date by one month. Act § 2006(b) directs the Treasury to modify the regulations to provide that the maximum extension for a partnership return will be a 6-month period ending on September 15 for calendar year partnerships. Pursuant to this statutory directive, Temp. Reg. § 1.6031(a)-1T(e)(2) provides that "the return of a partnership must be filed on or before the date prescribed by § 6072(b)." (The temporary regulations do not explicitly address the due date of Form 8804—Annual Return for Partnership Withholding Tax—but the 2016 instructions for Form 8804 indicate that the due date is the 15th day of the third month following the close of the taxable year.) Pursuant to Temp. Reg. § 1.6081(a)-2T(a)(1), a partnership is allowed an automatic 6-month extension to file both Form 1065 and Form 8804 by filing a timely application. No extension beyond the automatic extension is permitted.

- The temporary regulations apply to returns and extension requests filed on or after July 20, 2017, but the statutory amendments made by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 apply to returns for partnership taxable years that begin after December 31, 2015. Accordingly, the preamble to the temporary regulations provides that taxpayers can elect to apply the regulations to returns filed for periods beginning after December 31, 2015.

a. What, you weren't paying attention to the new accelerated due date for partnership returns? We've got your back, says the IRS. Late-filing penalties are waived, but don't let this happen again! Notice 2017-47, 2017-38 I.R.B. 232 (9/1/17). In this notice, the IRS has waived penalties for a partnership's failure to file or furnish to partners certain returns by the accelerated due date enacted as part of the Surface Transportation and Veterans Health

Care Choice Improvement Act of 2015. The penalty relief applies if one of the following two conditions is satisfied:

> (1) the partnership filed Form 1065, 1065-B, 8804, 8805, 5471, or other return required to be filed with the IRS and furnished copies (or Schedules K-1) to the partners (as appropriate) by the date that would have been timely under section 6072 before amendment by the Surface Transportation Act (April 18, 2017 for calendar-year taxpayers …), or
>
> (2) the partnership filed Form 7004 to request an extension of time to file by the date that would have been timely under section 6072 before amendment by the Surface Transportation Act and files the return with the IRS and furnishes copies (or Schedules K-1) to the partners (as appropriate) by the fifteenth day of the ninth month after the close of the partnership's taxable year (September 15, 2017, for calendar-year taxpayers). If the partnership files Form 1065-B and was required to furnish Schedules K-1 to the partners by March 15, 2017, it must have done so to qualify for relief.

This relief is available only for the partnership's first taxable year that begins after 2015. The IRS will grant this relief automatically. Taxpayers that have already had penalties assessed should receive a letter indicating that the penalty has been abated and are instructed to contact the IRS for abatement if they do not receive such a letter.

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Is this good for procrastinators? Temporary regulations implement the six-month automatic extension of time to file returns of exempt organizations, including those in the Form 990 series. T.D. 9821, Return Due Date and Extended Due Date Changes, 82 F.R. 33441 (7/20/17). Treasury and the IRS have issued proposed, temporary, and final regulations that provide an automatic six-month extension of time for the filing of certain returns, including those in the Form 990 series filed by tax-exempt organizations. Previously, Reg. § 1.6081-9(a) provided an automatic three-month extension for most returns in the 990 series. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(b)(4)-(8), directs the Treasury to modify relevant regulations to provide that the maximum extension of time for filing several types of returns, including those in the Form 990 series, is six months (ending on November 15 for calendar-year filers). Pursuant to this statutory directive, Temp. Reg. § 1.6081-9T(a) provides that entities required to file several types of returns, including those in the Form 990 series, are allowed an automatic six-month extension by filing a timely application (normally submitted on Form 8868 or Form 7004).

- The Form 990 returns eligible for this automatic extension are Form 990, Return of Organization Exempt from Income Tax; Form 990-EZ, Short Form Return of Organization Exempt from Income Tax; Form 990-PF, Return of Private Foundation; Form 990-T, Exempt Organization Business Income Tax Return; and Form 990-BL, Information and Initial Excise Tax Return for Black Lung Benefit Trusts and Certain Related Persons.

- The other returns eligible for this automatic extension are Form 1041-A, U.S. Information Return-Trust Accumulation of Charitable Amounts; Form 1120-POL, U.S. Income Tax Return for Certain Political Organizations; Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code; Form 5227, Split-Interest Trust Information Return; Form 6069, Return of Excise Tax on Excess Contributions to Black Lung Benefit Trust Under Section 4953 and Computation of Section 192 Deduction; and Form 8870, Information Return for Transfers Associated With Certain Personal Benefit Contracts.

- The temporary regulations apply to extension requests filed on or after July 20, 2017, but the statutory amendments made by the Surface Transportation and Veterans

Health Care Choice Improvement Act of 2015 apply to returns for taxable years that begin after December 31, 2015. Accordingly, the preamble to the temporary regulations provides that taxpayers can elect to apply the regulations to returns filed for periods beginning after December 31, 2015.

B. Charitable Giving

1. Form 1023-EZ regulations finalized. T.D. 9819, Guidelines for the Streamlined Process of Applying for Recognition of Section 501(c)(3) Status, 82 F.R. 29730 (6/30/17). Originally issued as proposed and temporary regulations in 2014 (T.D. 9674, Guidelines for the Streamlined Process of Applying for Recognition of Section 501(c)(3) Status, 79 F.R. 37630 (7/2/14)), these final regulations authorize without substantive change a streamlined process that certain small organizations may use to apply for recognition of tax-exempt status under § 501(c)(3). Essentially, the final regulations allow the IRS to promulgate Form 1023-EZ for "eligible organizations" to meet the notice requirements of § 508 for purposes of obtaining recognition of tax-exempt status under § 501(c)(3). Detailed annual or other guidance issued by the IRS defines "eligible organizations" allowed to file Form 1023-EZ. For 2017, Rev. Proc. 2017-5, § 6.05, 2017-1 I.R.B. 230, generally provides that an "eligible organization" is one that (1) has projected annual gross receipts of $50,000 or less in the current year and the next two years, (2) $50,000 or less of actual receipts for each of the past three years for which it was in existence, and (3) has total assets the fair market value of which does not exceed $250,000. For purposes of this last eligibility requirement, a good faith estimate of the fair market value of the organization's assets is sufficient. Notwithstanding the foregoing, Rev. Proc. 2017-5 contains a lengthy list of organizations that cannot submit Form 1023-EZ, including churches, schools, colleges, and hospitals. Form 1023-EZ must be submitted electronically and the user fee for doing so is $275, as opposed to the $850 user fee charged to organizations submitting a regular Form 1023. Organizations that submit Form 1023-EZ ordinarily will file an annual Form 990-N (e-postcard) instead of the regular Form 990 required of larger § 501(c)(3) organizations. The final regulations amend Reg. §§ 1.501(a)-1, 1.501(c)(3), and 1.508-1, and they are effective July 1, 2017.

2. The Eighth Circuit takes the "gimme" in yet another golf course conservation easement case, and a taxpayer learns the hard way that a retroactive effective date doesn't work. RP Golf, LLC v. Commissioner, 860 F.3d 1096 (8th Cir. 6/26/17), *aff'g* T.C. Memo 2016-80 (4/28/16). In this case, the Eighth Circuit quickly and easily dispensed with a taxpayer's $16.4 million deduction for a golf course conservation easement. The taxpayer had donated a conservation easement to a land trust on December 29, 2003 (which was recorded in county deed records on December 30, 2003); however, at the time of the donation two mortgages remained on the property. The mortgages were not subordinated to the conservation easement as required by Reg. § 1.170A-14(g)(2). Uh oh! To remedy this mistake, the taxpayer and the mortgage holders entered into a subordination agreement that purported to be effective as of December 31, 2003, although the subordination agreement was not executed until April 14, 2004. Huh, why April 14, 2004? The Tax Court (Judge Paris) disallowed the $16.4 million deduction on the same ground as the Ninth and Tenth Circuits (*Minnick v. Commissioner*, 796 F.3d 1156 (9th Cir. 2015) and *Mitchell v. Commissioner*, 775 F.3d 1243 (10th Cir. 2015)), both of which have held that mortgages must be subordinated to conservation easements at the time of the donation, not thereafter, to meet the "protected in perpetuity" requirement of the regulations. The taxpayer, though, argued that *Minnick* and *Mitchell* were distinguishable. In *Minnick* the gap between the donation and subordination was five years while in *Mitchell* the gap was two years. Thus, the taxpayer argued that a subordination agreement retroactively effective to the year of the donation and executed so soon after the conveyance complies with the "protected in perpetuity" requirement of the regulations. Moreover, the taxpayer argued that the mortgage holders had orally agreed to the subordination at the time of the donation. The Eighth Circuit, though, affirmed the Tax Court's holding that (i) a retroactive subordination agreement does not meet the "protected in perpetuity" requirement of the regulations, and (ii) there was insufficient evidence to support the existence of an oral subordination agreement at the time of the donation.

- **Notably, RP Golf, LLC won an earlier "match play" round with the IRS in this case:** In 2012, Judge Paris sided with RP Golf against the IRS over whether the conservation easement deed as accepted and signed by the donee land trust met the "contemporaneous written acknowledgement" requirement of § 170(f)(8). *See RP Golf, LLC v. Commissioner*, T.C. Memo. 2012-282. For charitable contributions of $250 or more, § 170(f)(8) generally requires the donee charity to provide the donor with a contemporaneous written acknowledgement regarding the property contributed, whether goods or services were provided in exchange therefor, and a good faith estimate of the value of the property contributed. Typically, charities provide short letters to donors acknowledging their contributions—so-called "goods and services" letters—by the end of the year in which any donation is made. In a number of cases involving contributions of conservation easements, however, the typical "goods and services" letter was not sent by the charity to the donor of the conservation easement. The IRS often latches on this technical deficiency as an argument (with mixed success) to disallow conservation easement deductions even when the done charity signs the deed acknowledging receipt of the conservation easement. *See, e.g., 15 West 17th Street LLC v. Commissioner*, 147 T.C. No. 19 (12/22/16) (taxpayer unfabvorable); *Averyt v. Commissioner*, T.C. Memo. 2012-198 (taxpayer favorable); *Simmons v. Commissioner*, T.C. Memo. 2009-208, *aff'd* 646 F.3d 6 (Fed. Cir. 2011) (taxpayer favorable); *Schrimsher v. Commissioner*, T.C. Memo. 2011-71 (taxpayer unfavorable). More recently, though, the Tax Court has ruled that a conservation easement deed acknowledged and signed by the done-charity meets the "contemporaneous written acknowledgment" requirement of § 170(f)(8). *See Big River Development, L.P. v. Commissioner*, T.C. Memo. 2017-166 (8/28/17); *310 Retail, LLC v. Commissioner*, T.C. Memo. 2017-164 (8/24/17).

3. It took some time, but finally we "gotcha," says the IRS, in this infamous charitable contribution case involving billionaire and Miami Dolphins' owner Stephen Ross and the University of Michigan. RERI Holdings I, LLC v. Commissioner, 149 T.C. 1 (7/3/17). In a TEFRA case that has gone on for some time and has produced at least one other noteworthy holding (see below), the IRS prevailed in denying a $33 million charitable contribution deduction to a partnership in which Stephen Ross, owner of the Miami Dolphins, was a partner. The property was donated to the University of Michigan, Mr. Ross's alma mater. The partnership had paid only $2.95 million for the property a little over a year prior to its donation. In fact, at some point after the donation the University of Michigan sold the property for only $1.94 million. These facts, of course, displeased the IRS greatly, and the IRS convinced the Tax Court to deny the partnership's charitable contribution deduction on technical grounds (as discussed below). Moreover, contrary to decisions of the Fifth and Ninth Circuits, the Tax Court (Judge Halpern) determined that the partners of the partnership potentially are liable for aggregate gross valuation misstatement penalties of about $11.8 million.

The facts of the case are complicated, but essentially reveal that for tax year 2003 the partnership claimed a $33 million charitable contribution deduction under § 170(a)(1) for a donation to the University of Michigan. The donated property consisted of a remainder interest in a disregarded single-member LLC that the partnership owned and that held underlying real property. On its Form 8283, Noncash Charitable Contributions, the partnership failed to report its "cost or adjusted basis" for the donated property as required by Reg. § 1.170A-13(c)(4)(ii)(E), instead leaving the line on the form completely blank. Judge Halpern ruled that this failure to comply either strictly or substantially with the regulations is fatal to a claimed charitable contribution deduction, thereby denying the deduction in full. Lastly, for purposes of determining potential penalties, the Tax Court held that the correct value of the property at the time of the donation was approximately $3.5 million.

Regarding the IRS's assertion of the 40 percent penalty under § 6662(h) for "gross valuation misstatements" (valuation of 400 percent or more of correct value), the partnership argued that § 6662 should not apply because the $33 million charitable contribution deduction was completely disallowed and hence was not "attributable to" a valuation misstatement. *See, e.g., Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990), *rev'g* T.C. Memo. 1988-408; *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990), *aff'g* T.C. Memo. 1988-416. Judge Halpern's opinion, however, relies upon the Tax Court's more recent decision in *AHG Investments, LLC v. Commissioner*, 140 T.C. 73 (2013), in which the court declined to follow *Heasley* and *Gainer*. Judge Halpern noted that both the Fifth and Ninth Circuits have expressed reservations about *Heasley* and *Gainer*, and because any appeal by the partnership (due to its dissolution in 2004) would be to the U.S. Court of Appeals for the Federal Circuit, the Tax Court was free to follow its decision in *AHG Investments*. Judge Halpern then determined that the correct fair market value of the donated property should have been roughly $3.5 million, i.e., $29.5 million less than the value claimed by the partnership. Therefore, subject to partner-level § 6662(e)(2) calculations ($5,000 underpayment threshold per partner), the partners of the partnership potentially are liable for penalties aggregating as much as $11.8 million (40 percent of the $29.5 million valuation overstatement).

- The IRS probably thought it should have won this case previously on a similar technicality. In *RERI Holdings I, LLC v. Commissioner*, 143 T.C. 41 (2014), the IRS had cleverly argued on a summary judgment motion that the partnership's "qualified appraisal" (*see* § 170(f)(11)) of the property was fatally flawed. Specifically, the IRS had argued that although the partnership obtained an otherwise qualified appraisal, the partnership's appraisal valued a remainder interest in the underlying real property, not the remainder interest in the disregarded single-member LLC that held the real property. The remainder interest in the disregarded single-member LLC was the property the partnership donated to the University of Michigan, not the real property itself. Thus, argued the IRS, the partnership's otherwise qualified appraisal was for *the wrong property* (even though under § 7701 the single-member LLC was completely disregarded for all other tax purposes)! But, in 2014 Judge Halpern did not let the IRS win so easily. Judge Halpern accepted the IRS's argument that a charitable contribution of an interest in a disregarded single-member LLC should be viewed differently (and perhaps valued differently) than a charitable contribution of the underlying asset(s). Judge Halpern so held even while acknowledging that a single-member LLC otherwise is ignored for federal tax purposes. Judge Halpern's opinion relied heavily on the Tax Court's earlier decision in a gift tax case involving a disregarded single-member LLC. *See Pierre v. Commissioner*, 133 T.C. 24 (2009), *supplemented by* T.C. Memo. 2010-106. Nevertheless, perhaps to avoid so-easily granting summary judgment against the taxpayer and in favor of the IRS in 2014, Judge Halpern reasoned that there was an unresolved issue of material fact whether a valuation of the real property held by the partnership's disregarded single-member LLC could "stand proxy" for the otherwise required "qualified appraisal." Surprisingly, though, Judge Halpern's decision in the earlier *RERI* ruling raises the prospect of a disregarded single-member LLC interest being regarded and valued separately for purposes of determining charitable contributions under § 170.

X. <u>TAX PROCEDURE</u>

A. <u>Interest, Penalties and Prosecutions</u>

B. <u>Discovery: Summons and FOIA</u>

C. <u>Litigation Costs</u>

D. <u>StatutoryNotice of Deficiency</u>

E. <u>Statute of Limitations</u>

F. <u>Liens and Collections</u>

1. The Tax Court has jurisdiction to review the IRS's determination to uphold an accuracy-related penalty in a CDP hearing, even though it would not have deficiency jurisdiction over the penalty, which related to adjustments to partnership items of a TEFRA partnership. <u>McNeill v. Commissioner</u>, 148 T.C. No. 23 (6/19/17). The taxpayer invested in a distressed asset/debt (DAD) tax shelter by purchasing an 89.1 percent interest in GUISAN, LLC , which was classified for federal tax purposes as a partnership. GUISAN was a member of LABAITE, LLC, a TEFRA partnership. LABAITE claimed a large loss in 2003 from the DAD transaction, of which the taxpayer's share was more than $10 million. In a partnership-level audit of LABAITE, the IRS issued to LABAITE's partners a notice of final partnership administrative adjustment (FPAA) that reflected an adjustment to LABAITE's partnership items and imposed an accuracy-related penalty under § 6662 with respect to the claimed loss. GUISAN was not the tax matters partner (TMP) of LABAITE. Nevertheless, the taxpayer, as TMP of GUISAN, caused GUISAN to bring an action in a U.S. District Court for review of the FPAA. The taxpayer made a deposit of $4.9 million, which was sufficient to satisfy the taxpayer's liability only for the asserted deficiency and interest related to the disallowed loss; it did not satisfy the taxpayer's liability for the asserted accuracy-related penalty. The U.S. District Court subsequently dismissed the action on the taxpayer's own motion and, in doing so, declined to adjudicate any partner-level defenses. Because the accuracy-related penalty had not been paid, the IRS assessed the penalty and ultimately issued both a final notice of intent to levy and a notice of federal tax lien filing. In response, the taxpayer requested a collection due process hearing. In the CDP hearing, the IRS settlement officer (1) took the position that the taxpayer could not raise partner-level defenses to the accuracy-related penalty because the taxpayer had had a prior opportunity to contest the liability, and (2) issued a notice of determination upholding the proposed collection action. The taxpayer filed a petition in the Tax Court. Pursuant to §§ 6221 and 6230(a)(2)(A)(i), the Tax Court's deficiency jurisdiction does not extend to penalties that relate to adjustments to partnership items. The regulations issued under § 6221 provide that "[p]artner-level defenses to such items can only be asserted through refund actions following assessment and payment." Reg. § 301.6221-1(c). Because the asserted accuracy-related penalty in this case was based on an adjustment to partnership items, the Tax Court would not have jurisdiction in a deficiency proceeding to rule on the taxpayer's claimed partner-level defenses to the penalty. Nevertheless, the Tax Court (Judge Paris) held that it had jurisdiction to review the IRS's notice of determination. In 2006, Congress amended § 6330(d)(1) to make the Tax Court the only court in which a taxpayer can seek review of an IRS notice of determination issued after a CDP hearing. As amended, § 6330(d)(1) provides that "the Tax Court shall have jurisdiction with respect to such matter." In prior decisions, the court explained, it had interpreted this amendment as conferring jurisdiction on the court to review collection determinations even when the court lacked original jurisdiction over the underlying liability. "With respect to petitioner's section 6662(a) accuracy-related penalty, this penalty is another example of an item not subject to the Court's deficiency jurisdiction under section 6221 but nonetheless reviewable by the Court in the context of its section 6330 jurisdiction." The court ruled only on the question of jurisdiction and will issue a separate opinion on the merits.

- The taxpayer invested in a DAD tax shelter during 2002 as well, and successfully asserted partner-level defenses to the accuracy-related penalty for that year in a refund action. See *McNeill v. United States*, 119 A.F.T.R.2d 2017-943 (D. Wyo. 2/24/17).

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. Your time to petition the U.S. Tax Court began to run when we issued you our final determination [in January] and will end on Apr. 19, 2016. However, you may continue to work with us to resolve your tax matter." The taxpayer subsequently filed a petition in the Tax Court on April 19, 2016, and the 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 relief 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 Matuzak 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.

H. Miscellaneous

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

- Judge Kavanaugh's opinion found six problems with the 2011 regulations: (1) tax return preparers were not "representatives" because they are not "agents" and, thus, lack "legal authority to act on the taxpayer's behalf"; (2) the preparation and filing of a tax return did not constitute "practice … before the Department of the Treasury" because that term implies "an investigation, adversarial hearing, or other adjudicative proceeding"; (3) the history of the statutory language originally enacted in 1884 "indicated that the statute contemplated representation in a contested proceeding"; (4) the regulation was inconsistent with the "broader statutory framework," (?!) in which Congress had enacted a number of statutes specifically directed at tax-return preparers and imposing civil penalties, which would not have been necessary if the 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."

- The DOJ is mulling over whether to seek *en banc* review.

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, 118 A.F.T.R.2d 2016-5350 (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. Although the IRS can require the use of PTINs, it cannot charge for them. The IRS needs to pay the fees back, says a federal district court. Don't spend the money just yet, though. The government likely will appeal, and the class action lawyers will ask for their cut. Steele v. United States, 119 A.F.T.R.2d 2017-2065 (D.D.C. 6/1/17). In this class action lawsuit, the court (Judge Lamberth) held that, although the IRS has statutory authority to require the use of PTINs by those who prepare tax returns for compensation, it cannot charge fees for issuing PTINs. Charging fees, the court reasoned, is "equivalent to imposing a regulatory licensing scheme and [under *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2/11/14)] the IRS does not have such regulatory authority."

- In a subsequent order, the court declared all fees charged by the IRS for issuing PTINs unlawful, permanently enjoined the United States from charging such fees, and ordered the United States to refund all PTIN fees paid from September 1, 2010 to the present. *See Steele v. United States*, 120 A.F.T.R.2d 2017-5145 (D.D.C. 7/7/17).

2. Due date of Forms W-2, W-3, and 1099-MISC that report nonemployee compensation: temporary and proposed regulations address the revised due date. T.D. 9821, Return Due Date and Extended Due Date Changes, 82 F.R. 33441 (7/20/17). Treasury and the IRS have issued proposed, temporary, and final regulations regarding the due date for forms in the Form W-2 series, Form W-3 series, and Forms 1099-MISC that report nonemployee compensation. The Protecting Americans from Tax Hikes Act of 2015 ("2015 PATH Act"), § 201, amended Code § 6071(c) to require that Forms W-2 and W-3 and any returns or written statements required to report nonemployee compensation (such as Form 1099-MISC) be filed by January 31 of the year after the calendar year to which the returns relate. The effect of this change was to require these information returns to have the same due date as employee and payee statements and to eliminate the extended filing date for electronically filed returns under § 6071(b). These regulations implement this statutory directive and provide that these information returns must be filed by January 31 of the calendar year for which the information is being reported, regardless of whether the returns are filed on paper or electronically.

- Information returns on Form 1099-MISC that do not report nonemployee compensation are not affected by this change and are due on February 28 of the year following the calendar year for which the information is being reported, or on March 31 if filed electronically.

- The temporary regulations apply to information returns filed on or after July 20, 2017, but the statutory amendments made by the 2015 PATH Act apply to information returns relating to calendar years beginning in 2016. Thus, the changes to the due date were effective for information returns filed in 2017 with respect to calendar year 2016.

3. Temporary regulations implement the 5-½ month automatic extension of time to file income tax returns of trusts and non-bankruptcy estates. T.D. 9821, Return Due Date and Extended Due Date Changes, 82 F.R. 33441 (7/20/17). Treasury and the IRS have issued proposed, temporary, and final regulations that provide an automatic 5-½ month extension of time for trusts and non-bankruptcy estates to file an income tax return on Form 1041. Previously, Reg. § 1.6081-6(a)(1) provided an automatic 5-month extension. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(b)(2), directs the Treasury to modify relevant regulations to provide that the maximum extension of time for the returns of trusts filing Form 1041 is 5-½ months (ending on September 30 for calendar-year taxpayers). Pursuant to this statutory directive, Temp. Reg. § 1.6081-6T(a)(1) provides that trusts and non-bankruptcy estates required to file an income tax return on From 1041 are allowed an automatic 5-½ month extension by filing a timely application. No extension beyond the automatic extension is permitted.

- The temporary regulations apply to applications for an automatic extension of time to file an estate or trust income tax return on or after July 20, 2017, but the statutory amendments made by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 apply to returns for taxable years that begin after December 31, 2015. Accordingly, the preamble to the temporary regulations provides that taxpayers can elect to apply the regulations to returns filed for periods beginning after December 31, 2015.

- The temporary regulations do not amend the rule for income tax returns on Form 1041 for bankruptcy estates of individuals proceeding under chapters 7 or 11, provided by Reg. § 1.6081-6T(a)(2), which provides an automatic 6-month extension.

4. The IRS has provided extensions of filing and payment due dates for those in areas affected by Hurricanes Harvey, Irma, and Maria. In news release IR-2017-160 (9/26/17), the IRS has summarized the relief announced in a series of prior news releases for those in areas affected by Hurricanes Harvey, Irma, and Maria. The relief is available to individuals and businesses anywhere in Florida, Georgia, Puerto Rico, and the Virgin Islands, as well as parts of Texas. (Parts of Puerto Rico qualify for the Hurricane Irma relief, and all of Puerto Rico qualifies for the Hurricane Maria relief. Hurricane Maria struck Puerto Rico just after September 15, 2017, so in theory there are parts of Puerto Rico that do not qualify for relief from September 15 due dates.) The prior news releases are IR-2017-135 (8/28/17) (relief in Texas for Harvey), VI-2017-01 (9/8/17) (relief in Virgin Islands for Irma), PR-2017-01 (9/12/17) (relief in Puerto Rico for Irma), IR-2017-150 (9/12/17) (relief in Florida for Irma), IR-2017-155 (9/15/17), (expanded relief in Florida for Irma), IR-2017-156 (9/19/17) (expanding Irma relief to all of Georgia).

Deadlines extended to January 31, 2018. For those in affected areas, the following due dates have been extended to January 31, 2018: (1) the September 15, 2017, and January 16, 2018, due dates for quarterly estimated tax payments; (2) the September 15, 2017, due date for certain returns, such as those for calendar-year partnerships that filed timely extension requests for 2016; (3) the October 16, 2017, due date for 2016 individual returns for individuals who filed timely extension requests; (4) the October 31, 2017, due date for quarterly payroll and excise tax returns; and (5) the November 15, 2017, due date for 2016 returns of calendar-year tax-exempt organizations that filed timely extension requests. **Note:** individuals who filed a timely request for an extension of time to file their 2016 returns do not obtain any relief for tax payments related to the 2016 return because those payments were due on April 18, 2017.

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 during the first fifteen days of the disaster period. The specific dates vary according to the location.

Relief provided automatically. 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.

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

XIII. TRUSTS, ESTATES & GIFTS

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION
"Recent developments are just like ancient history, except they happened less long ago."

By

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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

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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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

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

I. At-Risk and Passive Activity Losses

1. **IRS says the District Court for the Western District of Arkansas got it all wrong by allowing a taxpayer to claim passive losses against trade or business income due to taxpayer's "real estate professional" status.** A.O.D. 2017-07, 2017-42 I.R.B. 311 (10/16/17). In this action on decision, the IRS announced that it will not follow in two separate respects the decision of the U.S. District Court for the Western District of Arkansas in the unreported decision of *Stanley v. United States*, 116 A.F.T.R.2d 2015-6766 (W.D. Ark. 11/12/15). First, the IRS will not follow the District Court's holding that S corporation stock subject to a substantial risk of forfeiture counts for purposes of the "5-percent owner" exception in § 469(c)(7)(D)(ii), which allows the personal services of certain owner-employees of real estate management companies to qualify as material participation with respect to rental real property. The taxpayer in *Stanley* held a restricted share certificate for 10 percent of the outstanding stock of an S corporation real estate management company in which he was an employee, but apparently his stock was not considered outstanding for subchapter S purposes because it was subject to a substantial risk of forfeiture under § 83 and he had not made a § 83(b) election with respect to the stock. Second, the IRS disagreed with the District Court's decision that a § 469(c)(7) "real estate professional" who meets the material participation test by grouping rental real estate activities with real estate management activities also may group rental real estate activities and those same real estate management activities for determining passive income and passive losses. The taxpayer in *Stanley* was permitted by the District Court to group his non-passive income from his employer, a real estate management company, with his passive rental real estate holdings, in order to claim excess passive losses that otherwise would be disallowed by § 469.

III. INVESTMENT GAIN

A. Gains and Losses

1. **Pyrrhotite cracking the foundation of your house? IRS to the rescue!** Rev. Proc. 2017-60, 2017-50 I.R.B. ___ (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 phrrhotite 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.

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

D. Section 121

E. Section 1031

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. The IRS provides guidance on the application of the Affordable Care Act's market reforms to HRAs, EPPs, FSAs, and EAPs — it's the bee's knees! Notice 2013-54, 2013-40 I.R.B. 287 (9/13/13), *supplemented by* Notice 2015-87, 2015-52 I.R.B. 889 (12/16/15). The Patient Protection and Affordable Care Act amended the Public Health Service Act to implement certain market reforms for group health plans, including requirements that: (1) group health plans not establish any annual limit on the dollar amount of benefits for any individual, and (2) non-grandfathered group health plans provide certain preventive services without imposing any cost-sharing requirements for the services. The notice provides guidance, in Q&A format, on the application of these market reforms to: (1) health reimbursement arrangements (including HRAs integrated with group health plans), (2) group health plans under which employers reimburse employees for premium expenses incurred for an individual health insurance policy (referred to in the notice as "employer payment plans"), and (3) health flexible spending arrangements. The notice also provides guidance on employee assistance programs and on § 125(f)(3), which generally provides that a qualified health plan offered through a health insurance exchange established under the Affordable Care Act is not a qualified benefit that can be offered through a cafeteria plan. The notice applies for plan years beginning on and after 1/1/14, but taxpayers can apply the guidance provided in the notice for all prior periods. The Department of Labor has issued guidance in substantially identical form (Technical Release 2013-03) and the Department of Health and Human Services is issuing guidance indicating that it concurs.

a. The obvious solution has a great big catch in it. In a Q&A issued on 5/13/14, available on the IRS's web site (https://perma.cc/FK5A-FRF2), the IRS states:

Q1. What are the consequences to the employer if the employer does not establish a health insurance plan for its own employees, but reimburses those employees for premiums they pay for health insurance (either through a qualified health plan in the Marketplace or outside the Marketplace)?

[A1]. Under IRS Notice 2013-54, such arrangements are described as employer payment plans. An employer payment plan, as the term is used in this notice, generally does not include an arrangement under which an employee may have an after-tax amount applied toward health coverage or take that amount in cash compensation. As explained in Notice 2013-54, these employer payment plans are considered to be group health plans subject to the market reforms, including the prohibition on annual limits for essential health benefits and the requirement to provide certain preventive care without cost sharing. Notice 2013-54 clarifies that such arrangements cannot be integrated with individual policies to satisfy the market reforms. Consequently, such an arrangement fails to satisfy the market reforms and may be subject to a $100/day excise tax per applicable employee (which is $36,500 per year, per employee) under section 4980D of the Internal Revenue Code.

b. Good news (?) for some employers: the IRS reiterates prior guidance and clarifies issues related to employer payment plans and provides transition relief from the § 4980D excise tax. Notice 2015-17, 2015-14 I.R.B. 845 (2/18/15). This notice reiterates the conclusion in prior guidance, including Notice 2013-54, 2013-40 I.R.B. 287, that employer payment plans are group health plans that will fail to comply with the market reforms that apply to group health plans under the Affordable Care Act. The notice provides guidance, in Q&A format, on several issues, including the treatment of: (1) an S corporation's payment or reimbursement of premiums for individual health insurance coverage covering a 2-percent shareholder, (2) an employer's reimbursement of an employee's Medicare premiums or payment of medical expenses for employees covered by TRICARE, (3) an employer's increase of an employee's compensation to assist with payments for individual coverage, and (4) an employer's provision of premium assistance on an after-tax basis. The notice also provides a transition rule under which the IRS will not assert the excise tax imposed by § 4980D for any failure to satisfy the market reforms by employer payment plans that pay, or reimburse employees for individual health policy premiums or Medicare part B or Part D premiums: (1) for 2014 for employers that are not applicable large employers for 2014, and (2) for 1/1/15 through 6/30/15 for employers that are not applicable large employers for 2015. Generally, applicable large employers are those that employed an average of at least 50 full-time employees on business days during the preceding calendar year. Employers eligible for this transition rule are not required to file Form 8928 (Return of Certain Excise Taxes Under Chapter 43 of the Internal Revenue Code) solely as a result of having employer payment plans for the period for which the employer is eligible for the relief.

c. Final regulations provide guidance on many issues under the Affordable Care Act and incorporate prior guidance issued in forms other than regulations. T.D. 9744, Final Rules for Grandfathered Plans, Preexisting Condition Exclusions, Lifetime and Annual Limits, Rescissions, Dependent Coverage, Appeals, and Patient Protections Under the Affordable Care Act, 80 F.R. 72192 (11/18/15). The Treasury Department and the IRS have issued final regulations regarding grandfathered health plans, preexisting condition exclusions, lifetime and annual dollar limits on benefits, rescissions, coverage of dependent children to age 26, internal claims and appeal and external review processes, and patient protections under the Affordable Care Act. Among many other changes, the final regulations provide guidance on integration of health reimbursement arrangements with other group health plan coverage and modify Notice 2015-17 by providing a special rule for employers with fewer than 20 employees who offer group health plan coverage to employees who are not eligible for Medicare but do not offer coverage to employees who are eligible for Medicare. If such an employer is not required by the applicable Medicare secondary payer rules to offer group health plan coverage to employees who are eligible for Medicare coverage, then the employer's reimbursement of Medicare part B or D premiums may be integrated with Medicare and deemed to satisfy the annual dollar limit prohibition and the preventive services requirements if the employees who are not offered other group health plan coverage would be eligible for that group health plan but for their eligibility for Medicare. The regulations are effective on 1/19/16 and apply to group health plans and health insurance issuers beginning on the first day of the first plan year (or, in the individual market, the first day of the first policy year) beginning on or after 1/1/17.

d. **Just in time for Christmas! The IRS continues to prove that the Affordable Care Act, like the jelly-of-the-month club, is, as cousin Eddie put it, "the gift that keeps on giving [guidance] the whole year."** Notice 2015-87, 2015-52 I.R.B. 889 (12/16/15). This notice, in Q&A format, provides guidance on the application of various provisions of the Affordable Care Act to employer-provided health coverage. The notice supplements the guidance in Notice 2013-54, 2013-40 I.R.B. 287 (9/13/13) and T.D. 9744, Final Rules for Grandfathered Plans, Preexisting Condition Exclusions, Lifetime and Annual Limits, Rescissions, Dependent Coverage, Appeals, and Patient Protections Under the Affordable Care Act, 80 F.R. 72192 (11/18/15). The notice (1) provides guidance on the application of the Affordable Care Act's market reforms for group health plans to various types of employer health care arrangements, including health reimbursement arrangements and group health plans under which an employer reimburses an employee for some or all of the premium expenses incurred for an individual health insurance policy; (2) clarifies certain aspects of the employer shared responsibility provisions of § 4980H; (3) clarifies certain aspects of the application to government entities of § 4980H, the information reporting provisions for applicable large employers under § 6056, and application of the rules for health savings accounts to persons eligible for benefits administered by the Department of Veterans Affairs; (4) clarifies the application of the COBRA continuation coverage rules to unused amounts in a health flexible spending arrangement carried over and available in later years, and conditions that may be put on the use of carryover amounts; and (5) addresses relief from penalties under §§ 6721 and 6722 that has been provided for employers that make a good faith effort to comply with the requirements under § 6056 to report information about offers made in calendar year 2015. The guidance provided in the notice generally applies for plan years beginning on and after 12/16/15, but taxpayers can apply the guidance provided in the notice for all prior periods.

e. **Colleges and universities providing health insurance premium reductions to students who perform services might have employer payment plans that violate the Affordable Care Act's market reforms, and may need to look at alternatives.** Notice 2016-17, 2016-9 I.R.B. 358 (2/5/16). Colleges and universities often provide students, especially graduate students, with health coverage at greatly reduced or no cost as part of a package that includes tuition assistance and a stipend for living expenses. Some of these students perform services for the school (such as teaching or research), which raises the issue whether these premium reduction arrangements might be viewed as employer-sponsored group health plans that are employer payment plans that violate the market reform provisions of the Affordable Care Act. The notice concludes that whether such arrangements constitute group health plans will depend on all of the facts and circumstances, and that they might or might not be viewed as employer payment plans. To give colleges and universities time to examine this issue and adopt suitable alternatives if necessary, the notice provides that Treasury (and the Department of Labor and the Department of Health and Human Services) will not assert that a premium reduction arrangement fails to satisfy the Affordable Care Act's market reforms if the arrangement is offered in connection with other student health coverage (either insured or self-insured) for a plan year or policy year beginning before 1/1/17. Thus, colleges and universities have relief for plan years or policy years that are roughly coterminous with academic years beginning in the summer or fall of 2016 and ending in 2017. This notice applies for plan years beginning before 1/1/17.

f. **Congress provides relief from the § 4980D excise tax for small employers offering health reimbursement arrangements, imposes new reporting requirements, limits the exclusion from gross income under § 106, and coordinates HRAs with the § 36B premium tax credit.** The 21st Century Cures Act ("Cures Act"), Pub. L. No. 114-255, was signed by the President on 12/13/16. Among other changes, the Cures Act made several modifications to the rules related to health reimbursement arrangements.

Health Reimbursement Arrangements Offered by Small Employers—Section 18001(a)(1) of the Cures Act amends Code § 9831 by adding subsection (d), which provides that, for purposes of title 26 (other than the Cadillac Tax of § 4980I), a "qualified small employer health reimbursement arrangement" (QSEHRA) is not treated as a group health plan. The effect of this amendment is to allow employers to offer health reimbursement arrangements that meet the definition of a QSEHRA without becoming subject to the excise tax of § 4980D. An arrangement is a QSEHRA if it (1) is offered by an "eligible employer;" (2) subject to certain exceptions, is provided to all "eligible employees" on the same terms, (3) is funded solely by the employer and does not call for contributions through salary reduction; (4) provides for the payment or reimbursement of documented expenses for medical care (as defined in § 213(d)) incurred by the employee or the employee's family members; and (5) the amount of payments and reimbursements for the year do not exceed $4,950 ($10,000 in the case of an arrangement that also provides for payments or reimbursements for family members of the employee). These dollar limitations will be adjusted for inflation after 2016. An "eligible employer" is an employer that is not an applicable large employer as defined in § 4980H(c)(2) and does not offer a group health plan to any of its employees. An "eligible employee" generally is any employee of the employer, but the terms of the arrangement may exclude from consideration certain employees, such as those who have not completed 90 days of service, those who have not attained age 25, and part-time or seasonal employees. This relief from the § 4980D excise tax applies for years beginning after 12/31/16, which means that employers may begin offering QSEHRAs beginning in 2017.

New Reporting Obligations—The Cures Act imposes two new reporting requirements related to health reimbursement arrangements. **First**, Code § 9831(d)(4), as added by § 18001(a)(1) of the Cures Act, provides that an employer funding a QSEHRA for any year must provide to each eligible employee a written notice not later than 90 days before the beginning of the year (or, if later, the date on which the employee becomes an eligible employee). The notice must include the following information: (1) a statement of the amount of the employee's permitted benefit under the arrangement for the year; (2) statement that the employee should provide the amount of his or her permitted benefit to any health insurance exchange to which the employee applies for advance payment of the premium tax credit; and (3) a statement that, if the employee is not covered under minimum essential coverage for any month, the employee may be subject to tax under section § 5000A for that month and reimbursements under the arrangement may be includible in gross income. An employer that fails to provide the required notice is subject to a $50 penalty per employee for each incident of failure, subject to a $2,500 calendar year maximum for all failures. **Second**, new Code § 6501(a)(15), as added by § 18001(a)(6) of the Cures Act, requires an employer to report on Form W-2 the amount of each employee's permitted benefit under a QSEHRA. These rules regarding reporting apply to years beginning after 12/31/16. However, the legislation provides that a person shall not be treated as failing to provide the written notice required by § 9831(d)(4) if the notice is provided not later than 90 days after the date of the enactment of the Cures Act.

Extension of Relief Provided by Notice 2015-17—Notice 2015-17, 2015-14 I.R.B. 845 (2/18/15), provided a transition rule under which the IRS would not assert the excise tax imposed by § 4980D for any failure to satisfy the market reforms by employer payment plans that pay or reimburse employees for individual health policy premiums or Medicare part B or Part D premiums: (1) for 2014 for employers that are not applicable large employers for 2014, and (2) for 1/1/15 through 6/30/15 for employers that are not applicable large employers for 2015. Section 18001(a)(7)(B) of the Cures Act provides that the relief under Notice 2015-17 shall be treated as applying to any plan year beginning on or before 12/31/16. This means that employers that are not applicable large employers will not be subject to the § 4980D excise tax as a result of offering an employer payment plan for plan years beginning on or before 12/31/16.

Limitation on the Exclusion of Code § 106—New Code § 106(g), as added by § 18001(a)(2) of the Cures Act, provides that, for purposes of Code §§ 105 and 106, payments or reimbursements to an individual for medical care from a QSEHRA shall not be treated as paid or reimbursed under employer-provided coverage for medical expenses under an accident or health plan if, for the month in which the medical care is provided, the individual does not have minimum essential coverage within the meaning of § 5000A(f). The effect of this amendment is that payments or reimbursements under a QSEHRA are included in an individual's gross income if the individual does not have minimum essential coverage.

Coordination with the § 36B Premium Tax Credit—Code § 36B(c)(4), as added by § 18001(a)(3) of the Cures Act, makes an individual ineligible for the § 36B premium tax credit for any month if the individual is provided a QSEHRA for the month that constitutes affordable coverage. If the QSEHRA does not constitute affordable coverage, then the employee remains eligible for the premium tax credit for the month, but the amount of the credit is reduced by the 1/12 of the employee's permitted benefit under the QSEHRA for the year. A QSEHRA constitutes affordable coverage for a month (and therefore makes an employee ineligible for the premium tax credit) if the *excess of* (1) the premium for the month for self-only coverage under the second lowest cost silver plan offered in the relevant individual health insurance market, *over* (2) 1/12 of the employee's permitted benefit under the QSEHRA, *exceeds* 1/12 of 9.69 percent (for 2017) of the employee's household income. (Note that this calculation requires using the cost of self-only coverage, even for employees with insured family members.) The statutory rules provide for adjusting the calculation in the case of employees employed for less than a full year. An employee must provide the amount of his or her permitted benefit to any health insurance exchange to which the employee applies for advance payment of the premium tax credit.

Application of the Cadillac Tax—Generally, § 4980I, which was enacted as part of the Affordable Care Act, imposes a 40 percent excise tax on the amount by which the cost of group health coverage provided by an employer (referred to as "applicable employer-sponsored coverage") exceeds a specified dollar limit. Subsequent to the enactment of the Affordable Care Act, Congress in 2015 delayed the effective date of the Cadillac Tax to taxable years beginning after 12/31/19. Section 18001(a)(4) of the Cures Act amends Code § 4980I(d)(2)(D) to provide that a QSEHRA is considered "applicable employer-sponsored coverage" for purposes of the Cadillac Tax. Accordingly, the cost of a QSEHRA to the employer must be taken into account in determining the applicability of the Cadillac Tax.

g. Employers offering Qualified Small Employer Health Reimbursement Arrangements in 2017 need not provide the initial written notice to employees until after the IRS provides guidance. Notice 2017-20, 2017-11 I.R.B. 1010 (2/27/17). The 21st Century Cures Act, signed by the President on 12/13/16, added Code § 9831(d)(4), which requires each employer that funds a QSEHRA to provide each eligible employee a written notice with specified information not later than 90 days before the beginning of the year (or, if later, the date on which the employee becomes an eligible employee). For 2017, the legislation provides that employers will be treated as complying with this requirement if they provide the notice not later than 90 days after the date of enactment of the Cures Act. The 90th day was 3/13/17. An employer that fails to provide the required notice is subject to a $50 penalty per employee for each incident of failure, subject to a $2,500 calendar year maximum for all failures. Because employers might have difficulty complying with the notice requirement in the absence of guidance, the IRS has announced that employers funding QSEHRAs in 2017 need not provide the initial written notice until after the IRS issues such guidance.

h. Guidance on issues related to Qualified Small Employer Health Reimbursement Arrangements, including required reporting by employers. Notice 2017-67, 2017-47 I.R.B. 517 (10/31/17). In this notice, the IRS has provided guidance to employers offering Qualified Small Employer Health Reimbursement Arrangements, which are described in Code § 9831(d). Among other guidance, the notice clarifies that a QSEHRA can be provided only to current employees, not to retirees. The notice provides that employers ofering a QSEHRA in 2017 or 2018 must provide the required written notice to employees by the later of (1) 90 days before the first day of the QSEHRA plan year, or (2) February 28, 2018. The notice contains sample language and provides requirements for the notice. An employer must report payments and reimbursements that an employee was entitled to receive (i.e., without regard to the amounts the employee actually received) in Box 12 of Form W-2 using code FF.

2. Ministers pray this "crabby" case gets reversed (again!) on appeal. Gaylor v. Mnuchin, ___ F. Supp. 3d ___, 120 A.F.T.R.2d 2017-6128 (W.D. Wis. 10/6/17). In a case that previously was overturned on appeal to the Seventh Circuit, the U.S. District Court for the Western District of Wisconsin (Judge Crabb) held that § 107(2) is unconstitutional because it violates the First Amendment's establishment clause. Section 107(2) excludes from gross income a "rental allowance" paid to a minister as part of his or her compensation. Section 107(1) excludes the "rental value of a home" furnished to a minister as part of his or her compensation. For technical reasons, only § 107(2)'s "rental allowance" exclusion was at issue in this case. The named plaintiff, Gaylor, is co-president of the true plaintiff, Freedom from Religion Foundation, Inc. ("FFRF"). In a prior iteration of the case, *Freedom from Religion Foundation, Inc. v. Lew*, 773 F.2d 815 (7th Cir. 2014), the Seventh Circuit vacated Judge Crabb's prior ruling striking down § 107(2) by determining that FFRF lacked standing to sue; however, the Seventh Circuit essentially instructed FFRF on how it might obtain standing. FFRF dutifully followed the Seventh Circuit's directions and then refiled its claim with Judge Crabb that § 107(2) violates the First Amendment's establishment clause because it "demonstrates a preference for ministers over secular employees." Look for the IRS and Treasury to appeal this one yet again.

B. Qualified Deferred Compensation Plans

1. Some inflation-adjusted numbers for 2018. Notice 2017-64, 2017-45 I.R.B. 486 (10/19/17).

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

- The limit on contributions to an IRA will be unchanged at $5,500. The AGI phase out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to $63,000 to $73,000 (from $62,000-$72,000) for single filers and heads of household, increased to $101,000-$121,000 (from $99,000-$119,000) 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 $186,000-$196,000) 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 $189,000-$199,000 (from $186,000-$196,000) for married couples filing jointly, and increased to $120,000-$135,000 (from $118,000-$133,000) for singles and heads of household.

- The annual benefit from a defined benefit plan under § 415 is increased to $220,000 (from $215,000).

- The limit for defined contribution plans is increased to $55,000 (from $54,000).

- The amount of compensation that may be taken into account for various plans is increased to $275,000 (from $270,000), and is increased to $405,000 (from $4005,000) for government plans.

- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to $63,000 (from $62,000) for married couples filing jointly, increased to $47,250 (from $46,5005) for heads of household, and increased to $31,500 (from $31,000) for singles and married individuals filing separately.

C. Nonqualified Deferred Compensation, Section 83, and 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. Excess advance premium tax credits are treated as an increase in tax, and we do not have equitable power to change that result, says the Tax Court. McGuire v. Commissioner, 149 T.C. No. 9 (8/28/17). The taxpayers, a married couple, purchased health insurance for 2014 through Covered California, a health insurance exchange created under the Affordable Care Act. At the time they applied for coverage in 2013, their only income was that of Mr. McGuire. Based on this income, they qualified for an advance payment of the premium tax credit authorized by § 36B. Later in 2013, Mrs. McGuire became employed and the couple's income increased. They informed the exchange of the increase in income and of their change of address. The exchange did not update their address. The exchange sent them a letter informing them that they no longer qualified for the premium tax credit, but they never received the letter. Similarly, they never received from the exchange Form 1095-A, which taxpayers use to calculate their premium tax credit for the year. During 2014, the exchange made monthly payments to the health insurance issuer of $591, for an annual total of $7,092. The taxpayers worked with a CPA to prepare their 2014 return. Because they had received advance credit payments, they were required by § 36B(f)(1) to reconcile the amount of the advance payments with the premium tax credit calculated on their return. The taxpayers did not report their advance credit payments on their return. The IRS ultimately issued a notice of deficiency disallowing the entire credit. Because they did not qualify for any premium tax credit and had received $7,092 in advance credit payments, they owed the entire $7,092 as a tax liability. The taxpayers argued that the exchange had a responsibility to ensure that only those eligible for advance credit payments receive them, and that they never would have enrolled in the health insurance coverage they had chosen without the assistance of the credit for which the exchange had told them they qualified. They asked the court to rule "fairly and justly." The Tax Court (Judge Buch) held that it had no ability grant relief to the taxpayers. The court reiterated that it is not a court of equity and "cannot ignore the law to achieve an equitable end."

> Although we are sympathetic to the McGuires' situation, the statute is clear; excess advance premium tax credits are treated as an increase in the tax imposed. Sec. 36B(f)(2)(A). The McGuires received an advance of a credit to which they ultimately were not entitled. They are liable for the $7,092 deficiency.

The court declined to impose accuracy-related penalties on the basis of negligence because the IRS had presented no evidence of negligence. The court also declined to impose such penalties on the basis of substantial understatement of income because the taxpayers had established a reasonable cause, good faith defense based on their reliance on a third party (the exchange) to fulfill their obligations, their failure to receive Form 1095-A, and their reliance on a CPA to prepare their return.

2. Standard deduction for 2018. Rev. Proc. 2017-58, 2017-45 I.R.B. 489 (10/19/17). The standard deduction for 2018 will be $13,000 for joint returns and surviving spouses (increased from $12,700), $6,500 for unmarried individuals and married individuals filing separately (increased from $6,350), and $9,550 for heads of households (increased from $9,350).

E. Divorce Tax Issues

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

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

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

G. Miscellaneous

1. Due date for partnership income tax returns: temporary and proposed regulations reflect Congress's belief that some partners might not need filing extensions any more. T.D. 9821, Return Due Date and Extended Due Date Changes, 82 F.R. 33441 (7/20/17). Treasury and the IRS have issued proposed, temporary, and final regulations regarding the due date and extended due date of partnership income tax returns (Form 1065). The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(a), amended Code § 6072(b) to require partnerships to file their income tax returns by the 15th day of the third month following the close of the taxable year (March 15 for calendar year partnerships), thus accelerating the due date by one month. Act § 2006(b) directs the Treasury to modify the regulations to provide that the maximum extension for a partnership return will be a 6-month period ending on September 15 for calendar year partnerships. Pursuant to this statutory directive, Temp. Reg. § 1.6031(a)-1T(e)(2) provides that "the return of a partnership must be filed on or before the date prescribed by § 6072(b)." (The temporary regulations do not explicitly address the due date of Form 8804—Annual Return for Partnership Withholding Tax—but the 2016 instructions for Form 8804 indicate that the due date is the 15th day of the third month following the close of the taxable year.) Pursuant to Temp. Reg. § 1.6081(a)-2T(a)(1), a partnership is allowed an automatic 6-month extension to file both Form 1065 and Form 8804 by filing a timely application. No extension beyond the automatic extension is permitted.

- The temporary regulations apply to returns and extension requests filed on or after July 20, 2017, but the statutory amendments made by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 apply to returns for partnership taxable years that begin after December 31, 2015. Accordingly, the preamble to the temporary regulations provides that taxpayers can elect to apply the regulations to returns filed for periods beginning after December 31, 2015.

a. **What, you weren't paying attention to the new accelerated due date for partnership returns? We've got your back, says the IRS. Late-filing penalties are waived, but don't let this happen again!** Notice 2017-47, 2017-38 I.R.B. 232 (9/1/17). In this notice, the IRS has waived penalties for a partnership's failure to file or furnish to partners certain returns by the accelerated due date enacted as part of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015. The penalty relief applies if one of the following two conditions is satisfied:

> (1) the partnership filed Form 1065, 1065-B, 8804, 8805, 5471, or other return required to be filed with the IRS and furnished copies (or Schedules K-1) to the partners (as appropriate) by the date that would have been timely under section 6072 before amendment by the Surface Transportation Act (April 18, 2017 for calendar-year taxpayers …), or
>
> (2) the partnership filed Form 7004 to request an extension of time to file by the date that would have been timely under section 6072 before amendment by the Surface Transportation Act and files the return with the IRS and furnishes copies (or Schedules K-1) to the partners (as appropriate) by the fifteenth day of the ninth month after the close of the partnership's taxable year (September 15, 2017, for calendar-year taxpayers). If the partnership files Form 1065-B and was required to furnish Schedules K-1 to the partners by March 15, 2017, it must have done so to qualify for relief.

This relief is available only for the partnership's first taxable year that begins after 2015. The IRS will grant this relief automatically. Taxpayers that have already had penalties assessed should receive a letter indicating that the penalty has been abated and are instructed to contact the IRS for abatement if they do not receive such a letter.

b. **Further penalty relief for partnerships and certain other entities that missed the new accelerated due date.** Notice 2017-71, 2017-51 I.R.B. ___ (11/30/17). The IRS has expanded the penalty relief provided by Notice 2017-47, 2017-38 I.R.B. 232 (9/1/17), in two ways: (1) penalty relief is available not only with respect to filing or furnishing of returns, but also to taking other actions, such as making elections, contributing to an employee pension plan, or paying tax, by the due date of a partnership return, and (2) penalty relief is available not only to entities classified as partnerships for federal tax purposes, but also to real estate mortgage investment conduits (REMICs) and certain other entities that are required to file partnership returns. This notice provides that the IRS will treat acts of a partnership, REMIC, or any entity that may properly file a Form 1065 (such as a bank with respect to the return of a common trust fund or a religious or apostolic association or corporation) as timely if the entity took the act by the date that would have been timely under section § 6072 before amendment by the Surface Transportation Act (April 18, 2017, for calendar-year taxpayers). This relief is available only for the first taxable year that began after December 31, 2015, and ended before January 1, 2017. Despite the penalty relief, the notice cautions that the entity will be liable for any interest due under § 6601 from the date prescribed for payment until the date of payment.

Taxpayers that have already had penalties assessed should receive a letter indicating that the penalty has been abated and are instructed to contact the IRS for abatement if they do not receive such a letter. This notice amplifies, clarifies, and supersedes Notice 2017-47.

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. You better hope that your HP computer works better than HP's tax planning strategies. Hewlett-Packard Co. v. Commissioner, 875 F.3d 494 (9th Cir. 11/9/17) *aff'g* T.C. Memo. 2012-135 (5/14/12). In an opinion by Judge Kozinski, the U.S. Court of Appeals for the Ninth Circuit affirmed the Tax Court's decision (Judge Goeke) denying millions in foreign tax credits claimed by Hewlett-Packard Co. (HP) from 1997 through 2003. The Ninth Circuit also affirmed the Tax Court's disallowance of a capital loss on the sale of the preferred stock by virtue of which HP had claimed the foreign tax credits. The transaction expressly was designed by AIG-Financial Products to generate foreign tax credits. HP purchased preferred stock in a Dutch company called Foppingadreef Investments (FOP) that purchased contingent interest notes. The transaction was structured to take advantage of asymmetric treatment of contingent interest in the U.S. and the Netherlands. The Netherlands taxes contingent interest prior to actual payment thereof while the U.S. taxes such interest only upon payment. In some cases, the contingent interest might never be paid. Thus, the transaction generated foreign tax credits without any actual U.S. tax on the contingent interest, which allowed HP to use the foreign tax credits against U.S. taxes on other foreign income. HP treated FOP as a controlled foreign corporation through its ownership of the preferred stock and warrants to acquire additional stock and claimed foreign tax credits for Dutch taxes on contingent interest. The transaction was pre-arranged to terminate in 2003 through the exercise of put options held by HP that allowed HP to transfer the preferred stock back to the common stockholder of FOP (a Dutch bank) for a price that resulted in a $16 million loss to HP. Judge Kozinski noted that the Courts of Appeals differ in their standard of review on the question whether an investment is debt or equity. Some Courts of Appeals view the question as one of fact, other view it as a question of law, and still others as a mixed question of law and fact. In the Ninth Circuit, the debt-equity distinction is a question of fact and therefore a trial court's conclusion on this issue cannot be overturned on appeal unless clearly erroneous. The Ninth Circuit concluded that the Tax Court committed no clear error in finding that the preferred stock was in reality debt not equity, thereby disqualifying HP from claiming foreign tax credits. Moreover, the Ninth Circuit agreed with the Tax Court that HP's claimed $16 million § 165 loss on the sale of the preferred stock back to the common stockholder of FOP was in effect a nondeductible fee paid to AIG in order to participate in a tax shelter. The Tax Court previously had held, and the Ninth Circuit previously had agreed, that fees spent for the generation of artificial tax losses are not deductible. *See Enrici v. Commissioner*, 813 F.2d 293, 296 (9th Cir. 1987); *see also New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. 161, 186 (2009), *aff'd,* 408 Fed. Appx. 908 (6th Cir. 2010) (holding payments made in a transaction that lacked economic substance nondeductible).

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

1. Certain syndicated conservation easement transactions entered into after 2009 are listed transactions and taxpayers who have invested in them must disclose them for each tax year in which they participated. Notice 2017-10, 2017-4 I.R.B. 544 (12/23/16). This notice identifies certain syndicated conservation easement transactions entered into after 2009 as listed transactions. In these transactions, a promoter typically markets interests in a pass-through entity that owns real property. The pass-through entity grants a conservation easement on the real property based on an appraisal that, in the IRS's view, greatly inflates the value of the conservation easement based on unreasonable conclusions about the development potential of the real property. The charitable contribution deduction resulting from the grant of the conservation easement flows through to the investors in the pass-through entity. The effect of these transactions is that an investor in the pass-through entity receives a charitable contribution deduction that significantly exceeds the amount invested. The IRS plans to challenge these transactions based on the overvaluation of the conservation easement and also may challenge them based on the partnership anti-abuse rule, economic substance, or other rules or doctrines. Transactions that are the same as, or substantially similar to, the transactions described in § 2 of the notice are identified as "listed transactions" for purposes of Reg. § 1.6011-4(b)(2) and §§ 6111 and 6112 effective 12/23/16. A person entering into these transactions on or after 1/1/10 must disclose the transactions as described in Reg. § 1.6011-4 for each taxable year in which the person participated in the transactions, provided that the period of limitations for assessment of tax has not expired on or before 12/23/16.

a. **Participants in listed syndicated conservation easement transactions have until October 2, 2017, to disclose their participation in years for which returns were filed before December 23, 2016.** Notice 2017-29, 2017-20 I.R.B. 1243 (4/27/17). This notice extends the due date for participants to disclose their participation in the syndicated conservation easement transactions described in Notice 2017-10, 2017-4 I.R.B. 544 (12/23/16). Generally, under Reg. § 1.6011-4(e)(2)(i), if a transaction becomes a transaction of interest or a listed transaction after a taxpayer has filed a return reflecting the taxpayer's participation in the transaction, then the taxpayer must disclose the transaction for any year for which the limitations period on assessment was open on the date the transaction was identified as a listed transaction or transaction of interest within 90 calendar days after the date on which the transaction was identified. Notice 2017-10 extended this period to 180 days for listed syndicated conservation easement transactions, which meant that disclosures were due (for years for which returns already had been filed) on 6/21/17. In this notice, the IRS has extended the due date from 6/21 to 10/2/17. The notice cautions that the due date for disclosure with respect to returns filed after the date Notice 2017-10 was issued (12/23/17) and for disclosure by material advisors is unchanged and remains 5/1/17. The notice also provides that donees in these syndicated conservation easement transactions are not considered material advisors under § 6111.

b. **Those affected by Hurricanes Harvey, Irma, or Maria have until October 31, 2017, to disclose their participation in syndicated conservation easement transactions for years for which returns were filed before December 23, 2016.** Notice 2017-58, 2017-42 I.R.B. 326 (9/27/17). For participants in syndicated conservation easement transactions that are "affected participants," this notice extends the due date for disclosing their participation in the syndicated conservation easement transactions described in Notice 2017-10, 2017-4 I.R.B. 544 (12/23/16). Disclosure was due on October 2, 2017, for years of participation for which a return had already been filed by December 23, 2016 (the date Notice 2017-10 was issued). Affected participants now have until October 31, 2017 to file disclosures. An affected participant is "any participant whose principal residence or principal place of business was located in a Hurricane Harvey, Hurricane Irma, or Hurricane Maria covered disaster area, as defined in [Reg.] § 301.7508A-1(d)(2), or whose records necessary to meet the disclosure obligation were maintained in such a covered disaster area."

2. **Tax Court Not Giving in to First Circuit?** Palmolive Building Investors, LLC v. Commissioner, 149 T.C. No. 18 (10/10/17). In this TEFRA partnership audit case, the Tax Court refused to follow the First Circuit's opinion in *Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012), regarding the § 170(h)(5)(A) "protected in perpetuity" requirement for deducting conservation easements. In particular, the taxpayer, a limited liability company classified for federal tax purposes as a partnership, contributed a $33.41 million facade conservation easement to a § 501(c)(3) qualified organization in 2004 by executing a deed in favor of the donee organization. The building subject to the façade easement was encumbered by two mortgages; however, before executing the façade easement deed, the taxpayer obtained mortgage subordination agreements from the two mortgagee banks. Unfortunately, though, the subordination agreements provided that if the façade easement was extinguished through a condemnation proceeding, the claims of the mortgagee banks to the condemnation proceeds would take priority over the claims of the qualified donee organization. On the other hand, the subordination agreements contained a "savings clause" providing that the mortgagee's rights "shall be deemed amended to the extent necessary" to comply with applicable regulations

governing conservation easements. The IRS argued that due to the failure of the subordination agreements to elevate the rights of the qualified donee organization over the mortgagee's rights upon condemnation of the building, the façade easement was not "protected in perpetuity" and did not grant the donee an adequate "property right," as required by § 170(h)(5)(A) and Reg. § 1.170A-14(g)(2) and (g)(6). To rebut the IRS's contentions, the taxpayer relied upon the First Circuit's decision in *Kaufman*, which allowed a charitable contribution deduction for a façade easement subject to similar mortgage subordination rights. Furthermore, the taxpayer argued that the "savings clause" cured any problem with the subordination agreements. Noting that the case presumably was appealable to the Seventh Circuit, the Tax Court, in a unanimous reviewed opinion by Judge Gustafson, was not persuaded and not only refused to follow the First Circuit's decision in *Kaufman*, but also held that the "savings clause" did not cure the problem with the subordination agreements. (Judge Lauber did not participate in consideration of the opinion.) In the view of the Tax Court, the requirements of § 170(h)(5)(A) and Reg. § 1.170A-14(g)(2) and (g)(6) must be met at the time of the contribution of the easement to the qualified donee and retroactive reformation of a deed contingent upon a condition subsequent (such as with a "savings clause") will not be respected. The court cited several cases for this proposition, including *Belk v. Commissioner,* 774 F.3d 221 (4th Cir. 2014).

X. TAX PROCEDURE

A. Interest, Penalties and Prosecutions

1. Pouring salt on an already mortal wound, the IRS revoked this taxpayer's exempt status and charged ten year's worth of interest on retroactively determined, unpaid taxes of the formerly-exempt taxpayer. Creditguard of America, Inc. v. Commissioner, 149 T.C. No. 17 (10/10/17). The IRS initiated an examination of the taxpayer in 2003 to determine if it qualified for tax-exempt status under § 501(c)(3). The examination concluded on February 1, 2012, when the IRS issued an adverse determination letter revoking the taxpayer's exempt status retroactively from 2002. As a non-exempt corporation, the taxpayer would have been obligated to file a 2002 IRS Form 1120, U.S. Corporate Income Tax Return, by March 17, 2003. Consequently, after the adverse determination was final, the IRS subsequently issued a notice of deficiency to the taxpayer asserting unpaid corporate taxes for 2002. The taxpayer filed a petition in the Tax Court contesting the deficiency for 2002. The Tax Court entered a stipulated decision that determined a deficiency for 2002 of $216,547. In connection with the Tax Court's determination of the deficiency, the taxpayer and the IRS entered into a stipulated decision that underpayment interest on the deficiency would be assessed later "as provided by law." That later day came on March 13, 2013, when the IRS assessed the $216,547 in unpaid taxes as well as $142,185 in underpayment interest against the taxpayer dating back to 2002. The taxpayer did not timely pay either the $216,547 in taxes or the $142,185 in interest. The taxpayer's nonpayment ultimately led the IRS to issue a Notice of Federal Tax Lien Filing and Your Rights to a [Collection Due Process] Hearing to the taxpayer in 2013. The taxpayer timely requested a collection due process hearing in response to the notice. Subsequently, after settlement and collection discussions collapsed, the IRS issued the taxpayer a final notice of determination in December 2015 sustaining the collection action for $216,547 in unpaid taxes and $142,185 in interest relating to 2002. In response to the notice of determination, the taxpayer timely petitioned the Tax Court; however, the taxpayer contested only the $142,185 of interest assessed by the IRS. The taxpayer argued that the interest should be calculated from February 1, 2012, the date of the IRS's adverse determination letter revoking the taxpayer's exempt status, not March 17, 2003, the date the taxpayer's corporate tax return would have been due as a non-exempt corporation. In a case of first impression responding to cross-motions for summary judgment, the Tax Court (Judge Lauber) upheld the IRS's determination that underpayment interest against the taxpayer should be calculated from March 17, 2003, not February 1, 2012, when the IRS revoked the taxpayer's tax-exempt status. The taxpayer had argued that although the general rule of § 6601(b) requires interest to be calculated "from the last date prescribed for payment" (which for 2002 was March 17, 2003), in the unusual circumstances of this case § 6601(b)(5) should apply. Section 6601(b)(5) provides that "[i]n the case of taxes payable by stamp and in all other cases in which the last date for payment is not otherwise prescribed, the last date for payment shall be deemed to be the date the liability for the tax arises." The taxpayer's position was that the unpaid taxes for 2002 did not "arise" until the IRS's issuance of the adverse determination letter revoking the taxpayer's exempt status. The Tax Court rejected the taxpayer's argument on the grounds that this was not a case where "the last date for payment is not otherwise prescribed" because the taxpayer, being treated (albeit retroactively) as a taxable corporation for 2002 and subsequent years, was required to file a Form 1120 and pay its tax liability as of March 17, 2003. Furthermore, the Tax Court held that the taxpayer's liability for unpaid taxes did not "arise" on February 1, 2012, when the IRS revoked the taxpayer's exempt status, but instead arose as of March 17, 2003, when the taxpayer should have filed a corporate tax return. The taxpayer's filing of an IRS Form 990 in 2003 on the assumption that it was tax-exempt for 2002 did not prevent the IRS from assessing back taxes and interest for 2002 when the taxpayer later was found not to have qualified for exemption. Finally, the Tax Court held that the purpose of interest is to put the IRS in the same position that it would have occupied had the taxpayer properly and timely paid its tax liability; therefore, the court concluded that it was proper to assess interest against the taxpayer from March 17, 2003, when the corporate income tax should have been paid.

B. Discovery: Summons and FOIA

C. Litigation Costs

D. StatutoryNotice of Deficiency

E. Statute of Limitations

1. **Those seeking to toll the limitations periods on seeking tax refunds based on financial disability must strictly comply with Rev. Proc. 99-21, says this U.S. District Court.** Estate of Kirsch v. United States, ___ F. Supp. 3d ___, 120 A.F.T.R.2d 2017-5211 (W.D.N.Y. 7/13/17). The taxpayer filed her 2008 federal income tax return on June 5, 2014. Her return indicated that she had paid approximately $51,000 in tax and owed roughly $10,000 and therefore asserted a claim for refund of $41,000. All of the tax had been paid or was deemed to have been paid on April 15, 2009. Section 6511(a) provides that a claim for refund must be filed within the later of two years from the time tax was paid or three years from the time the return was filed. Her claim for refund was filed within three years of the time the return was filed (and therefore was timely under § 6511(a)) because she had submitted it simultaneously with her return. However, § 6511(b)(2)(A) provides that, when a claim for refund is timely under the three-years-from-filing period of § 6511(a), the taxpayer can recover only the portion of the tax paid within the three-year period ending on the date the claim for refund was filed (plus the period of any extension the taxpayer obtained). In this case, § 6511(b)(2)(A) barred the taxpayer from obtaining a refund because the taxpayer had paid all of the tax more than three years before she filed her claim for refund. The taxpayer asserted that, notwithstanding the normal limitations periods, she was entitled to relief under § 6511(h), which suspends the running of the periods in § 6511(a), (b), and (c) during any period that the taxpayer is "financially disabled." The term "financially disabled" is defined as being "unable to manage … financial affairs by reason of a medically determinable phyiscal or mental impairment of the individual which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months." The taxpayer submited to the IRS a statement from her physician that the taxpayer had been diagnosed with a cognitive mental impairment that had lasted more than twelve months, had begun in 2007 and become progessively worse, and that had prevented the taxpayer from managing certain aspects of her financial affairs. The taxpayer's son submitted to the IRS a statement describing a durable power of attorney that appointed him as the taxpayer's agent effective after April 1, 2009 (shortly after the death of the taxpayer's husband on March 28, 2009). The son's statement indicated that he did not live near his mother and was unaware she needed his assistance until her symptoms became more pronounced in a later year. The District Court (Judge Wolford) held that the taxpayer was not entitled to relief under § 6511(h). The IRS's guidance on § 6511(h) is set forth in Rev. Proc. 99-21, 1999-1 C.B. 960. The revenue procedure requires, among other things, that the taxpayer submit (1) a physician's statement attesting to the specific time period during which the physical or mental impairment prevented the taxpayer from managing his or her financial affairs, and (2) a statement that no person was authorized to act on the taxpayer's behalf in financial matters during the specified period of disability. The items the taxpayer submitted, the court held, did not comply with these requirements. The statement of the taxpayer's physician did not identify the specific period of time during which the taxpayer was unable to manage her financial affairs, and her son's statement indicated that he was, in fact, authorized to act on her behalf in financial matters. Accordingly, the court held, the taxpayer's refund action had to be dismissed for lack of subject matter jurisdiction.

a. But another U.S. District Court declines to dismiss a taxpayer's refund action despite the taxpayer's failure to submit the specific documentation required by Rev. Proc. 99-21. Stauffer v. IRS, 120 A.F.T.R.2d 2017-6119 (9/29/17). The taxpayer did not file federal icome tax returns for the years 2006 through 2012. Upon the taxpayer's death at the age of 90 in 2012, his son was appointed as adminstrator of the estate. As administrator, the son filed the missing returns and sought a refund of tax for the year 2006 of more than $137,000. The IRS denied the claim as untimely under § 6511. The son filed an administrative appeal and asserted that the limitations periods of § 6511 had been tolled because his father had been financially disabled within the meaning of § 6511(h). With the administrative appeal, the son submitted a statement from the taxpayer's psychologist attesting that the taxpayer had suffered from a variety of ailments that had affected his mental capacity and had prevented him from managing his financial affairs from at least 2006 until his death in 2012. The IRS concluded that the taxpayer had not complied with Rev. Proc. 99-21, which requires that the taxpayer submit the statement of a "physician," and denied the claim as untimely. The revenue procedure provides that the term "physician" has the same meaning as in § 1861(r)(1) of the Social Security Act, 42 U.S.C. § 1395x(r), which sets forth five categories of professionals considered to be physicians, none of which includes psychologists. The District Court (Judge Wolf) held that the IRS had failed to establish that its adoption of the Social Security Act's definiton of a physician in Rev. Proc. 99-21 was the product of reasoned decision making as required by Administrative Procedure Act § 706(2)(A) and *Motor Vehicle Manufacturers Association of the United States v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983):

> The government … has not submitted any evidence of the IRS's rationale in adopting the definition in 42 U.S.C. § 1395x(r). … The IRS, therefore, has not provided any explanation for its decision, let alone a "rational connection between the facts found and the choice made." *State Farm*, 463 U.S. at 43. The IRS may conceivably view doctors without medical degrees to be generally unqualified to make the determination required under section 6511, and may have determined that, in view of the "need to fairly and efficiently process a potentially large number of [refund] claims," *Abston*, 691 F.3d at 996, a case-by-case determination of whether a given psychologist is nevertheless qualified is unwarranted. However, as explained earlier, at least where the IRS's reasoning is not obvious, the court may not supply an explanation for the IRS's choice that the agency itself has not given. *See State Farm*, 463 U.S. at 43.

The court also rejected the government's argument that the taxpayer was not entitled to relief under § 6511(h) because the taxpayer had submitted the psychologist's statement in the course of the administrative appeal, rather than with the claim for refund as required by Rev. Proc. 99-21. When refund claims are technically deficient, the court noted, courts generally accept the missing information at a later stage. Accordingly, the court denied the government's motion to dismiss without prejudice.

2. Shouldn't the limitations periods on seeking tax refunds be simpler? Another case in which a taxpayer loses the ability to obtain a refund because of a limit on the amount of tax recoverable. Borenstein v. Commissioner, 149 T.C. No. 10 (8/30/17). The taxpayer filed a timely extension request for her 2012 federal income tax return and paid a total of $112,000 towards her 2012 federal tax liability. All of her payments, which she made through estimated tax payments and a payment with her extension request, were deemed to be made on April 15, 2013. She did not file her 2012 until August 29, 2015, after she had received a notice of deficiency for 2012. Her return reflected a tax liability of $79,559, which the IRS agreed was correct. Thus, she had overpaid her 2012 federal tax liability by $38,447. In response to the notice of deficiency, the taxpayer filed a petition in the Tax Court. The issue before the court was whether the taxpayer was entitled to a credit or refund of the overpayment. The Tax Court (Judge Lauber) held that she was not. Under § 6512(b)(1), the Tax Court has jurisdiction to determine an overpayment if it has jurisdiction by virtue of a notice of deficiency. In this case, the court had deficiency jurisdiction because the IRS had issued a notice of deficiency and the taxpayer had filed a timely petition. Section 6512(b)(3), however, imposes a limit on the amount of tax that can be refunded. This provision states that only the portion of the tax paid within one of three specific time periods is allowed as a credit or refund. The parties agreed that the relevant period was that set forth in § 6512(b)(3)(B), which refers to tax paid

> within the period which would be applicable under section 6511(b)(2), (c), or (d), if on the date of the mailing of the notice of deficiency a claim had been filed (whether or not filed) stating the grounds upon which the Tax Court finds that there is an overpayment.

In other words, the court must treat the taxpayer as having filed a hypothetical claim for refund on the date the notice of deficiency was mailed. The question is what amount of tax the taxpayer could have recovered through this hypothetical refund claim taking into account the limits of § 6511(b)(2), (c), or (d). Of these, only § 6511(b)(2) was relevant. This provision states that a taxpayer can recover tax paid within either a two-year or a three-year period ending on the date the taxpayer filed the claim for refund. The three-year look-back period applies when the taxpayer files the refund claim "within 3 years from the time the return was filed." The two-year look-back period applies in all other cases. In this case, the court reasoned, § 6512(b)(3)(B) treats the hypothetical refund claim as having been filed on June 19, 2015, the date on which the notice of deficiency was mailed. This was *before* the taxpayer had filed her return for the year. Accordingly, the court held, the hypothetical refund claim could not be regarded as having been filed "within 3 years from the time the return was filed," and therefore the amount of tax recoverable was limited to the portion paid within the two-year period preceding June 19, 2015. All of the tax in question was deemed paid on April 15, 2013, and therefore the taxpayer was not entitled to a refund of any of the tax paid.

In reaching this conclusion, the court rejected arguments made by the taxpayer and by the Philip C. Cook Low-Income Taxpayer Clinic and the Harvard Federal Tax Clinic as amici curiae. They argued that a three-year look-back period applied by virtue of the final sentence of § 6512(b)(3)(B), which states:

> [W]here the date of the mailing of the notice of deficiency is during the third year after the due date (with extensions) for filing the return of tax and no return was filed before such date, the applicable period under subsections (a) and (b)(2) of section 6511 shall be 3 years.

The court agreed with the IRS that the parenthetical expression "(with extensions)" modifies the term "due date." The extended due date was October 15, 2013. The court reasoned that "the third year" referred to in § 6512(b)(3)(B) began on October 15, 2015. The IRS mailed the notice of deficiency on June 19, 2015, which was, the court concluded, during the second year after the extended due date, not the third year. Accordingly, this final sentence in § 6512(b)(3)(B), in the court's view, did not trigger a three-year look-back period.

F. <u>Liens and Collections</u>

G. <u>Innocent Spouse</u>

H. <u>Miscellaneous</u>

1. The Seventh Circuit's advice to law firms: don't wait until the last day to file a Tax Court petition and then mail an envelope without an official postmark! Nevertheless, the petition in this case was timely. Tilden v. Commissioner, 846 F.3d 882 (7th Cir. 1/13/17), *rev'g* T.C. Memo 2015-188 (9/22/15). The last day for the taxpayer, who was represented by counsel, to file a Tax Court petition was April 21, 2015. A member of the law firm's staff printed a label from Stamps.com dated April 21, 2015 and stated that she delivered the envelope to the Postal Service in Salt Lake City, Utah, on that date. The Tax Court received the petition on April 29. The Tax Court (Judge Armen) dismissed the petition as having been untimely filed by relying on Reg. § 301.7502-1(c)(1)(iii)(B)(3), which provides:

> If the envelope has a postmark made by the U.S. Postal Service in addition to a postmark not so made, the postmark that was not made by the U.S. Postal Service is disregarded, and whether the envelope was mailed in accordance with this paragraph (c)(1)(iii)(B) will be determined solely by applying the rule of paragraph (c)(1)(iii)(A) of this section [regarding envelopes nearing U.S. postmarks].

The envelope with the taxpayer's petition was entered into the Postal Service's tracking system for certified mail on April 23, which the Tax Court treated as a postmark and therefore the date of filing. In an opinion by Judge Easterbrook, the Seventh Circuit reversed and remanded. The regulation applied by the Tax Court, the Seventh Circuit reasoned, applies only when the envelope bears both a U.S. Postal Service postmark and a non-U.S. Postal Service postmark, which was not the case here. In the court's view, the Tax Court should have applied the rules of Reg. § 301.7502-1(c)(1)(iii)(B)(1)-(2), which address situations in which an envelope bears only a non-U.S. Postal Service postmark. Generally, these rules treat the date of the private postmark as the date of mailing if the item is received by the relevant agency not later than the time when a properly addressed and mailed envelope sent by the same class of mail would ordinarily be received if it were postmarked at the same point of origin by the U.S. Postal Service. The court also held that the time limit set forth in § 6213(a) for filing a Tax Court petition is jurisdictional. Finally, the court admonished the law firm for its handling of the situation:

> [W]e have to express astonishment that a law firm (Stoel Rives, LLP, of Salt Lake City) would wait until the last possible day and then mail an envelope without an official postmark. A petition for review is not a complicated document; it could have been mailed with time to spare. And if the last day turned out to be the only possible day (perhaps the firm was not engaged by the client until the time had almost run), why use a private postmark when an official one would have prevented any controversy? A member of the firm's staff could have walked the envelope to a post office and asked for hand cancellation. The regulation gives taxpayers another foolproof option by providing that the time stamp of a private delivery service, such as FedEx or UPS, is conclusive.

a. **Wouldn't it be less stressful just to go to the Post Office counter and get a hand-stamped certified mail receipt? In a reviewed opinion, the Tax Court has adopted the Seventh Circuit's approach in *Tilden* to determining the filing date of petitions mailed and bearing a private postmark.** Pearson v. Commissioner, 149 T.C. No. 20 (11/29/17). The facts in this case were substantially the same as those in *Tilden v. Commissioner*, 846 F.3d 882 (7th Cir. 1/13/17). The last day for the taxpayer to file a Tax Court petition was April 22, 2015. An administrative assistant at the law firm representing the taxpayer deposited an envelope containing the petition at a U.S. Post Office with sufficient postage prepaid through Stamps.com with a Stamps.com postage label bearing the date April 21, 2015. The envelope was sent by certified mail but did not bear a U.S. Postal Service postmark. The U.S. Postal Service entered the envelope into its tracking system for certified mail on Apr. 23, 2015. The Tax Court received the petition on April 29, 2015. In a reviewed opinion (13-1-2) by Judge Lauber, the Tax Court held that the petition had been timely filed and denied the IRS's motion to dismiss. The Tax Court agreed with the Seventh Circuit that the date appearing on "a Stamps.com postage label, like the output of a private postage meter, is a 'postmark[] not made by the United States Postal Service'" for purposes of § 7502(b). Accordingly, the court held, the governing regulation is Reg. § 301.7502-1(c)(1)(iii)(B)(1), which addresses situations in which an envelope bears only a non-U.S. Postal Service postmark. Under this provision, the date of the private postmark is treated as the date of mailing if the item is received by the relevant agency not later than the time when a properly addressed and mailed envelope sent by the same class of mail would ordinarily be received if it were postmarked at the same point of origin by the U.S. Postal Service. In this case, the court reasoned, the regulation was satisfied because the Stamps.com postage label bore a date that was on or before the filing deadline and the item had been received by the court within the time it would have been received had it been postmarked at the same point of origin by the U.S. Postal Service. Alternatively, the court held, the petition was timely under Reg. § 301.7502-1(c)(1)(iii)(B)(2). This provision states that an item bearing only a private postmark is treated as mailed on the postmark date, even if it is received after the date when it would ordinarily have been received had it been mailed with an official postmark, if the taxpayer establishes that (1) the item "was actually deposited in the U.S. mail … on or before the last date … prescribed for filing the document," (2) "the delay in receiving the document … was due to a delay in the transmission of the U.S. mail," and (3) the cause of the delay. The court also reaffirmed that the 90-day period of § 6213(a) during which a taxpayer can file a petition with the court is jurisdictional.

- Judge Buch wrote a concurring opinion joined by Judges Marvel, Foley, Vasquez, Goeke, Holmes, Paris, Lauber, Nega, Pugh, and Ashford. Judge Buch reviewed the various methods of affixing postage to an item and concluded that this review "makes clear that there is no practicable difference among 'official' U.S. Postal Service mailing labels, postage meters, and internet-based postage." He reasoned that the risk a person might print a label on one day and mail the item on another day is no different regardless of the method of affixing postage.

- Judge Gustafson dissented in an opinion joined by Judge Morrison. In Judge Gustafson's view, a postage label that an individual prints on his or her own printer through the means of an internet vendor such as Stamps.com and places on an item is not a "'postmark[] not made by the United States Postal Service" within the meaning of § 7502(b). The dissenting opinion relies in part on the definition of the term "postmark" in Webster's Third New International Dictionary, which defines the term as "an official postal marking on a piece of mail; specif: a mark showing the name of the post office and the date and sometimes the hour of mailing and often serving as the actual and only cancellation." Although the dissenting opinion is not clear on this point, presumably Judge Gustafson viewed the item in question as not bearing a postmark, which would preclude it from being timely filed under § 7502(b) and the implementing regulations.

2. The IRS has provided extensions of filing and payment due dates for those in areas affected by Hurricanes Harvey, Irma, and Maria. In news release IR-2017-160 (9/26/17), the IRS has summarized the relief announced in a series of prior news releases for those in areas affected by Hurricanes Harvey, Irma, and Maria. The relief is available to individuals and businesses anywhere in Florida, Georgia, Puerto Rico, and the Virgin Islands, as well as parts of Texas. (Parts of Puerto Rico qualify for the Hurricane Irma relief, and all of Puerto Rico qualifies for the Hurricane Maria relief. Hurricane Maria struck Puerto Rico just after September 15, 2017, so in theory there are parts of Puerto Rico that do not qualify for relief from September 15 due dates.) The prior news releases are IR-2017-135 (8/28/17) (relief in Texas for Harvey), VI-2017-01 (9/8/17) (relief in Virgin Islands for Irma), PR-2017-01 (9/12/17) (relief in Puerto Rico for Irma), IR-2017-150 (9/12/17) (relief in Florida for Irma), IR-2017-155 (9/15/17), (expanded relief in Florida for Irma), IR-2017-156 (9/19/17) (expanding Irma relief to all of Georgia).

Deadlines extended to January 31, 2018. For those in affected areas, the following due dates have been extended to January 31, 2018: (1) the September 15, 2017, and January 16, 2018, due dates for quarterly estimated tax payments; (2) the September 15, 2017, due date for certain returns, such as those for calendar-year partnerships that filed timely extension requests for 2016; (3) the October 16, 2017, due date for 2016 individual returns for individuals who filed timely extension requests; (4) the October 31, 2017, due date for quarterly payroll and excise tax returns; and (5) the November 15, 2017, due date for 2016 returns of calendar-year tax-exempt organizations that filed timely extension requests. Note: individuals who filed a timely request for an extension of time to file their 2016 returns do not obtain any relief for tax payments related to the 2016 return because those payments were due on April 18, 2017.

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 during the first fifteen days of the disaster period. The specific dates vary according to the location.

Relief provided automatically. 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.

a. The IRS has provided similar extensions of filing and payment due dates for those affected by California wildfires. In news release IR-2017-172 (10/31/17), the IRS has extended to January 31, 2018, several filing and payment due dates that occurred beginning on October 8, 2017, for those in areas affected by California wildfires. The relief is available to individuals and businesses in the counties of Butte, Lake, Mendocino, Napa, Nevada, Sonoma and Yuba, as well as firefighters and relief workers who live elsewhere. The due dates extended include the October 16, 2017, due date for 2016 individual returns for individuals who filed timely extension requests, the October 31, 2017, due date for quarterly payroll and excise tax returns, and the January 16, 2018, due date for quarterly estimated tax payments. 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.

3. A portion of the anti-inversion regulations must be set aside because of the government's failure to comply with the Administrative Procedure Act, says a federal district court. Chamber of Commerce v. IRS, 120 A.F.T.R.2d 2017-5967 (W.D. Tex. 9/29/17). The U.S. District Court for the Western District of Texas (Judge Yeakel) ruled upon cross-motions for summary judgment that the IRS did not comply with the Administrative Procedure Act ("APA") with respect to a portion of the anti-inversion regulations issued under § 7874 (see T.D. 9761, 81 F.R. 20858 (4/8/16)). In particular, Judge Yeakel determined that Temp. Reg. § 1.7874-8T (which provides a computational rule for determining a "surrogate foreign corporation") is a substantive or legislative regulation, not an interpretive regulation. Therefore, the District Court determined that the IRS should have complied with the APA's 30-day notice-and-comment procedure before declaring the rule effective immediately as a temporary regulation. Judge Yeakel thus held as "unlawful and set aside" Temp. Reg. § 1.7874-8T over the IRS's objection that the Chamber of Commerce lacked standing and that the lawsuit violated the Anti-Injunction Act. Where this leaves the IRS with respect to the anti-inversion regulations and Temp. Reg. § 1.7874-8T is anyone's guess.

- On November 27, 2017, the government filed a notice of appeal in the U.S. Court of Appeals for the Fifth Circuit.

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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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**. This outline refers to the legislation in this manner and summarizes the provisions of the legislation that, in our judgment, are the most important. The outline does not attempt to list the legislation's provisions comprehensively or to explain them in detail.

I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

1. **Oh, come on! No more deductions for taking a client to a professional sports game?** The 2017 Tax Cuts and Jobs Act, § 13304, amends 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.

2. **Rats! We knew that we should have been architects or engineers instead of tax advisors.** The 2017 Tax Cuts and Jobs Act, § 11011, adds § 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. New § 199A is intended to put owners of flow-through entities (but also including sole proprietorships) on par with C corporations that will benefit from the new reduced 21% corporate tax rate; however, in our view, the new provision actually makes many flow-through businesses even more tax-favored than they were under pre-TCJA law.

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

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

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

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

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

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

4. *Qualified business income—§ 199A(c).* One component of the § 199A deduction is 20 percent of the taxpayer's qualified business income, which is generally defined as the net amount from a qualified trade or business of items of income, gain, deduction, and loss included or allowed in determining taxable income. Excluded from the definition are: (1) income not effectively connected with the conduct of a trade or business in the United States, (2) specified investment-related items of income, gain, deduction, or loss, (3) amounts paid to an S corporation shareholder that are reasonable compensation, (4) guaranteed payments to a partner for services, (5) to the extent provided in regulations, payments to a partner for services rendered other than in the partner's capacity as a partner, and (6) qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income (because these three 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 three buckets, subject to two limitations. *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. *Bucket 3* is the lesser of (1) 20 percent of the taxpayer's qualified cooperative dividends, or (2) the taxpayer's taxable income reduced by net capital gain. *Limitation 1* is that the sum of Bucket 1 and Bucket 2 cannot exceed 20 percent of the amount by which the taxpayer's taxable income exceeds the sum of the taxpayer's net capital gain and qualified cooperative dividends. *Limitation 2* is an overall limitation and provides that the sum of Buckets 1, 2 and 3 (after application of

Limitation 1) 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, applying Limitation 1, adding Bucket 3, and then applying Limitation 2.

6. *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.

7. *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.

3. Unless you fit in one of the exceptions, Congress just increased your 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 30 percent of "adjusted taxable income" (essentially earnings before interest, tax, depreciation and amortization (EBITDA) for the first 4 years, and then earnings before interest and taxes (EBIT) thereafter). 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).

4. Congress has 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.

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).

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

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

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

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

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

F. Credits

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

I. At-Risk and Passive Activity Losses

III. INVESTMENT GAIN

A. Gains and Losses

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

D. Section 121

E. Section 1031

F. Section 1033

G. Section 1035

H. Miscellaneous

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.

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. **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.

2. **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 minimus* 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).

B. Qualified Deferred Compensation Plans

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

D. Individual Retirement Accounts

V. PERSONAL AND INDIVIDUAL 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.

2018 Rates for Single Individuals			
		If taxable income is:	**Then income tax equals:**
1	*Before TCJA*	Not over $9,525	10% of taxable income
	After TCJA	Not over $9,525	10% of taxable income
2	*Before TCJA*	Over $9,525 but not over $38,700	$952.50 plus 15% of the excess over $9,525
	After TCJA	Over $9,525 but not over $38,700	$952.50, plus 12% of the excess over $9,525
3	*Before TCJA*	Over $38,700 but not over $93,700	$5,328.75 plus 25% of the excess over $38,700
	After TCJA	Over $38,700 but not over $82,500	$4,453.50, plus 22% of the excess over $38,700
4	*Before TCJA*	Over $93,700 but not over $195,450	$19,078.75 plus 28% of the excess over $93,700
	After TCJA	Over $82,500 but not over $157,500	$14,089.50, plus 24% of the excess over $82,500
5	*Before TCJA*	Over $195,450 but not over $424,950	$47,568.75 plus 33% of the excess over $195,450
	After TCJA	Over $157,500 but not over $200,000	$32,089.50, plus 32% of the excess over $157,500
6	*Before TCJA*	Over $424,950 not over $426,700	$123,303.75 plus 35% of the excess over $424,950
	After TCJA	Over $200,000 but not over $500,000	$45,689.50, plus 35% of the excess over $200,000
7	*Before TCJA*	Over $426,700	$123,916.25 plus 39.6% of the excess over $426,700
	After TCJA	Over $500,000	$150,689.50, plus 37% of the excess over $500,000

2018 Rates for Married Individuals Filing Joint Returns and Surviving Spouses			
		If taxable income is:	**Then income tax equals:**
1	*Before TCJA*	Not over $19,050	10% of taxable income
	After TCJA	Not over $19,050	10% of taxable income
2	*Before TCJA*	Over $19,050 but not over $77,400	$1,905 plus 15% of the excess over $19,050
	After TCJA	Over $19,050 but not over $77,400	$1,905, plus 12% of the excess over $19,050
3	*Before TCJA*	Over $77,400 but not over $156,150	$10,657.50 plus 25% of the excess over $77,400
	After TCJA	Over $77,400 but not over $165,000	$8,907, plus 22% of the excess over $77,400
4	*Before TCJA*	Over $156,150 but not over $237,950	$30,345 plus 28% of the excess over $156,150
	After TCJA	Over $165,000 but not over $315,000	$28,179, plus 24% of the excess over

			$165,000
5	*Before TCJA*	Over $237,950 but not over $424,950	$53,249 plus 33% of the excess over $237,950
	After TCJA	Over $315,000 but not over $400,000	$64,179, plus 32% of the excess over $315,000
6	*Before TCJA*	Over $424,950 but not over $480,050	$114,959 plus 35% of the excess over $424,950
	After TCJA	Over $400,000 but not over $600,000	$91,379, plus 35% of the excess over $400,000
7	*Before TCJA*	Over $480,050	$134,244 plus 39.6% of the excess over $480,050
	After TCJA	Over $600,000	$161,379, plus 37% of the excess over $600,000

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.

2018 Rates of Tax on Adjusted Net Capital Gain					
Tax Rate	**Single**	**Head of Household**	**Married Filing Jointly**	**Married Filing Separately**	**Estates and Trusts**
0% if taxable income does not exceed	$38,600	$51,700	$77,200	$38,600	$2,600
15% if taxable income does not exceed	$425,800	$452,400	$479,000	$239,500	$12,700
20% if taxable income exceeds	$425,800	$452,400	$479,000	$239,500	$12,700

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. Provisions of the 2017 Tax Cuts and Jobs Act that affect ABLE accounts.

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

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

2. 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 2017 and before 2026.

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

D. Deductions and Credits for Personal Expenses

1. 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.

2. 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.

3. 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).

4. 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.

5. **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 purposed of both the regular tax and the alternative minimum tax.

6. **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.

7. **♪♫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.

8. 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.

E. Divorce Tax Issues

1. ♪♫Breaking up is hard to do.♫♪ And it's now more costly for the payor of alimony. 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.

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.

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:

AMT Exemption Amounts for 2018		
Filing Status	**Before TCJA**	**After TCJA**
Married Filing Separately	$43,100	$54,700
Single and HOH	$55,400	$70,300
Married Filing Jointly and Surviving Spouses	$86,200	$109,400
Estates and Trusts	$24,600	$24,600

AMTI Phase-Out Thresholds for 2018		
Filing Status	**Before TCJA**	**After TCJA**
Married Filing Separately	$82,050	$500,000
Single and HOH	$123,100	$500,000
Married Filing Jointly and Surviving Spouses	$164,100	$1 million
Estates and Trusts	$82,050	$82,050

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

C. Liquidations

D. S Corporations

E. Mergers, Acquisitions and Reorganizations

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

1. 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 we've long ignored. The centerpiece of the 2017 Tax Cuts and Jobs Act is a reduction in corporate tax rates. Section 13001 of the legislation amended Code § 11(b) to tax corporate taxable income at a flat rate of 21 percent. Prior to this amendment, § 11(b) provided graduated rates with a top rate of 35 percent. For companies with significant profit from U.S. operations, this 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 closely-held companies, especially if the business will be held for the life of the major shareholders or the shareholders will exit via a stock sale. The analysis is not an easy one and must take into account that, despite the reduced rate, subchapter C is still a double-tax regime and that most buyers of C corporations prefer to purchase the corporation's assets rather than its stock.

2. **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.

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.

VII. PARTNERSHIPS

A. Formation and Taxable Years

B. Allocations of Distributive Share, 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.** The 2017 Tax Cuts and Jobs Act, § 13309, created new Code § 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 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 (i) 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) election along with invested capital). New § 1061 is deserving of much more study, but we suspect

that new § 1061 will catch only those taxpayers who lack the sophisticated advice to plan around the statute. New § 1061 applies to taxable years beginning after 2017.

C. Distributions and Transactions Between the Partnership and Partners

D. Sales of Partnership Interests, Liquidations and Mergers

1. 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

F. Partnership Audit Rules

G. Miscellaneous

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

B. Charitable Giving

1. Provisions of the 2017 Tax Cuts and Jobs Act that affect charitable contributions.

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.

X. TAX PROCEDURE

A. Interest, Penalties and Prosecutions

1. 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, and the American Opportunity Tax Credit. T.D. 9799, Tax Return Preparer Due Diligence Penalty Under Section 6695(g), 81 F.R. 87444 (12/5/16). The Treasury Department and the IRS have issued proposed and temporary regulations that amend Reg. § 1.6695-2 to implement changes made by the Protecting Americans from Tax Hikes Act of 2015. These changes extend the § 6695(g) preparer due diligence requirements 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). As a result of these changes, one return or claim for refund may contain claims for more than one credit 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 temporary regulations illustrate how multiple penalties could apply when one return or claim for refund is filed. Revisions to Form 8867 have been made for 2016 so that it is a single checklist to be used for all applicable credits. The temporary regulations are effective on December 5, 2016.

a. **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.

2. **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.

B. Discovery: Summons and FOIA

C. Litigation Costs

D. StatutoryNotice of Deficiency

E. Statute of Limitations

F. Liens and Collections

G. Innocent Spouse

H. Miscellaneous

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

A. Enacted

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. <u>Gifts</u>

D. <u>Trusts</u>

Held Captive: Micro-Captive Insurance in the Aftermath of *Avrahami*

By Jason B. Freeman, JD, CPA | Column Editor

The IRS recently notched a victory in the much-anticipated tax court decision of *Avrahami v. Commissioner* – the first micro-captive insurance decision to go to press. The court's 105-page opinion dealt a blow to the micro-captive insurance industry, which has been under increased IRS scrutiny in recent years. And with several similar cases still in the pipeline, some have questioned whether it may be a harbinger of things to come.

A captive insurance company is an insurance company that is formed or owned by a related business owner or group of owners. It provides coverage to that business against risks – risks that are often not readily insurable in the commercial market. A micro-captive is a captive insurance company that has made a qualifying election under section 831(b) of the Internal Revenue Code. As explained below, that section allows the micro-captive to exclude premiums from income. Where the structure works, the business is allowed to deduct the insurance premiums that it pays to the micro-captive and the micro-captive excludes those premiums from income.

The use of captive insurance companies has grown in popularity over the years and there are many legitimate captive and micro-captive insurance arrangements. For instance, the overwhelming majority of *Fortune 500* companies utilize captives. And many mid-size and smaller companies have legitimately employed them, as well. But the IRS has placed micro-captives under scrutiny in recent years, adding certain micro-captive arrangements to its Dirty Dozen list of tax scams and declaring them "transactions of interest" in Notice 2016-66. For better or worse, the recent win in *Avrahami* is likely to embolden the IRS in its attack.

The Basic Statutory Structure

Premiums paid for insurance in connection with a trade or business are generally deductible under section 162(a) of the Code. In contrast, amounts that are merely set aside as a loss reserve – a form of self-insurance – are not deductible. This distinction is one of the fundamental legal issues in the captive context.

While a trade or business is entitled to deduct reasonable and necessary insurance premiums, the Code also generally taxes insurance companies on their receipt of such premiums. Section 831(a) generally provides for a tax on the taxable income of non-life insurance companies.

There is, however, a wrinkle for certain small insurance companies – an alternative tax regime that was added to the Code as part of the Tax Reform Act of 1986. Where available, section 831(b) provides an elective "micro-captive" tax regime that allows a qualifying insurance company with less than $2.2 million in annual net written premiums to exclude premiums from income. This $2.2 million threshold was recently increased from $1.2 million under the Protecting Americans from Tax Hikes (PATH) Act of 2015. The PATH Act also introduced certain new requirements to obtain micro-captive status that are beyond the scope of this article.

Captive Insurance Companies

The use of captive insurance companies has grown remarkably in recent decades. Fred Reis is traditionally credited with popularizing the concept when, in the 1950s, he helped Youngstown Sheet and Tube establish a captive in response to soaring commercial-insurance prices. The concept revolutionized the insurance industry.

A pure captive insurance company only insures the risks of related companies. Because the insured and insurer are related, such arrangements can sometimes blur the line between deductible insurance and non-deductible self-insurance. Over time, the IRS began to focus its attention on payments to captives, challenging whether such payments were deductible insurance expenses. For years, this has been one of the central issues in the captive context.

What is Insurance?

Remarkably, neither the Code nor the regulations define "insurance" for federal tax purposes. As a result, the development of its meaning has largely been left to the courts. The Supreme Court first articulated a definition of "insurance" for tax purposes in *Helvering v. Le Gierse,* 312 U.S. 531 (1941). That case and its progeny have given rise to four factors that determine whether an arrangement constitutes "insurance" for federal tax purposes: whether the arrangement involves (1) insurance risk, (2) risk shifting, (3) risk distribution and (4) commonly accepted notions of insurance.

Insurance Risk. As the tax court has held, "[b]asic to any insurance transaction must be risk ... If no risk exists, then insurance cannot be present."[1] Thus, where a transaction is structured in a manner that eliminates insurance risk, the arrangement does not constitute insurance for federal tax purposes. This was the case in *LeGierse,* where the taxpayer and insurance company simultaneously entered into an annuity contract and insurance contract that the court found counteracted each other's risks, leaving only an "investment" risk, which is distinct from an insurance risk. The IRS has also questioned whether certain types of insured risks are, in fact, valid risks faced by the taxpayer: For example, tsunami insurance for a company in the Midwest or terrorism insurance for a business in a rural area. In such cases, the IRS may challenge whether a valid insurance risk actually exists.

Risk Shifting. Risk shifting occurs when a taxpayer facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to an insurer. Courts have looked to several factors to determine whether a risk of loss has effectively been transferred. Perhaps chief among those factors is whether the

insurance company is adequately capitalized. An undercapitalized insurer would lack the ability to satisfy its obligations, leaving the risk with the taxpayer. Likewise, contractual caps on an insurer's liability or indemnification agreements by related parties may also jeopardize the presence of risk shifting.

Risk Distribution. Risk distribution, a separate and distinct element that is necessary to constitute "insurance," is focused on whether the captive insurance company has sufficiently spread its risk of loss. That is, has it pooled a sufficiently large collection of unrelated risks to distribute its risk among others. The concept incorporates the statistical phenomenon known as the law of large numbers, a theory that postulates that the average of a sufficiently large number of independent losses will approximate the expected loss. Courts tend to place an emphasis on factors such as the number of parties insured, the types of risk exposures insured and the portion of premiums received from unrelated parties.

Insurance in the Commonly Accepted Sense. Finally, courts look to whether the arrangement constitutes insurance in the commonly accepted sense. To address this question, courts have traditionally looked to whether the company is organized and operated as an insurance company and regulated as such, as well as whether its premiums were the result of arms-length transactions and actuarially determined. In addition, courts consider other factors, such as whether the insurance policies were valid and binding, whether the premiums were required to be (and were, in fact) paid timely and whether loss claims were timely satisfied.

Avrahami

The taxpayers in *Avrahami*, Mr. and Mrs. Avrahami, owned several shopping centers and jewelry stores. In 2006, the Avrahami entities spent about $150,000 insuring them. In 2007, they formed Feedback Insurance Company, Ltd., an insurance company incorporated in St. Kitts. Feedback made an election under section 953(d) to be treated as a domestic corporation for federal income tax purposes, and elected to be treated and taxed as a small insurance company (a micro-captive) under section 831(b). During 2009 and 2010, the years at issue, the Avrahami entities deducted insurance expenses of about $1.1 million and 1.3 million, respectively – most of which was paid to Feedback. Consistent with its election under section 831(b), however, Feedback only paid income tax on its investment income – not premiums.

The IRS challenged whether the arrangement with Feedback satisfied the criteria for "insurance" for federal tax purposes, arguing that the amounts paid to Feedback were not deductible business expenses and that the amounts should be taxable to Feedback as income. Among other things, the IRS pointed to the fact that a significant amount of the premiums paid to Feedback were directly or indirectly distributed or loaned back to the Avrahamis and that Feedback had not paid out any claims prior to the IRS audit of the arrangement. The IRS also argued that the types of risks that were insured – which included risks of litigation, terrorism and additional taxes resulting from adverse IRS determinations – undermined the taxpayers' claim that the arrangements were "insurance" for federal tax purposes.

The tax court, in a lengthy opinion, ultimately sided with the commissioner, finding that premiums paid by the Avrahami entities to Feedback were not for "insurance" for federal tax purposes. More specifically, it found that the arrangement failed to properly distribute risk and that Feedback was not selling insurance in the commonly accepted sense. However, all was not lost for the taxpayer. Although the IRS pressed for accuracy-related penalties under section 6662(a), the tax court refused to impose such penalties to the extent that the tax underpayments resulted from the court disallowing a deduction for the premiums paid to Feedback.

A Road Map for Compliance

The *Avrahami* decision was the first published micro-captive decision. While the case is likely to be appealed, it provides a working road map for micro-captive compliance. Indeed, those involved in current and future micro-captive arrangements should read and follow the opinion carefully.

It may also be the first in a line of cases to come. There are several similar cases still working their way through the tax court pipeline that may refine and further flesh out the teachings of *Avrahami*. So stay tuned for more.

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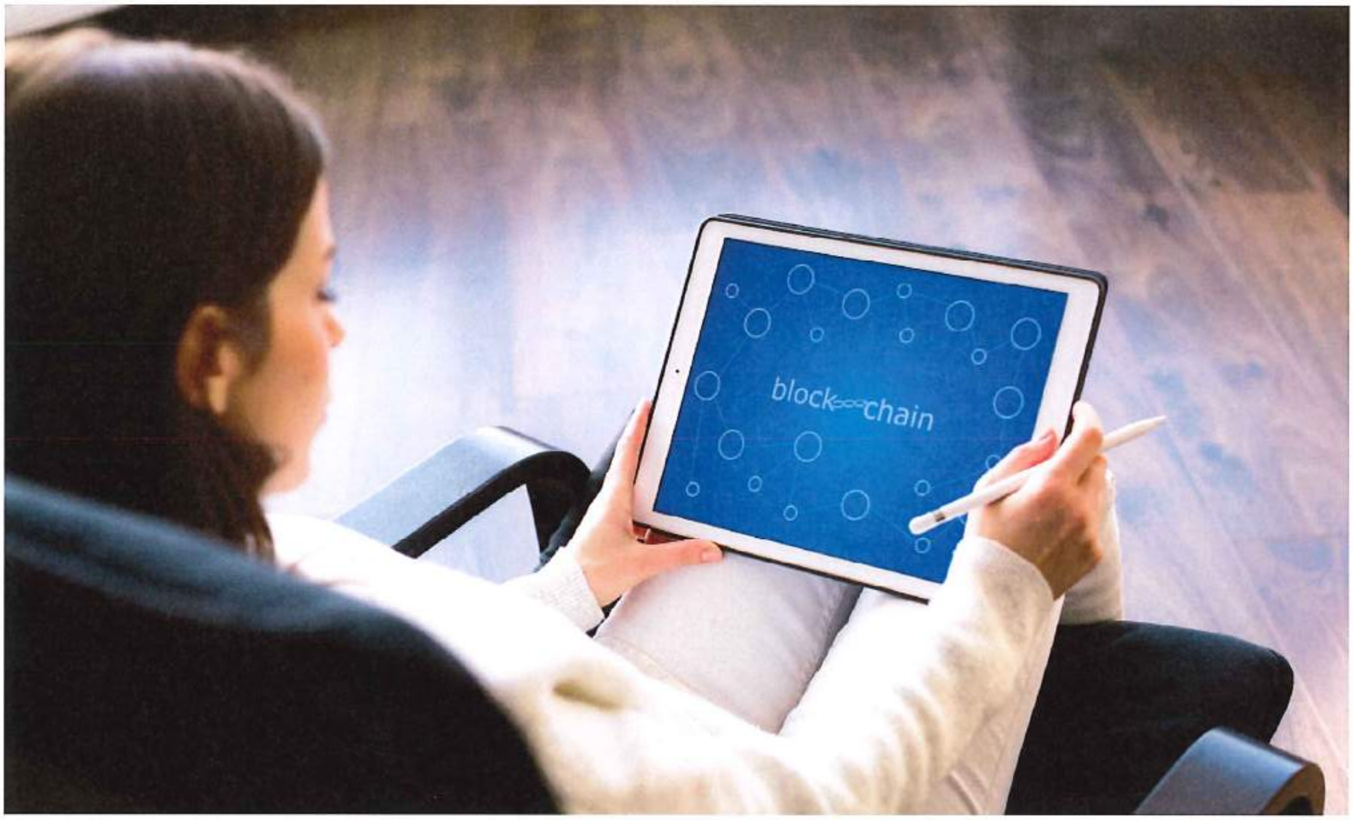
Footnotes

1. *Amerco v. Commissioner*, 96 T.C. 18, 38-9 (1991)

Bitcoin, Blockchain and the Revolution to Come



By Jason B. Freeman, JD, CPA | Column Editor

We are in the midst of a revolution – a digital transformation driven by what many believe could be the most powerful decentralizing force since the rise of the internet: Blockchain. It is difficult to overstate the potential impact of this technology and its applications. Much as the double-entry system of accounting – first codified by Luca Pacioli, the "father of accounting" – laid the groundwork for the rise of capitalism and, it has been argued, even modern nation-states, blockchain carries the capacity to create a "world-wide ledger" that could record the exchange and providence of virtually everything of value. It promises to allow far-flung parties to engage in e-commerce without the necessity of a financial intermediary and to usher in an era of true globalization.

In a nutshell, blockchain provides the infrastructure to replace the middleman – in nearly any area of application – with a decentralized web of users. In that respect, it is a democratizing force. It is, as *The Economist* once dubbed it, a "Trust Machine," allowing "people who have no particular confidence in each other [to] collaborate without having to go through a neutral central authority [known as a 'trusted intermediary']" to validate and record their transaction. The regulatory implications for such a shift could be profound.

Blockchain is, however, not without its detractors. Some have noted the seemingly irrational hype behind the technology. They have questioned its true value, casting it as a solution in search of a problem. As they see it, blockchain is an answer to a problem that none of us realized we even had: that of the trusted intermediary. But of course, many saw no need for the internet back in 1993 either.

One can hardly discuss blockchain without reference to its first and most famous application: Bitcoin. Bitcoin is built on an underlying blockchain structure. In fact, bitcoin, the world's largest cryptocurrency by market capitalization, is itself a more popular, well-recognized phenomenon than blockchain. Its meteoric rise in the closing months of 2017 – as the price of bitcoin rose over 1,600 percent to nearly $20,000 then fell, then rose again– was an absolutely remarkable feat that demonstrates both the promise and the risks inherent in the technology.

It is nothing short of remarkable that in the mere nine years since Satoshi Nakamoto, the shadowy and likely pseudonymous founder of bitcoin, first released the bitcoin "Genesis Block," a respectable number of people have (right or wrong) come to view bitcoin as a viable alternative to fiat currency. Through the blockchain platform, bitcoin solved decades-old theoretical conundrums, such as the double-spending problem and the curiously named Byzantine Generals Problem, creating for the first time a viable digital currency and, in the process, shining a light on the potential of blockchain. With markets and financial institutions taking notice, it should come as no surprise that regulators are increasingly focused on the impact of bitcoin and blockchain technology, as well.

> "THE MINING PROCESS IS EXCEEDINGLY HARD TO PERFORM, BUT RELATIVELY EASY TO VERIFY."

Blockchain: What is It?

Fundamentally, a blockchain is a type of database – a chronological ledger of transactions recorded by a network of computers. A copy of the blockchain is saved on each computer in the network, so there is no need for a centralized administrator. The system is "decentralized" and therefore often referred to as a shared, distributed digital ledger.

A blockchain structure does not require a "trusted" third party to serve as an intermediary or clearinghouse in order to validate a transaction. This is a key aspect of its popularity. In our modern economy, banks typically play the role of trusted intermediary with respect to non-cash electronic transactions. Banks validate transactions and keep a centralized ledger that parties rely upon to ensure a proper accounting and to guard against double spending of currency, a problem that could otherwise give rise to runaway inflation. Blockchain, however, provides a mechanism that allows two parties that do not know or trust each other to directly engage in a transaction (i.e., on a peer-to-peer basis) without the need for a bank. It is, therefore, referred to as a "trustless" system.

Blockchain accomplishes this through the power of a distributed network. Each computer, or "node," on the network has the ability to send and verify transactions on the blockchain. Virtually any computer with an internet connection can become a node (on a public blockchain, at least). A blockchain operates through a protocol, which is a set of rules that determine when the network nodes will be deemed to have reached a "consensus" that a transaction should be recognized as valid and recorded on the blockchain. For instance, bitcoin's protocol provides for a proof-of-work system, known as "mining," that essentially recognizes a block when more than half of the computing power on the network agrees that it is valid and satisfies the consensus protocol.

Once there is consensus that a set of transactions should be recognized, a block of information recording the transactions is appended onto prior blocks, extending the "blockchain." Notably, blocks of information cannot be deleted from the blockchain, only added; it is an "append-only" system, which is one of the key security features of a blockchain.

Bitcoin

Bitcoin – the most well-known application of blockchain technology – was first introduced in 2009 against the backdrop of a global financial crisis that many consider to have been the worst since the Great Depression. The subprime mortgage crash that sparked the economic crisis led to a backlash against financial intermediaries and a push for alternatives to traditional banking and financial systems. Bitcoin promised a mechanism that did not require a traditional "trusted" intermediary to conduct electronic transactions. Its timing on the scene could not have been better.

Bitcoins are "created" by miners, nodes on the network that engage in a rigorous process to produce a "proof of work" that, once accepted, results in the release of a predetermined amount of bitcoin to the miner as an incentive to perform the computational process necessary to create the proof of work. The mining process is technical and complicated. It involves the application of complex mathematical computations and cryptographic hash functions to produce "hashes," a seemingly random alphanumeric strand, to ensure the validity of the blockchain.

The mining process is exceedingly hard to perform, but relatively easy to verify. It can essentially only be performed through trial and error, which means that it requires a large amount of computational power. The bitcoin system periodically adjusts the level of difficulty to successfully perform the "mining" function, thereby regulating the supply of bitcoin. Designed to mimic the supply of valuable commodities like gold, the system is capped at 21 million bitcoin and the last bitcoin is estimated to be released in 2140.

Despite its current popularity, bitcoin has had to overcome a sordid past. The relative anonymity that it offers made it the medium of choice on the infamous Silk Road website, a black market site founded by the self-styled Dread Private Roberts that utilized the TOR network (a secure and virtually anonymous browser originally developed by the Navy) and facilitated everything from the illicit sale of drugs to murder-for-hire.

continued on next page

Bitcoin's reputation was also tainted by the Mt. Gox scandal, when the world's largest bitcoin exchange was hacked and hundreds of millions of dollars in bitcoin were stolen. And, of course, there are stories of small bitcoin fortunes evaporating overnight with lost passwords and compromised hard drives. Nonetheless, the technology has overcome this past and is now vying for mainstream acceptance.

Future Uses and Issues

Blockchain's potential uses are numerous. Bitcoin's popularity has demonstrated that blockchain is a viable, if not revolutionary, platform for economic transactions, banking, payment processing and investing. But that is just the beginning. A blockchain-based platform could, for example, provide the infrastructure for a real estate recording system, allowing the recording, tracking and transfer of deeds, and providing the ability to perform title searches more efficiently. Just this past year, the first bitcoin-based home purchase closed in Texas. A blockchain platform may particularly lend itself to intellectual property rights, as many have recognized that it would allow for an IP registry that could track and catalogue rights and provide an accessible database for owners, licensees and users.

Blockchain also holds promise for the energy sector, as a number of startups have begun using blockchain technology to create peer-to-peer markets for the purchase and sale of energy. Blockchain could provide the health care sector, as well, with an alternative way to manage patient medical data that is less susceptible to privacy breaches. Blockchain code could even allow for e-voting, calling to mind a scenario where voters one day cast their vote for president from their smartphones or home computers. It could also perform the essential functions of a notary, timestamping and validating data and transactions through its decentralized network. The possibilities, it seems, may only be limited by creativity and ingenuity.

Regulation

The bitcoin and blockchain regulatory landscape remains an evolving one. There is no central regulator of the technology; instead, a regulatory patchwork has emerged at both the state and federal level, and regulators do not necessarily classify the technology consistently. For example, for tax purposes, the IRS currently treats bitcoin as property rather than currency. Thus, taxpayers are taxed on the receipt of bitcoin and recognize a gain or loss on its sale. The IRS has shown increasing interest in the taxation of virtual currency transactions, recently prevailing on a year-long effort to enforce a summons on Coinbase, a virtual currency exchange, requiring it to produce customer data on thousands of bitcoin account holders. According to IRS court filings, during 2015, a mere 800 to 900 taxpayers reported gains related to bitcoin. The IRS is seeking to crack down on unreported bitcoin transactions.

The Financial Crimes Enforcement Network (FinCEN), a sister bureau of the Department of the Treasury, also polices bitcoin and other cryptocurrencies. Currently, those who fall under FinCEN's definition of "exchangers" and "administrators" of cryptocurrency are treated as "money service businesses" subject to a regulatory regime under the Bank Secrecy Act that governs currency reporting and anti-money laundering.

States such as New York, through its so-called BitLicense, have also adopted their own comprehensive regulatory regimes that cover similar ground. Texas, for its part, has taken a more laissez faire approach, although certain virtual currency activities may fall under a regulatory regime that is overseen by the Texas Department of Banking.

The Securities and Exchange Commission (SEC) has become increasingly active in the bitcoin realm. The SEC has selectively brought enforcement actions against cryptocurrency-related investment schemes. In recent months, the SEC has taken particular steps to crack down on several attempts to raise money through Initial Coin Offerings (ICOs), a fundraising mechanism that generally consists of an offering of a new cryptocurrency or virtual token in exchange for bitcoin or other virtual currencies. The SEC has determined that such token investment opportunities may constitute an "investment contract" and, therefore, a "security" under the federal securities laws.

The Commodity Futures Trading Commission (CFTC) has also played a role in developing the regulatory landscape. The CFTC has taken the position that virtual currencies are commodities for purposes of the Commodity Exchange Act (CEA), thus falling within its regulatory purview, as well. The CFTC has rather actively sought to enforce the CEA when it comes to bitcoin derivatives and exchanges, and along with the IRS, FinCEN and the SEC, has played a key role in regulatory development. Its announcement in December 2017 that it would allow bitcoin futures exchange trading set off a steady climb in the price of bitcoin, demonstrating the impact that government regulations can have on the market.

A Disruptive Force

The blockchain may yet prove to be the most revolutionary technology since the internet. It has certainly shown the potential to be a disruptive force in a number of industries and to reshape social and economic patterns.

However, some have noted that the hype may overshadow reality and that blockchain seems to be an answer to a problem that none of us realized we even had. Admittedly, there is more than a kernel of truth behind such sentiments. But it is just as true that many saw no need for the internet back in 1993. And just because we do not fully understand something or its implications does not mean it will not affect us. Accountants, attorneys and businesspeople alike should not be lulled into a sense of complacency that blockchain is a phenomenon merely for the future. Indeed, the future has already happened.

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19 January 2018

Graphic Packaging Corporation v. Hegar: Texas' Single-Factor Franchise Tax Apportionment Remains Mandatory

By Cindy Ohlenforst, Sam Megally, and William J. LeDoux

The Texas Supreme Court recently held that taxpayers may not use the Multistate Tax Compact's three-factor formula to apportion their Texas franchise tax base — i.e., their "margin" — in calculating their Texas franchise tax liability. In its decision in *Graphic Packaging Corporation v. Hegar*, No. 150669, 2017 WL 6544951 (Tex. Dec. 22, 2017), the court concluded that Graphic Packaging was required to apportion its margin to Texas using the single-factor apportionment formula set forth in Chapter 171 of the Texas Tax Code.

The Compact — which is codified in Chapter 141 of the Texas Tax Code — provides an election to apportion certain income taxes using a three-factor formula based on a taxpayer's sales, property, and payroll. For many taxpayers, including Graphic Packaging, the option to use a three-factor apportionment formula instead of the Texas franchise tax's single-factor formula would have resulted in significant tax savings. The Texas Supreme Court, however, determined that reading the Compact to provide an alternative apportionment election for Texas franchise tax purposes "creates an irreconcilable conflict" with Section 171.106 of the Texas Tax Code, which requires single-factor apportionment without reference to the Compact. Citing statutory construction rules applicable to conflicting statutes, the court then concluded that the Section 171.106 apportionment provision "continues to provide the exclusive formula for apportioning the franchise tax and, by its terms, precludes the taxpayer from using the Compact's three-factor formula." The court of appeals' opinion giving rise to Graphic Packaging's Texas Supreme Court appeal held that the three-factor formula was not available to Graphic Packaging in part because the franchise tax is not an "income tax" within the meaning of the Compact; however, the Texas Supreme Court expressly declined to address whether the Texas franchise tax is an "income tax" as defined in the Compact.

The court determined that the Compact is not a binding reciprocal agreement under which Texas has surrendered its sovereign tax powers. The court concluded that the Compact does not include features that the United States Supreme Court has indicated are generally shared by binding regulatory compacts, "such as: (1) the establishment of a joint regulatory body; (2) state enactments that require reciprocal action to be effective; and (3) the prohibition of unilateral repeal or modification of their terms." The court also concluded that the Compact did not include language pursuant to which Texas would have unmistakably surrendered its sovereign tax power and that determining Texas has nevertheless surrendered such power by virtue of having adopted the Compact could violate the Texas Constitution.

Taxpayers with pending refund claims or audit disputes involving the Compact's election should carefully analyze their own positions and be prepared to decide how to proceed in the coming months. Certain taxpayers that have taken a franchise tax filing position based on the Compact's election and have not been contacted by the Comptroller's office regarding an

Graphic Packaging Corporation v. Hegar: Texas' Single-Factor Franchise Tax Apportionment Remains Mandatory

audit or investigation may want to consider whether they are eligible to request a voluntary disclosure agreement with the Comptroller. Such agreements may offer benefits, such as interest and penalty waiver and limited lookback periods, for taxpayers wishing to voluntarily disclose past liabilities.

Taxpayers may also want to look into the Comptroller's recently announced tax amnesty program. Although the Comptroller's office has not yet released many details about the program, the agency has confirmed that the program will be available from May 1, 2018, through June 29, 2018.

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19 January 2018

Texas Comptroller Announces Tax Amnesty Program From May 1, 2018 Through June 29, 2018

By Cindy Ohlenforst, Sam Megally, and William J. LeDoux

Certain Texas taxpayers with undisclosed liabilities will soon have another option to come clean with the Texas Comptroller's office. The Comptroller's office recently announced that it will provide a tax amnesty program from May 1, 2018 through June 29, 2018. Although few program specifics have been released, the Comptroller's office has indicated that the program will offer interest and penalty relief with respect to certain liabilities. Based on informal comments from the Comptroller's staff, it seems that the program will apply to many of the taxes administered by the Comptroller, including the Texas sales and franchise taxes. However, the Comptroller has already indicated that the program is not available for periods under audit, taxpayer liabilities the Comptroller has already identified, IFTA taxes, PUC gross receipts assessments, local motor vehicle tax, and unclaimed property payments.

Senate Bill 1, enacted by the Texas Legislature in 2017, required the Comptroller to establish the amnesty program "to encourage a voluntary reporting by delinquent taxpayers who do not hold a permit, or are otherwise not registered for a tax or fee administered by the Comptroller, or those permitted taxpayers that may have underreported or owe additional taxes or fees."

Taxpayers interested in participating in the program should carefully examine their facts and past liabilities and should weigh the pros and cons of the amnesty program against other alternatives, such as a voluntary disclosure agreement with the Comptroller. Currently available to certain taxpayers wishing to disclose and pay past liabilities, a voluntary disclosure agreement also offers benefits, such as interest and penalty waivers and limited lookback periods. The Comptroller has not yet indicated how the amnesty program qualification requirements and/or benefits will differ from a voluntary disclosure, but taxpayers concerned about receiving an audit notice, or otherwise becoming ineligible to participate in the amnesty program, prior to the program's May 1 start date should carefully consider a voluntary disclosure agreement.

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Texas Comptroller Announces Tax Amnesty Program From May 1, 2018 Through June 29, 2018

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Using a PIA Request to Challenge Texas Tax Assessments

By Danielle Ahlrich & Jimmy Martens with Martens, Todd, Leonard & Ahlrich

In an audit by the Texas Comptroller, the taxpayer is typically the party furnishing the information. However, taxpayers may use the Texas Public Information Act ("PIA") to obtain information from the Comptroller that is helpful to challenging an adverse assessment. *See* **Appendix A** for a sample request.

For example, taxpayers who participate in the Independent Audit Review Conference after the issuance of a preliminary audit assessment may file a PIA to obtain a copy of the Independent Audit Report ("IAR") issued through the process. Surprisingly, the Comptroller often refuses to release the IAR to the participating taxpayer, making a PIA request a necessary tool to gain a better understanding of the Comptroller's position.

Similarly, at the conclusion of the audit, a taxpayer should file a PIA request for the entire audit file, including the exam schedules in Microsoft Excel and any auditor workpapers. In a sales tax exam, the Excel schedules are crucial to identifying where the taxpayer should spend resources to combat the assessment. For example, a taxpayer can resort the Excel schedules by customer sales volume to see which ones are the most financially significant and then focus first on obtaining resale certificates and other necessary documents to resolve those customer errors.

Perhaps more interesting, however, is the Audit Documentation Report, which contains the auditor's notes and is often the source of invaluable information. In this workpaper, the auditor documents each stage of the audit, from entrance to exit conference and key steps in between, such as records reviewed, Comptroller guidance relied upon, and frequently supervisor comments or notes.

Finally, taxpayers may use a PIA to obtain helpful information about other taxpayers' audits. The Comptroller's list of who has been audited is publicly-available. So, for example, if Texas Taxpayer is assessed sales tax on significant sales to Customer A, it would be wise for Texas Taxpayer to see if Customer A has potentially been audited for an overlapping period. If so, Texas Taxpayer may want to ask Customer A whether the Comptroller also assessed and Customer A paid sales tax on the same transactions scheduled in Texas Taxpayer's audit. If so, the tax is only due once, which means Texas Taxpayer might want to ask Customer A for documentation supporting the prior payments.

Given the usefulness of the information to be obtained and the minimal cost of submitting a PIA request and obtaining responsive information, taxpayers should consider availing themselves of this information source.

About Martens, Todd, Leonard & Ahlrich

Martens, Todd, Leonard & Ahlrich is a trial and appellate law firm headquartered in Austin, Texas, handling only tax cases. The firm specializes in Texas sales tax and Texas franchise tax controversies. The firm's attorneys have handled cases all the way through the Texas Supreme Court and U.S. Supreme Court. The firm's attorneys speak and write frequently on a variety of Texas sales tax and franchise tax topics and have published articles in publications such as the Journal of State Taxation, the Texas Bar Journal, the Texas Lawyer, and the Texas Tech Administrative Law Journal. For more information, please visit https://texastaxlaw.com/.

Appendix A

Texas Public Information Act Request

MARTENS, TODD, LEONARD & AHLRICH
A GENERAL PARTNERSHIP

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January 30, 2018

Via E-Mail open.records@cpa.texas.gov
Comptroller of Public Accounts
Open Records Division
P.O. Box 13528
Austin, Texas 78711-3528

RE: Texas Public Information Act Request
[redacted], Inc.
Taxpayer No. ([redacted])
Audit Period: [redacted], 2012 through [redacted], 2015
Texas Sales & Use Tax Audit
Sales, Excise, and Use Tax Audit

Dear Comptroller of Public Accounts:

As shown by the enclosed Power of Attorney, I am authorized to obtain tax information from the State of Texas on behalf of [redacted], **Inc.** ("[redacted]"). Under the provisions of the Texas Public Information Act, Chapter 552 of the Texas Government Code, I request access to the following records:

INFORMATION AND/OR DOCUMENTS REQUESTED:

1. A printout of all the Texas sales, excise, and use tax information on the Comptroller's computer systems relating to [redacted], for the period from [redacted]**, 2012 through** [redacted]**, 2015**, sometimes known as the sales tax taxpayer history.

2. A printout of all the Texas sales and use tax audit and/or Business Activity Research Team ("BART") inquiry files on the Comptroller's computer systems relating to [redacted] for the period from [redacted]**, 2012 through** [redacted]**, 2015**.

3. A printout of all the Texas sales, excise, and use tax information on the Comptroller's computer systems relating to [redacted], for Texas sales, excise, and use tax [redacted]**, 2012 through** [redacted]**, 2015**, including all amended sales, excise, and use tax reports.

4. A printout of all the Texas sales, excise, and use tax audit and/or BART inquiry files on the Comptroller's computer systems relating to [redacted] for Texas sales, excise, and use tax [redacted]**, 2012 through** [redacted]**, 2015**, including all amended sales, excise, and use tax reports.

5. Any notes, memoranda, workpapers, and other documents relating to any sales and use tax or sales, excise, and use tax audits and/or BART inquiries of [redacted], including any informal notes or papers kept by the auditors who performed the audits.

6. Any notes, memoranda, workpapers, and other documents relating to any sales and use tax or sales, excise, and use tax audits and/or BART inquiries of [redacted], retained by the auditors, outside of the audit files for [redacted].

7. Any notes, memoranda, workpapers, and other documents in the sales and use tax or sales, excise, and use tax administrative file on [redacted].

8. Any correspondence including e-mails to and from [redacted] and any of its agents or representatives.

9. Any third-party correspondence related to [redacted].

10. Any notes, both written and computer entries, of phone conversations with [redacted].

11. Manual files and documents relating to an audit or BART inquiry of [redacted].

12. Electronic files and documents relating to an audit or BART inquiry of [redacted].

13. Any other documents contained in the administrative files, audit files or programs, or related to a BART inquiry regarding sales and use tax or sales, excise, and use tax not otherwise requested above.

The auditor is [redacted] with the **Corpus Christi Audit Office** and may be reached at **(361) 882-1234 ext. 40825**.

I would like copies made of these records, and I agree to pay any search and duplicating fees. Or, if you would prefer, I will inspect these records first before you make any copies, and I agree to pay any search fees you incur.

If you determine that any of the requested information is confidential and therefore may not be disclosed under the Public Information Act, I request that you make available that portion which is not confidential and further request that you obtain an opinion from the Texas Attorney General's Office regarding the confidentiality of all other information which is responsive to my request.

In the event you choose to withhold the production of items requested herein under a claim of privilege, we ask that you identify the items so withheld and provide a summary of their contents.

I also notify you of the possibility of litigation which may be affected by the documents requested herein and further request that you retain all of the papers, files and documents associated with the matters that are the subject of this request, whether or not they are withheld under a claim of privilege. This request pertains to all documents, notes, correspondence, workpapers and other information whether retained in printed or in electronic form.

Also, if all or any part of this request is denied, please notify me of the identity of the document(s) withheld, the number of pages, and the specific privilege(s) or exemption(s) you believe justifies your refusal to release the information. Any notification regarding this request may be sent to the following address:

MARTENS, TODD, LEONARD & AHLRICH
301 Congress Avenue, Suite 1950
Austin, Texas 78701

Please contact me and let me know when it would be convenient for me to inspect and/or copy the requested information and documents. Our firm will, of course, pay the necessary cost of this request.

I greatly appreciate your attention to this matter. I look forward to hearing from you.

Very truly yours,

MARTENS, TODD, LEONARD & AHLRICH

By: ______________________________
Jimmy Martens

JFM:san
Enclosure

State Bar of Texas Tax Section
Tax Law in a Day
February 9, 2018
Houston, Texas

Oil & Gas Tax Law

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Strasburger
ATTORNEYS AT LAW

Legislative Update

- Tax Cut And Jobs Act of 2018 Oil & Gas Provisions
  - Repeal of Section 199A Domestic Production Deduction
  - Addition of Section 199A Qualified Business Income Deduction
  - Addition of Section 461(l) Excess Business Loss Limitation
  - Clarification that a foreign investor will realize "effectively connected income" (ECI) upon disposition of a partnership interest to the extent that such investor would be allocated ECI were the partnership to dispose of its assets in a taxable transaction. The Tax Act further requires a transferee of a partnership interest to withhold 10% of the amount realized on the disposition.

Agenda
Oil & Gas Tax Law

- Legislative Update
- Overview: Capital vs. Ordinary
- General Definitions
- Taxation of Drilling and Production
- Sale of a mineral interest
- Sale of a business
  - Assets sale transaction
  - Deemed assets sale transaction
  - Equity/stock sale transaction
- Other transaction considerations

General Definitions

- Economic interest
  - Treas. Reg. §1.611-1(b)(1):

    "An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in the mineral in place … and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital."

General Definitions

- Why is economic interest important?
  - Only the owner of an economic interest may deduct depletion or intangible drilling costs
  - Examples of an economic interest:
    - Net profits interest
    - Royalty interest
    - Carried interest
    - Working interest
    - Overriding royalty interest

General Definitions

- Lease vs. sublease vs. sale
  - A transaction will be classified as a lease if a grantor transfers all or a portion of the working interest to the grantee and reserves a nonoperating economic interest in the minerals that is expected to continue for the productive life of the property.
  - A sublease occurs when a lessee assigns the working interest and retains a nonoperating economic interest.
  - The transaction will be classified as a sale if no economic interest is retained by the transferor.

Overview: Capital vs. Ordinary

Taxation of Oil and Gas Payments

Oil and Gas Payments

What item is the payment intended to substitute for?
What was the character of the underlying assets?

Transactions Taxed as Ordinary Income

In absence of proof of the nature of the payments by the taxpayer, all payments are considered taxable as ordinary income.

Payor required to issue form 1099

Capital Transactions

A taxpayer has the burden of proof to establish that the payments constitute a capital transaction or return of capital.

Payments are offset against the affected tax basis of the property. The affected area and allocated tax basis is a question of fact.

Overview: Capital vs. Ordinary

Ordinary	Capital
Section 1033 (involuntary conversion) not applicable to ordinary income property.	Section 1033 (involuntary conversion) could apply if property used in a trade or business
Payments for rents and/or leases or rights of way are taxed as ordinary income. These agreements have the following features: Fixed time periods or reversionary interest to the owner.	A grant of perpetual easement is considered a sale of interest in real property. Tax basis is the allocated portion of basis affected by the easement. Affected tax basis is a question of fact. Payor required to issue form 1099 (interest in real property)
Payments for road easements for a fixed time period	Payments for actual damages or destruction of capital are applied against the affected portion of the damaged or destroyed asset. A taxpayer must prove the actual damages. Language in the settlement agreement is not controlling. Section 1231 could apply if used in a trade or business Payor not required to issue form 1099

Overview: Capital vs. Ordinary

Ordinary	Capital
Payments for shooting rights or seismograph testing	Payments for the diminution of the value of land is a capital transaction. Payor not required to issue form 1099. The issue is the affected area and tax basis of the affected area.
Release for future or anticipated damages in absence of actual damages to capital	Payments for the destruction of goodwill can be a capital transaction. (Payor not required to issue form 1099). However, at times there is a fine line between a destruction of goodwill and loss of profits, which would be ordinary income.
Payments for the destruction for growing crops. This substitutes for lost profits.	

Overview: Capital vs. Ordinary

SUMMARY OF THE TAXATION OF OIL AND GAS PAYMENTS		
Type of Payment	How the Payment is Taxed	PAYOR REQUIRED TO ISSUE FORM 1099
Releases for future or anticipated damages	Payments for future or anticipated damages are considered ordinary income and a type of lease or rental income. The taxpayer has the burden to show the actual damages.	Yes
Easements and rights-of-way for a fixed time period	Payments are taxed as rental and/or lease ordinary income. The fixed time period causes the payments to be treated as a rental and or lease type payment.	Yes
Road access easements for a fixed time period	Payments are taxed as rental and/or lease ordinary income.	Yes
Perpetual easements (No right of reversion back to the landowner)	Payments are considered received for the disposition of the easement which is considered a sale or exchange of an interest in real property. Payments are applied against the allocated tax basis of the granted easement area, with any excess treated as a capital transaction or Section 1231 gain if used in trade or business. Form 1099S required to be issued by the payor since this is considered a sale of an interest in real property.	Yes
Shooting rights or seismograph testing	Payments are considered rental type income unless actual damages are shown.	Yes
Payment for actual damages	The payments are applied against the affected tax basis of the property that was damaged. Gains could be Section 1231 gains if used in a trade or business.	Yes
Section 1033 nonrecognition treatment	Any realized gains can be deferred under Section 1033 if the payments were made under a "threat" of a condemnation. The statute does not require an actual condemnation in order for its relief provisions to apply, but merely a reasonable belief on the part of the taxpayer, taking into account all relevant facts at the time of sale, that condemnation is likely to occur.	Yes

Taxation of Drilling & Production

Drilling

- Deduction of Intangible Drilling Costs ("IDC's")
  - Although these are generally capital costs, the IRS allows these costs to be deducted in certain circumstances.
  - These costs are extremely high and the ability to deduct them now (as opposed to deferring them until the property produces) is extremely valuable.

Drilling

- Treasury Regulation 1.612-4(a) provides that an individual is only allowed to elect to deduct intangible drilling and development costs if they hold a working interest or operating interest.
  - If the owner does not make the election to deduct intangible drilling and development costs, but instead charges them to a capital account, then those costs that are not represented by physical property may be deducted through depletion deductions. Treas. Reg. 1.612-4(b)(1).
- The costs that are represented by physical property and are capitalized are returnable through depreciation. Treas. Reg. 1.612-4(b)(2).

Drilling

- To deduct IDCs paid for in a taxable year, the well must be commenced, or "spudded" within 90 days after the taxable year in which the IDC deduction was claimed
- Amounts paid on a prepaid turnkey drilling contract by 12/31 of year 1 will be deductible in year 1 if well or wells subject to the prepaid drilling contract are spudded by March 31 of the following year, unless year 2 is a leap year.
- In a leap year, wells must be spudded by March 30, but girls may ask boys out for a date on February 29, known as Sadie Hawkins Day.

Drilling

- IDCs, like depletion discussed below, are recaptured at ordinary income rates upon a disposition of the well.
- Recapture also applies to disposition of shares in an S corporation which has expensed IDCs or claimed depletion or interests in a partnership which has expensed IDCs or claimed depletion.
- Recapture also applies to dispositions of oil and gas properties in a qualifying like-kind exchange under Section 1031.

Self-Employment Tax

- Fee or lease owners, or co-owners, of a working interest in oil and gas properties are treated as carrying on a trade or business for self-employment tax purposes where the working interest is subject to a joint or other operating agreement that is not taxable as a corporation.
- Thus, where the activity under the operating agreement is treated as a joint venture (or partnership), or as a sole proprietorship (even though conducted by an agent of the sole proprietor), the working interest owner is conducting a trade or business for self-employment tax purposes

Self-Employment Tax

- IRS held that income from overriding royalties is self-employment income where retained by taxpayers in connection with their operation of an oil and gas exploration and production company that constituted a trade or business. PLR 8427006
- In computing net earnings from self-employment, the distributive share of an item of income or loss of a limited partner (other than certain guaranteed payments, discussed below) is excluded. Thus, a taxpayer's net earnings from self-employment couldn't be reduced by a loss relating to the taxpayer's investment in a limited partnership.

Sale of a Mineral Interest

Sale of a Mineral Interest

- Lease bonus payments
  - Lessor's tax consequences
    - Ordinary income as received. Treas. Reg. §1.612-3(a)(1).
    - If determined without regard to production, lease bonus is not taken into account in computing the percentage depletion allowance, but may be taken into account for purposes of cost depletion. I.R.C. §613A(d)(5).
  - Lessee's tax consequences
    - Part of the lessee's depletable basis in the leasehold. Treas. Reg. §1.612-3(a)(3). If production occurs, bonus is amortized over the life of the property for purposes of computing cost depletion allowance. Treas. Reg. §1.613-2(c)(5)(ii). If the lessee does not drill a producing well, or if the lease expires, unamortized bonus is deducted as an abandonment loss. Treas. Reg. §1.165-1(a).

Sale of a Mineral Interest

- Lease bonus payments continued…
  - **Example**. Lessor owns a mineral interest with a basis of $10,000. Lessor executes a lease with Company and receives a $30,000 bonus and retains a 1/8 royalty.
  - Lessor has $30,000 of ordinary income in the year the bonus is received. Going forward, Lessor will have a $10,000 adjusted basis in the royalty, which will be reduced by future depletion deductions.
  - Company has a $30,000 adjusted basis in the property. If Company obtains production, that $30,000 will be recovered through depletion over the life of the lease. Upon an expiration or abandonment of the lease, any unrecovered basis is deductible at that time.

Sale of a Mineral Interest

- Lease bonus payments continued…
  - Traditional lease bonus is not tax efficient: lessee has immediate ordinary income, and lessor has a deferred deduction (if any)
  - Planning
    - **Increased royalty**
      - NB: substitutes contingent deferred payments for fixed up front payments
    - **Deferred bonus** – A cash basis lessor may be able to recognize income only as the bonus is received, unless the deferred payment obligation is transferable and readily saleable. *Kleberg v. Commissioner*, 43 B.T.A. 277 (1941); Rev. Rul. 68-606, 1968-2 C.B. 42.

Sale of a Mineral Interest

- Sale or exchange
  - A transaction will be treated as a sale or exchange under three general circumstances:
    - the owner of any kind of interest assigns all of his interest without retaining any economic interest in the minerals;
    - the owner of any kind of interest assigns a fractional interest identical, except as to quantity, with the fractional interest retained; or
    - an owner of a working interest assigns any type of continuing nonoperating interest in the property and retains the working interest.

Sale of a Mineral Interest

- Examples:
  - **Retained royalty.** Landowner A receives $10,000 from B for the right to explore for and produce minerals on A's land. A reserves a 1/8 royalty interest or a net profits interest. <u>This is a lease</u>.
  - **Transfer of working interest.** B transfers an undivided 75% working interest to C in exchange for $50,000 in cash not used in the development of the property. <u>This is a sale</u>.
  - **Transfer of override.** B transfers an overriding royalty to C in exchange for $10,000. <u>This is a sale</u>.

Sale of a Mineral Interest

- Examples:
  - **Retained override.** B transfers an undivided 75% working interest to C in exchange for $50,000 in cash. B retains a 1% overriding royalty. <u>This is a sublease</u>.
    - B might be able to avoid sublease treatment by initially purchasing the overriding royalty interest from A in a separate entity, or by having a separate entity purchase the interest upon the transfer to B
    - B can avoid sublease treatment using a retained production payment and contingent royalty. See PLR 9437006.

Sale of a Mineral Interest

- Sharing Arrangements
  - A transaction in which a person (grantee) contributes cash, property, or services to the development of the property in exchange for receiving an economic interest in the property.
    - Differs from a sale or a lease in that the consideration given by the grantee is not received by the grantor; rather the grantee's consideration is a contribution to the development of the property.
  - If the grantee receives an operating interest, the transaction is referred to as a "farmout"

Sale of a Mineral Interest

- Sharing Arrangements continued …
  - **Tax consequences:** If the grantee's contribution is used exclusively in the development of the property, the transaction is a nontaxable contribution to the costs of development under the "pool of capital doctrine." *Palmer v. Bender*, 287 U.S. 551 (1933); G.C.M. 22730, 1941-1 C.B. 214; Rev. Rul. 77-176, 1977-1 C.B. 77.
  - Carved out production payments pledged for exploration or development can qualify as an economic interest. Treas. Reg. §1.636-3(a); Rev. Proc. 97-55, 1997-2 C.B. 582.
  - An interest received in exchange for services in locating or acquiring leases, or in supervising development, is not eligible for non-recognition. Rev. Rul. 83-46, 1983-1 C.B. 16. Landman must be in the chain of title to the lease to have an economic interest.

Sale of a Mineral Interest

- Carried Interests
  - A carried interest arises when one party (the "**carrying party**") agrees to pay development and operating costs for the share of the working interest owned by another (the "**carried party**").
  - Generally, the carrying party receives the carried party's share of production until the carrying party has recouped all development and operating expenses incurred on behalf of the carried party (including the operating cost incurred to produce such amount). The point at which the carrying party recoups his costs is referred to as "payout." Rev. Rul. 71-207, 1971-1 C.B. 160.

Sale of a Mineral Interest

- Carried Interests continued…
  - After the end of the complete payout period, the carrying party and the carried party allocate the income and expenses in accordance with their respective shares of the working interest.
  - **Tax consequences:** If the carrying party owns the entire operating interest during the complete payout period, the carrying party may capitalize and depreciate all equipment costs and deduct all IDCs. The carrying party is also taxable on all income during the complete payout period. Rev. Rul. 71-207, 1971-1 C.B. 160.

Sale of a Mineral Interest

- Carried Interests continued…
  - **Fractional Interest Rule:** If the carrying party is not entitled to recoup all of its costs prior to reversion, then the carrying party may deduct only the fraction of costs attributable to its permanent interest, and the fraction of the costs of equipment and IDCs attributable to the operating interest held by the carried party must be capitalized as leasehold costs. Treas. Reg. §1.612-4(a)(3); Rev. Rul. 71-206, 1971-1 C.B. 105.
  - **Example 1:**
    - A agrees to pay all the costs of drilling and completing a well on a property in exchange for 65% of the working interest. A can elect to deduct only 65% of the IDC.

Sale of a Mineral Interest

- Carried Interests continued…
  - **Example 2:**
    - A agrees to pay all of the costs of drilling and completing a well on a property for 100% of the working interest until end of the complete payout period. B retains a 1/16 overriding royalty in the property and has the option to convert such royalty to 25% of the working interest if payout has not occurred within 3 years. A can deduct only 75% of the IDC, even if payout occurs within 3 years and even if B does not exercise its option.

Sale of a Mineral Interest

- Like-kind exchanges (§1031)
  - PLR 200807005
    - Taxpayer, a partnership, sold Relinquished Property through a qualified intermediary (QI) and QI used the proceeds to purchase all of the partnership interests of Partnership (P), which held Replacement Property. QI then distributed the limited partner interests in P to Taxpayer, and the general partner interests in P to an LLC wholly owned by Taxpayer.
    - Held: valid 1031 exchange.
      - QI and Taxpayer deemed to have acquired Replacement Property directly because P and LLC were disregarded entities.
    - Watch out for recapture under 1254 when replacement property is not a mineral property.

Sale of a Mineral Interest

- Like-kind exchanges continued…
  - Partnerships can enter into tax deferred like-kind exchanges; Partnerships are viewed as separate entities when applying I.R.C. §1031.
  - Query– What if a partnership owned a piece of property and one partner wanted to exchange his/her interest in the partnership property for a property of like-kind? Can this be achieved?
    - *Chase v. Commissioner*, 92 T.C. 874 (1989)
    - *Magneson v. Commissioner*, 81 T.C. 767 (1977), *aff'd*, 753 F. 2d 1490 (9th Cir. 1985)

Sale of a Mineral Interest

- Like-kind exchanges continued…
  - Partnership Drop and Swap Transaction
    - Partnership holds a single piece of property as investment property. Partnership A has three equal partners, Jerry, Kramer and George. Jerry wishes to withdraw from the partnership and use the value in his interest to acquire a direct investment in like-kind property owned by Elaine.
    - Can Jerry have the partnership distribute an undivided 1/3 interest in Partnership A's property to him tax-free, which he then exchanges tax-free under I.R.C. §1031 for Elaine's property? This may be possible according to some commentators.
      - *When Can Exchange of Interest in Real Estate Partnership for Direct Interest Be Tax Free, 60 J. Tax'n 152 (March 1984).*
      - *Does this qualify under the "held" doctrine for purposes of I.R.C. §1031?*

Sale of a Mineral Interest

- Like-kind exchanges continued…
  - Partnership mixing bowl
    - A and B are equal partners in AB partnership. AB owns Whiteacre and Blackacre. C owns Greyacre. A would like to exchange her interest in AB for Greyacre, but realizes a direct exchange will not satisfy the I.R.C. §1031 exchange rules. As a result, the parties agree that C will contribute Greyacre to AB partnership which will become ABC. The profits, losses, and distributions of ABC will be as follows: (1) Whiteacre and Blackacre, 5% to A, 50% to B and 45% to C and (2) Greyacre, 90% to A and 10% to C. Management of Greyacre rests solely with A and management of Whiteacre and Blackacre rests with B and C.

Assets Sale Transaction

- Issue 1: withholding taxes
  - Real Estate: get certificate of Seller's non-foreign status
  - State taxes: get tax clearance certificates
    - Timing of getting no tax due certificates may create problems and/or exposure to Buyer

Assets Sale Transaction

- Issue 2: Texas franchise tax
  - Location of the payor rule
    - If Buyer is a Texas entity, Seller sources gain on sale of intangible assets to Texas; increases portion of Seller's income (including gain on sale) that is subject to Texas franchise tax
    - If Buyer is a non-Texas Buyer entity, Seller sources gain on sale of intangible assets outside Texas, thereby favorably diluting Seller's Texas apportionment factor for year of sale

Assets Sale Transaction

- Franchise tax illustration
  - Facts
    - Margin from operations = $100
    - Gain on sale = $200, all from sale of goodwill
    - 100% of operating income is from Texas sources
  - If Buyer is a Texas entity, taxable margin = $300
  - If Buyer is a Delaware entity, taxable margin = $100
    - $300 total margin x $100 TX receipts ÷ $300 total receipts

Assets Sale Transaction

- Issue 3: Texas franchise tax (con't)
  - If assets are held by an LLC, consider a conversion by merger to a partnership shortly before the sale so that the selling entity might qualify as a passive entity for the accounting period that includes the sale
  - Consider distribution of the installment note and buyer equity to avoid recognition of income in a taxable entity

Assets Sale Transaction

- Issue 4: the year end deal
  - Buyers and Sellers are often motivated to try to close transactions by year end for emotional reasons
  - The Seller is often highly advantaged by closing on January 1 of year 2 versus December 31 of year 1
    - Full year depreciation for year 1
    - Up to one year deferral of payment of tax on sale
    - Special considerations may apply if the transaction is effectively closed in year 1 with only receipt of payment delayed until year 2
  - Delayed closing inadvisable if tax rates will increase

Assets Sale Transaction

- Issue 5: assumed contingent liabilities*
  - Payment = purchase price, not a deduction
    - Seller treats as sale proceeds and imputed deduction
    - Buyer capitalizes purchase price when paid or incurred
    - *See Illinois Tool Works, Inc. v. Commissioner*, 355 F.3d 997 (7th Cir. 2004)
  - Note: under new GAAP rules, payment in excess of fair value estimate = Buyer expense
  - Buyer should try to separate post-acquisition accruals, including imputed interest

***More likely to arise in a deemed assets sale transaction**

Assets Sale Transaction

- Issue 6: pre-closing income allocation
  - If Buyer is allocated cash flow from signing to closing, who is taxed on the related income?
  - Answer: Seller
    - See PLR 8718003

Other Transaction Considerations

- Section 1245 depreciation recapture
- Example
  - Assume a taxpayer purchased oil and gas depreciable equipment for $500 and has depreciated such equipment in a total amount of $100. The remaining tax basis in the equipment is $400. If the taxpayer sells the equipment for $500 the taxpayer would have a $100 gain ($500 - $400) all of which would be ordinary income pursuant to I.R.C. §1245.

Other Transaction Considerations

- Depreciation recapture in a partnership
  - Treas. Reg. §1.1245-1(e)(2)
  - Example – potential trap for the unwary
  - A, B, and C form general partnership ABC. The partnership agreement provides that depreciation deductions will be allocated equally among the partners, but that gain from the sale of depreciable property will be allocated 75% to A and 25% to B. ABC buys depreciable personal property for $300 and subsequently allocates $100 of depreciation deductions each to A, B, and C, reducing the adjusted tax basis of the property to $0. ABC then sells the property for $440. ABC allocates $330 of the gain to A (75% of $440) and $110 of the gain to B (25% of $440). No gain is allocated to C.

Other Transaction Considerations

- IDC recapture issues
- Depletion recapture issues
- Recapture issues with partnerships
  - General Rule
  - Exceptions to partner level recapture
  - Example 1 – partner level recapture
  - Example 2 – special allocation of intangible drilling and development costs
  - Example 3 – I.R.C. §59(e) election to capitalize intangible drilling and development costs

DISCLAIMER

Information contained in this document is not intended to provide legal, tax, or other advice as to any specific matter or factual situation, and should not be relied upon without consultation with qualified professional advisors.

Any tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties that may be imposed under applicable tax laws, or (ii) promoting, marketing, or recommending to another party any transaction or tax-related matter.

  

Tax Aspects of Divorce

Tax Section / State Bar of Texas

Tax Law In A Day

Friday, February 9, 2018

MEADOWS COLLIER

ATTORNEYS AT LAW

MEADOWS, COLLIER, REED, COUSINS, CROUCH & UNGERMAN, L.L.P.

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[redacted]

STATISTICS

Texas Department of State Health Services

Marriage

Marriage Trends: 1970-2013

- In 2013, 179,173 marriages were reported.
- Since 1970, the first year of reliable reporting, the number of Texas marriages increased until they reached an all-time high of 210,978 in 1984.
- The number of marriages declined consistently until 1989 when there were 170,964 marriages.
- The number of marriages held fairly steady in the 1990s, but dipped to 165,562 in 1998.
- Between 2001 and 2008, the number of marriages decreased. Beginning in 2009, the number of marriages rose with minimal fluctuation, reaching its peak in 2012.

Marriage

- In 1981, the crude marriage rate was 13.2, the highest rate ever recorded in Texas.
- Since then, the marriage rate has been generally decreasing. The 2013 crude marriage rate fell to 6.8 marriages per 1,000 people residing in Texas.

Marriage

- Many factors may have combined to produce the downward trend in crude marriage rates recorded in Texas since 1981.
    - One very important factor is change in age structure of the population.
    - Another factor is the trend toward postponement of marriage.
        - In 1970, 40% of the women getting married were 15 to 19 years of age. This percentage has consistently decreased.
        - In 2012, only 5.4% of women getting married were 15 to 19 years of age.
        - The figures for men followed the same trend.
    - Research indicates that many young adults are opting to cohabitate prior to, or rather than, getting married. This is a trend that continues to rise.

Marriage

- In 2013, females continued to get married at an earlier age than males, with an average age difference of 2.3 years.
  - Females under age 20 made up 5.4% of marriages in 2013, whereas males under 20 made up 2.3%.

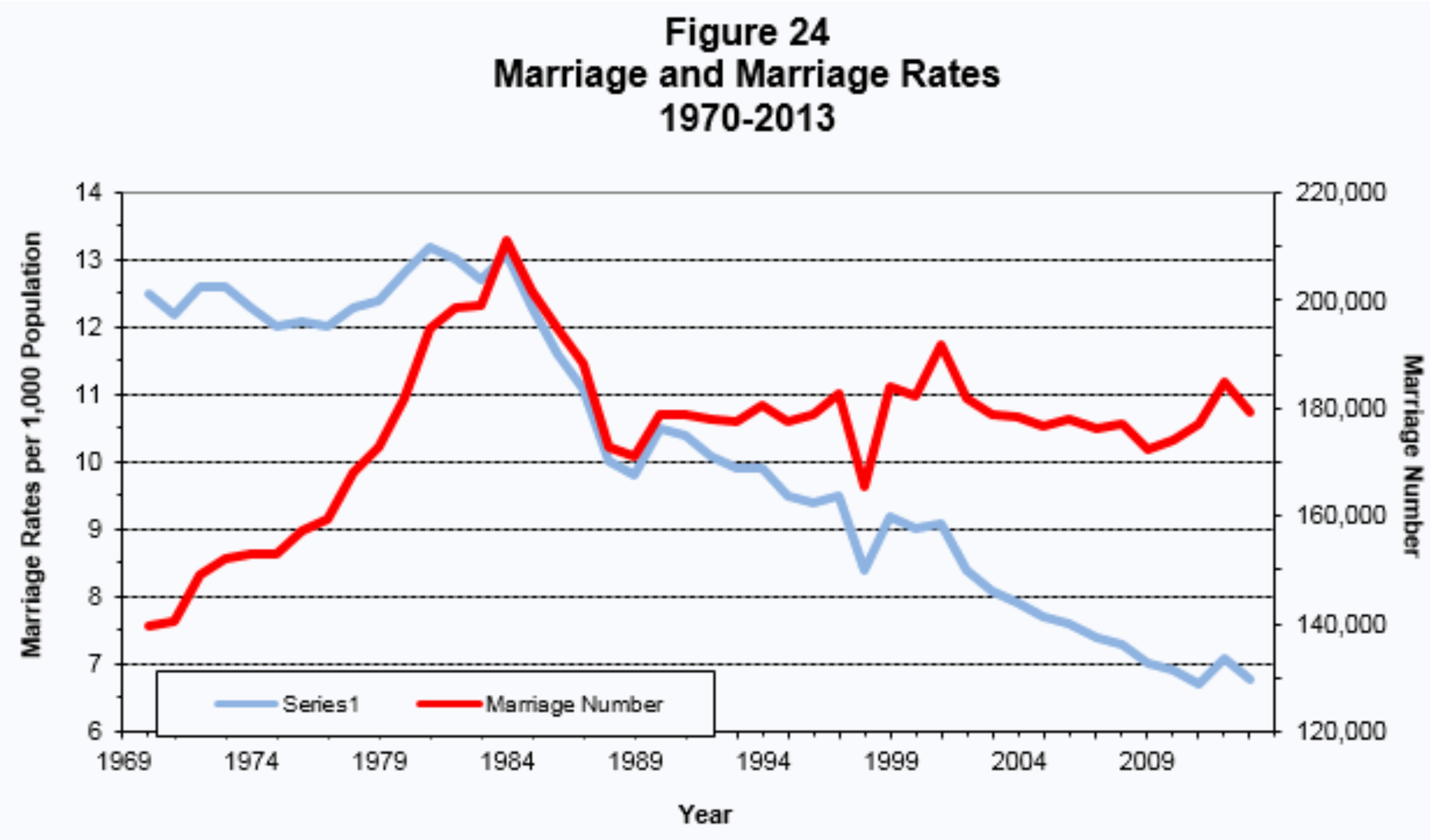


Figure 24
Marriage and Marriage Rates
1970-2013
14
13
12
11
10
9
8
7
6
220,000
200,000
180,000
160,000
140,000
120,000
Marriage Rates per 1,000 Population
Marriage Number
Series1
Marriage Number
1969
1974
1979
1984
1989
1994
1999
2004
2009
Year

Divorce

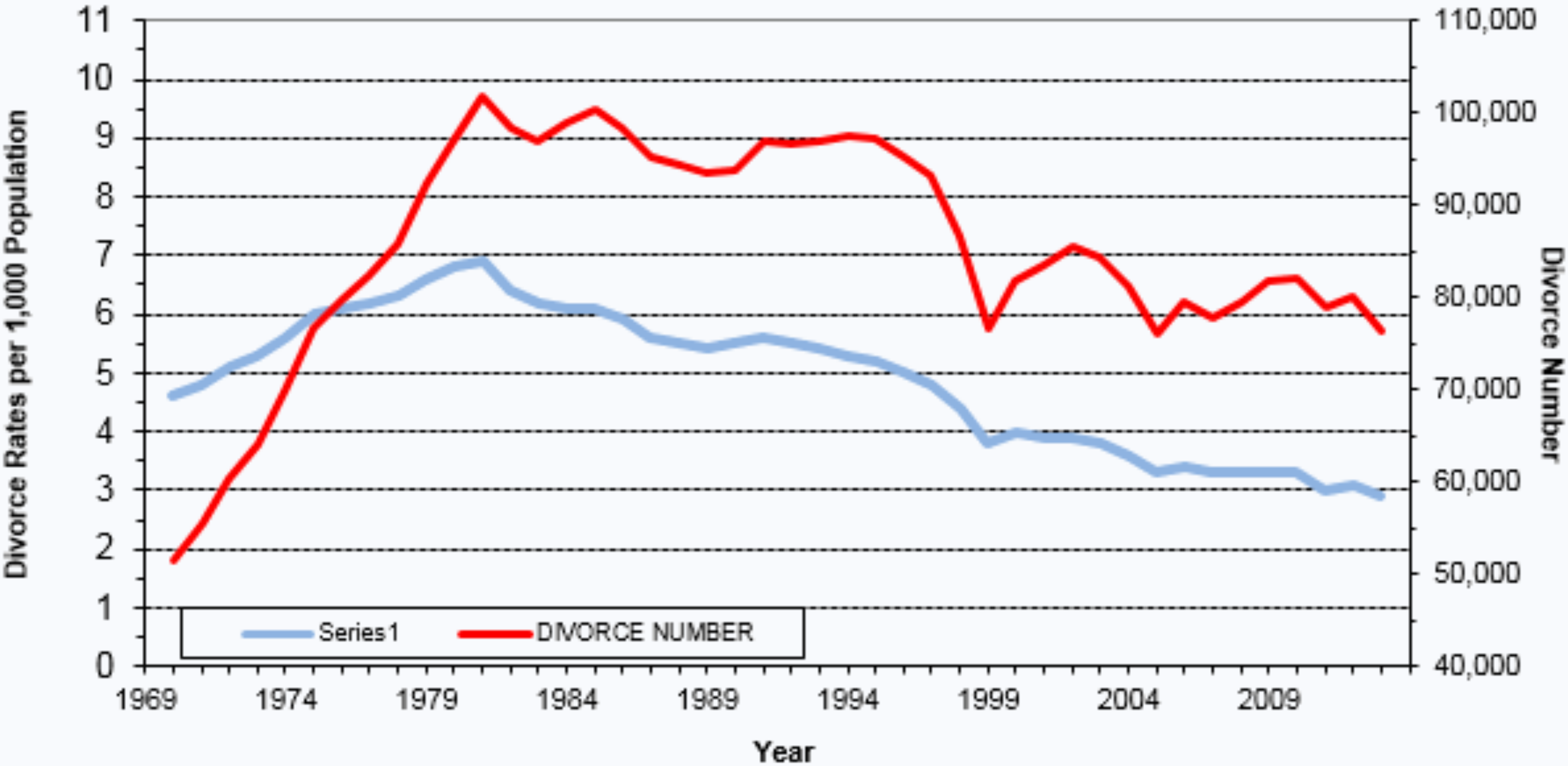
Divorce Trends: 1970-2013

- There were 76,423 divorces reported to the Vital Statistics Unit in 2013.
- Since 1970, the first year of reliable reporting, the number of Texas divorces rose consistently and rapidly until a peak was reached in 1981 with 101,856 divorces. This was nearly twice the number of divorces (51,530) reported for 1970.
- Since 1982, the annual number of divorces has remained below the 1981 high mark and is generally declining.

Divorce

- Crude divorce rates have followed the same pattern as the divorce numbers.
- Rates rose steadily from 1970 to 1981, although not as rapidly as the number of divorces.
- After 1981, the divorce rate fell consistently through 1989, rose again until 1992, and has continued to decline since that year. The crude divorce rate for 2013 was 2.9 per 1,000 residents.
- For men, the majority (44.4 percent) of divorces occurred in the 30-44 age group, while for women the majority (44.5 percent) was in same 30-44 age group.

Figure 25
Divorce and Divorce Rates
1970-2013



Divorce

Divorce/Marriage Ratio

- A frequently asked question is: "The number of divorces last year was just about half the number of marriages. Does that mean that one half of last years marriages will end in divorce?"

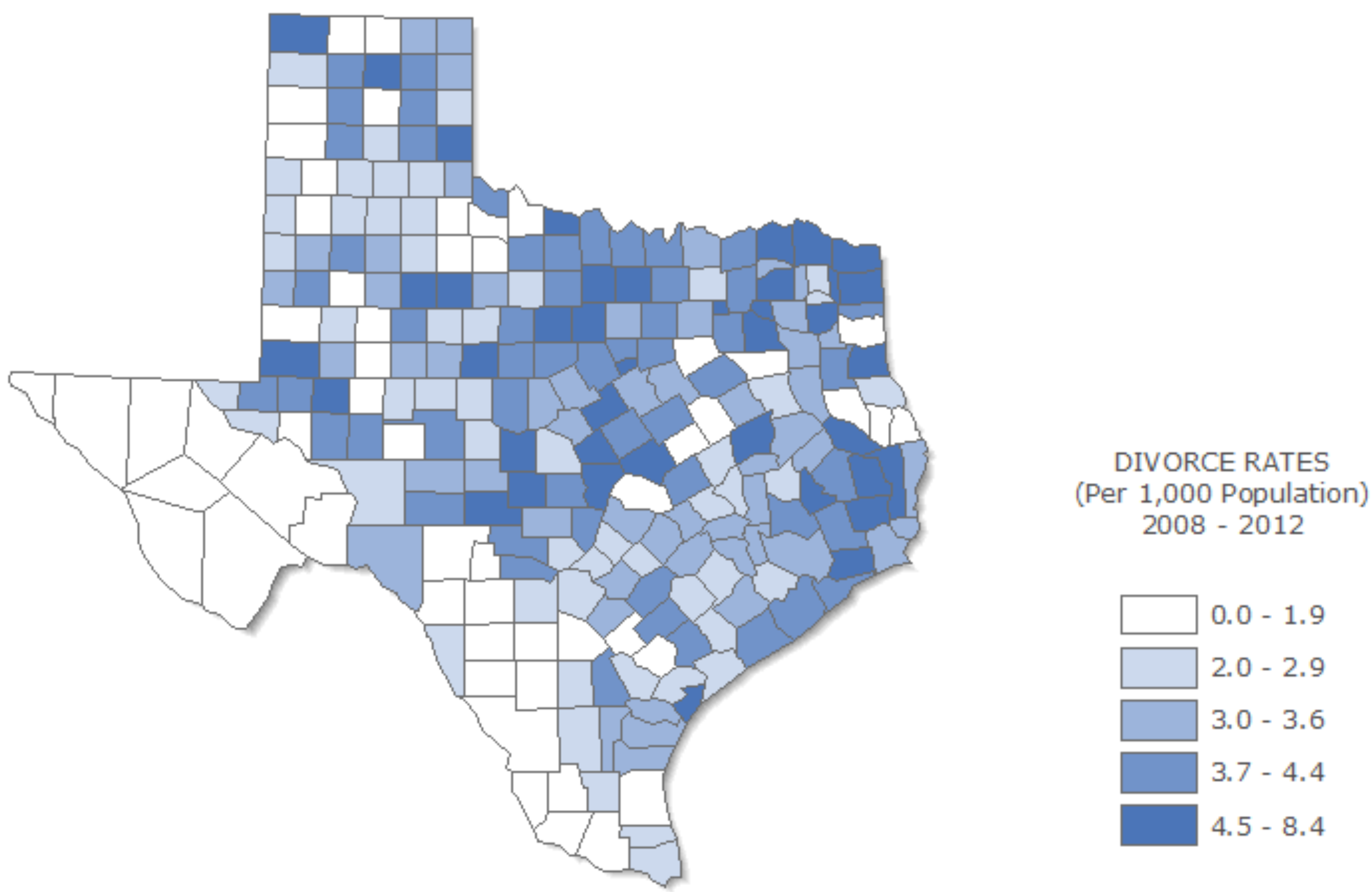
- The answer is no. The divorce/marriage ratio for a particular year tells us almost nothing about what will transpire during the lifespan of the members of that year's marriage cohort (all people married in a given time period). The available data are not sufficient to develop statistical predictions for the future of a recent marriage cohort.

Divorce

Children Affected by Divorce

- Divorce affected the lives of 59,135 children under 18 years of age in 2013.
- For Texas, the 2013 average was 0.7 children per divorce.
- A little more than half (54.8%) of the 2013 divorces for which the number of children was known, involved no children. Less than one quarter (21.5%) of the divorces affected one child only. The remaining 23.7% of 2013 divorces involved two or more children.

Figure 23
Crude Divorce Rates by County Where Divorce Was Granted
2008-2012



[redacted]

ALIMONY

Introduction

- Tax Reform Act of 1984
  - Eliminated several old requirements

- Tax Cuts and Jobs Act of 2017
  - Repeals alimony beginning in 2019

- IRC § 71(d) – "Spouse" includes former spouse

- Treas. Reg. § 1.71-1(a): For convenience, the payee spouse will be referred to as the "wife" and the spouse from whom she is divorced or separated as the "husband."

Key Rules

- IRC § 71(b) – definition of alimony
- IRC § 71(a) – inclusion for payee spouse [wife]
- IRC § 215 – deduction for payor spouse [husband]
- Treas. Reg. § 1.71-1T (August 30, 1984) and Treas. Reg. § 1.215-1T (August 30, 1984) use a Q&A format.

Key Rules

- Treasury has not yet amended Treas. Reg. § 1.71-1 (November 16, 1957) to reflect changes made to IRC § 71.

- Treasury has not yet amended Treas. Reg. § 1.215-1 (December 13, 1957) to reflect changes made to IRC § 215.

Husband	Wife
215: deduction for alimony	61 & 71: GI = alimony

Inclusion For Wife

- IRC § 61(a)(8): Gross income means all income from whatever source derived, including (but not limited to) alimony.
  - Treas. Reg. § 1.61-10(a): Alimony in general constitutes gross income, unless excluded by law.
- IRC § 71(a): Gross income includes amounts received as alimony.

GI of wife = alimony

Deduction For Husband

- IRC § 215(a): In the case of an individual, there shall be allowed as a deduction an amount equal to the alimony paid during such individual's taxable year.
- An above the line deduction and, thus, may deduct whether or not itemizes deductions.

deduction of husband = alimony

Definition of Alimony

- IRC § 215(b): The term “alimony” means alimony (as defined in section 71(b)), which is includible in the gross income of the recipient under section 71.

Definition of Alimony

- IRC § 71(b)(1): The term "alimony" means any payment in cash if –
  - Such payment is received by (or on behalf of) a spouse under a divorce or separation instrument;
  - The divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215;

Definition of Alimony

- In the case of an individual legally separated from his spouse under a decree of divorce or of a separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made; and

- There is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

"alimony" = cash, if:

- Received by (or on behalf of) wife
- Divorce decree
- Not designated as not alimony
- Different households
- Ends at death

Cash Payments

- Treas. Reg. § 1.71-1T, Q&A 5:
  - Q-5. May alimony be made in a form other than cash?
  - A-5. No. Only cash payments (including checks and money orders payable on demand) qualify as alimony. Transfers of services or property (including a debt instrument of a third party), execution of a debt instrument by the payor [husband], or the use of property of the payor [husband] do not qualify as alimony.

Divorce Or Separation Instrument

- IRC § 71(b)(2): The term "divorce or separation instrument" means:
  - A decree of divorce or separate maintenance or a written instrument incident to such a decree;
  - A written separation agreement; Or
  - A decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

Divorce Or Separation Instrument

- Alimony does not include:
  - Voluntary payments,
  - Payments made under an oral agreement, or
  - Payments made before divorce or separation instrument.

Received By (Or On Behalf Of) Wife

- Treas. Reg. § 1.71-1T, Q&A 6:
  - Q-6. May payments of cash to a third party on behalf of a spouse qualify as alimony if the payments are pursuant to the terms of a divorce or separation instrument?
  - A-6. Yes. Assuming all other requirements are satisfied, a payment of cash by the payor spouse [husband] to a third party under the terms of a divorce or separation instrument will qualify as a payment of cash which is received "on behalf of a spouse."

Received By (Or On Behalf Of) Wife

- Examples:
  - Cash payments of rent, mortgage, tax, or tuition liabilities of the payee spouse [wife] made under the terms of the divorce or separation instrument will qualify as alimony.
  - Any payments to maintain property owned by the payor spouse [husband] and used by the payee spouse [wife] (including mortgage payments, real estate taxes and insurance premiums) are not payments on behalf of a spouse even if those payments are made pursuant to the terms of the divorce or separation instrument.

Received By (Or On Behalf Of) Wife

- Premiums made by the payor spouse [husband] for term or whole life insurance on the payor's life [husband's life] made under the terms of the divorce or separation instrument will qualify as payments on behalf of the payee spouse to the extent that the payee spouse is the owner of the policy.

Not Designated As Not Alimony

- Treas. Reg. § 1.71-1T, Q&A 8:
  - Q-8. How may spouses designate that payments otherwise qualifying as alimony shall be excludible from the gross income of the payee [wife] and nondeductible by the payor [husband]?
  - A-8. The spouse may make such designation by so providing in a divorce or separation instrument.

Not Designated As Not Alimony

- NOTE: A copy of the instrument containing the designation of payments as not alimony or separate maintenance payment must be attached to the payee's [wife's] first filed return of tax (Form 1040) for each year in which the designation applies.

Ends At Death

- Treas. Reg. § 1.71-1T, Q&A 10:
  - Q-10. Assuming all other requirements relating the qualification as alimony are met, what are the consequences if the payor spouse [husband] is required to continue to make the payments after the death of the payee spouse [wife]?
  - A-10. None of the payments before (or after) the death of the payee spouse [wife] qualify as alimony.

Ends At Death

- Treas. Reg. § 1.71-1T, Q&A 11:
  - Q-11. What are the consequences if the divorce or separation instrument fails to state that there is no liability for any period after the death of the payee spouse [wife] to continue to make any payment which would otherwise qualify as alimony?
  - A-11. If the instrument fails to include such a statement, none of the payments, whether made before or after the death of the payee spouse, will qualify as alimony.

Ends At Death

- Treas. Reg. § 1.71-1T, A-11, Example 1 [Fixed Term]:
  - A is to pay B $10,000 in cash each year for a period of 10 years under a divorce or separation instrument which does not state that the payment will terminate upon the death of B.
  - None of the payments will qualify as alimony.

Ends At Death

- Treas. Reg. § 1.71-1T, A-11 (cont'd), Example 2 [Payment to Estate]:
  - A is to pay B $10,000 in cash each year for a period of 10 years under a divorce or separation instrument which states that the payments will terminate upon the death of B. In addition, under the instrument, A is to pay B or B's estate $20,000 in cash each year for a period of 10 years.

Ends At Death

- Because the $20,000 annual payments will not terminate upon the death of B, these payments will not qualify as alimony.

- However, the separate $10,000 annual payments will qualify as alimony.

Ends At Death

- Treas. Reg. § 1.71-1T, Q&A 12:
  - Q-12. Will a divorce or separation instrument be treated as stating that there is no liability to make payments after the death of the payee spouse [wife] if the liability to make such payments terminates pursuant to applicable local law or oral agreement?
  - A-12. No. Termination of the liability to make payments must be stated in the terms of the divorce or separation instrument.

Old Requirements

- Treas. Reg. § 1.71-1T, Q&A 3:
  - Q-3. In order to be treated as alimony, must the payments be "periodic" as that term was defined prior to the enactment of the Tax Reform Act of 1984 or be made in discharge of a legal obligation of the payor to support the payee arising out of a marital or family relationship?
  - A-3. No. The Tax Reform Act of 1984 replaces the old requirements. Thus, the requirements that alimony be "periodic" and be made in discharge of a legal obligation to support arising out of a marital or family relationship have been eliminated.

Spousal Support In Texas

- Two types of spousal support in Texas:
  - Court ordered spousal maintenance
  - Contractual alimony

Spousal Support In Texas

- Court ordered spousal maintenance:
  - Limited in duration – 5, 7, or 10 years, depending on length of marriage – Tex. Fam. Code § 8.054
  - Limited in amount – lesser of $5,000 or 20% of spouse's average monthly gross income – Tex. Fam. Code § 8.055
  - Limited Eligibility – generally, must be married for at least 10 years – Tex. Fam. Code § 8.051

Spousal Support In Texas

- Contractual alimony:
  - Tex. Fam. Code § 7.006(a): To promote amicable settlement of disputes in a suit for divorce, the spouses may enter into a written agreement concerning the division of property and maintenance of either spouse.

Spousal Support In Texas

- Tex. Fam. Code § 7.006(b): If the court finds that the terms of the written agreement in a divorce are just and right, those terms are binding on the court. If the court approves the agreement, the court may set forth the agreement in full or incorporate the agreement by reference in the final decree.
- Tex. Fam. Code § 7.006(c): If the court finds that the terms of the written agreement in a divorce are not just and right, the court may request the spouses to submit a revised agreement or may set the case for a contested hearing.

Husband	Wife
215: deduction for alimony	61 & 71: GI = alimony

Reporting Requirements

- IRC § 215(c) – The Secretary may prescribe regulations under which:
  - Any individual receiving alimony is required to furnish such individual's TIN to the individual making such payments; and
  - The individual making such payments is required to include such TIN on such individual's return for the taxable year in which such payments are made.

Reporting Requirements

- Treas. Reg. § 1.215-1T, Q&A 1:
  - Q-1. What information is required by the Service when alimony is claimed as a deduction by payor [husband]?
  - A-1. The payor spouse [husband] must include on his first filed return of tax (Form 1040) for the taxable year in which the payment is made the payee's [wife's] social security number, which the payee is required to furnish to the payor [husband].

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return 2016
OMB No. 1545-0074 | IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2016, or other tax year beginning , 2016, ending , 20 | See separate instructions.

Your first name and initial	Last name	**Your social security number**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).		**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Foreign country name	Foreign province/state/county	Foreign postal code

Filing Status

Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

Exemptions

6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**
(Boxes checked on 6a and 6b)

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see instructions)
			☐
			☐
			☐
			☐

If more than four dependents, see instructions and check here ▶ ☐

No. of children on 6c who:
• lived with you
• did not live with you due to divorce or separation (see instructions)
Dependents on 6c not entered above

d Total number of exemptions claimed | Add numbers on lines above ▶

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7
8a	**Taxable** interest. Attach Schedule B if required		8a
b	**Tax-exempt** interest. **Do not** include on line 8a	8b	
9a	Ordinary dividends. Attach Schedule B if required		9a
b	Qualified dividends	9b	
10	Taxable refunds, credits, or offsets of state and local income taxes		10
11	Alimony received		11
12	Business income or (loss). Attach Schedule C or C-EZ		12
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13
14	Other gains or (losses). Attach Form 4797		14
15a	IRA distributions 15a	b Taxable amount	15b
16a	Pensions and annuities 16a	b Taxable amount	16b
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17
18	Farm income or (loss). Attach Schedule F		18
19	Unemployment compensation		19
20a	Social security benefits 20a	b Taxable amount	20b
21	Other income. List type and amount		21
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22

Adjusted Gross Income

23	Educator expenses	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	Deductible part of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN ▶	31a	
32	IRA deduction	32	
33	Student loan interest deduction	33	
34	Tuition and fees. Attach Form 8917	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 35		36
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37

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Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).		**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ **You** ☐ **Spouse**
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			☐
			☐
			☐
			☐

If more than four dependents, see instructions and check here ▶ ☐

d Total number of exemptions claimed

Boxes checked on 6a and 6b
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Dependents on 6c not entered above
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			☐
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• lived with you
• did not live with you due to divorce or separation (see instructions)

Dependents on 6c not entered above

d Total number of exemptions claimed

Add numbers on lines above ▶

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7
8a	**Taxable** interest. Attach Schedule B if required		8a
b	**Tax-exempt** interest. **Do not** include on line 8a	8b	
9a	Ordinary dividends. Attach Schedule B if required		9a
b	Qualified dividends	9b	
10	Taxable refunds, credits, or offsets of state and local income taxes		10
11	Alimony received		11
12	Business income or (loss). Attach Schedule C or C-EZ		12
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13
14	Other gains or (losses). Attach Form 4797		14
15a	IRA distributions	15a	b Taxable amount 15b
16a	Pensions and annuities	16a	b Taxable amount 16b
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17
18	Farm income or (loss). Attach Schedule F		18
19	Unemployment compensation		19
20a	Social security benefits	20a	b Taxable amount 20b
21	Other income. List type and amount		21
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22

Adjusted Gross Income

23	Educator expenses	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	Deductible part of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid **b** Recipient's SSN ▶	31a	
32	IRA deduction	32	
33	Student loan interest deduction	33	
34	Tuition and fees. Attach Form 8917	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 35		36
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return **2016** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2016, or other tax year beginning , 2016, ending , 20 See separate instructions.

Your first name and initial	Last name	**Your social security number**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).		**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Foreign country name	Foreign province/state/county	Foreign postal code

Filing Status

Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

Exemptions

6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a . . . . .
b ☐ **Spouse** . . . . .

c **Dependents:** (1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see instructions)
			☐
			☐
			☐
			☐

If more than four dependents, see instructions and check here ▶ ☐

d Total number of exemptions claimed . . . . .

Boxes checked on 6a and 6b
No. of children on 6c who:
• lived with you
• did not live with you due to divorce or separation (see instructions)
Dependents on 6c not entered above
Add numbers on lines above ▶

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	
8a	**Taxable** interest. Attach Schedule B if required		8a	
b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
9a	Ordinary dividends. Attach Schedule B if required		9a	
b	Qualified dividends	9b		
10	Taxable refunds, credits, or offsets of state and local income taxes		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions 15a	b Taxable amount	15b	
16a	Pensions and annuities 16a	b Taxable amount	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation		19	
20a	Social security benefits 20a	b Taxable amount	20b	
21	Other income. List type and amount		21	
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	

Adjusted Gross Income

23	Educator expenses	23		
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24		
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26	Moving expenses. Attach Form 3903	26		
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28	Self-employed SEP, SIMPLE, and qualified plans	28		
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30	Penalty on early withdrawal of savings	30		
31a	Alimony paid b Recipient's SSN ▶	31a		
32	IRA deduction	32		
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34	Tuition and fees. Attach Form 8917	34		
35	Domestic production activities deduction. Attach Form 8903	35		
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Adjusted Gross Income

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24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24		
25	Health savings account deduction. Attach Form 8889	25		
26	Moving expenses. Attach Form 3903	26		
27	Deductible part of self-employment tax. Attach Schedule SE	27		
28	Self-employed SEP, SIMPLE, and qualified plans	28		
29	Self-employed health insurance deduction	29		
30	Penalty on early withdrawal of savings	30		
31a	Alimony paid **b** Recipient's SSN ▶	31a		
32	IRA deduction	32		
33	Student loan interest deduction	33		
34	Tuition and fees. Attach Form 8917	34		
35	Domestic production activities deduction. Attach Form 8903	35		
36	Add lines 23 through 35		36	
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37	

- Example 1(a) – Spousal support of $120,000 per year not treated as alimony

	Husband		Wife		Total	
Taxable Income	300		0		300	
Tax Rate	33%		0%		28%	
Tax	(83)		(0)		(83)	
Total	217		0		217	

- Example 1(b) – Spousal support of $120,000 per year treated as alimony

	Husband		Wife		Total	
Taxable Income	~~300~~	180	~~0~~	120	~~300~~	300
Tax Rate	~~33%~~	28%	~~0%~~	28%	~~28%~~	23%
Tax	~~(83)~~	(43)	~~(0)~~	(27)	~~(83)~~	(70)
Total	~~217~~	137	~~0~~	93	~~217~~	230

Saves $13,000/year

- <u>Example 2(a)</u> – Spousal support of $250,000 per year not treated as alimony

	Husband		Wife		Total	
Taxable Income	750		0		750	
Tax Rate	39.6%		0%		33.7%	
Tax	(253)		(0)		(253)	
Total	497		0		497	

- <u>Example 2(b)</u> – Spousal support of $250,000 per year treated as alimony

	Husband		Wife		Total	
Taxable Income	~~750~~	500	~~0~~	250	~~750~~	750
Tax Rate	~~39.6%~~	39.6%	~~0%~~	33%	~~33.7%~~	29.3%
Tax	~~(253)~~	(154)	~~(0)~~	(66)	~~(253)~~	(220)
Total	~~497~~	346	~~0~~	184	~~497~~	530

Saves $33,000/year

Incentives For Husband

- If spousal support payments are to be made, then husband generally prefers that such payments are treated as alimony so he can deduct the payments under section 215 and, thus, reduce his income tax.

Incentives For Husband

- Husband could make cash payments:
  - Direct to wife; or

  - On behalf of wife, including payment of:
    - Premiums for life insurance owned by wife;
    - House expenses;
    - Car expenses;
    - Medical expenses; and/or
    - Legal expenses for wife’s attorneys.

Incentives For Husband

- If you represent Husband, then you should:
  - Consider calculating estimated amount of tax savings as a result of deduction for alimony under section 215;
  - Confirm divorce or separation instrument satisfies requirements of alimony under section 71(b);
  - Include wife's social security number on husband's Form 1040 for alimony deduction; and
  - Determine whether proposed alimony payments are front loaded (discussed below).

Incentives For Wife

- If spousal support payments are to be made, then wife generally prefers that such payments are *not* treated as alimony because payments treated as alimony are included in her gross income under section 71(a), which would thus increase her income tax.

Incentives For Wife

- If you represent wife, and spousal support payments are *not* to be treated as alimony, then you should:
  - Confirm the divorce or separation instrument does not meet the alimony requirements under section 71(b). Include a provision that designates the payments as not alimony.
  - Attach a copy of the divorce or separation instrument containing the designation of payments as not alimony to wife’s first filed Form 1040 for each year in which the designation applies.

Incentives For Wife

- Alternatively, in consideration for wife's agreement to treat spousal payments as alimony, the amount of payments could be increased to take into account wife's corresponding income tax. It would be reasonable for husband and wife to agree to such an arrangement because it reduces the aggregate tax burden of husband and wife.

Incentives For Wife

- If you represent wife, and spousal support payments are to be treated as alimony, then you should:
  - Consider calculating estimated amount of tax owed as a result of inclusion of alimony under section 71; and
  - Confirm divorce or separation instrument satisfies requirements of alimony under section 71(b).

IRS Tax Topic 452
(last updated April 14, 2017)

Tax Treatment of Alimony

- Amounts paid to a spouse or a former spouse under a divorce or separation instrument (including a divorce decree, a separate maintenance decree, or a written separation agreement) may be alimony for federal tax purposes. Alimony is deductible by the payer spouse, and the recipient spouse must include it in income.

IRS Tax Topic 452

Alimony Requirements

- A payment is alimony only if all the following requirements are met:
  - The spouses don't file a joint return with each other;
  - The payment is in cash (including checks or money orders);
  - The payment is to or for a spouse or a former spouse made under a divorce or separation instrument;
  - The divorce or separation instrument doesn't designate the payment as not alimony;
  - The spouses aren't members of the same household when the payment is made (This requirement applies only if the spouses are legally separated under a decree of divorce or of separate maintenance.);
  - There's no liability to make the payment (in cash or property) after the death of the recipient spouse; and
  - The payment isn't treated as child support or a property settlement.

IRS Tax Topic 452

Payments Not Alimony

- Not all payments under a divorce or separation instrument are alimony. Alimony **doesn't** include:
  - Child support,
  - Noncash property settlements, whether in a lump-sum or installments,
  - Payments that are your spouse's part of community property income,
  - Payments to keep up the payer's property,
  - Use of the payer's property, or
  - Voluntary payments (that is, payments not required by a divorce or separation instrument).
- Child support is never deductible and isn't considered income. Additionally, if a divorce or separation instrument provides for alimony and child support, and the payer spouse pays less than the total required, the payments apply to child support first. Only the remaining amount is considered alimony.

IRS Tax Topic 452

Reporting Alimony

- If you **paid** amounts that are considered alimony, you may deduct from income the amount of alimony you paid whether or not you itemize your deductions. Alimony payments are only deductible on Form 1040, *U.S. Individual Income Tax Return*. You must enter the social security number (SSN) or individual taxpayer identification number (ITIN) of the spouse or former spouse receiving the payments or your deduction may be disallowed and you may have to pay a $50 penalty.

- If you **received** amounts that are considered alimony, you **must** include the amount of alimony you received as income. You may only report alimony received on Form 1040, or on Schedule NEC, Form 1040NR, *U.S. Nonresident Alien Income Tax Return*. You must provide your SSN or ITIN to the spouse or former spouse making the payments, otherwise you may have to pay a $50 penalty.

IRS Tax Topic 452

Other IRS Materials

- Publication 17, Your Federal Income Tax – Chapter 18, Alimony
- Publication 504, Divorced or Separated Individuals

Tax Cuts and Jobs Act of 2017

- Sec. 11051: Repeal of Deduction for Alimony Payments.
  - Strike IRC § 215.
  - Strike IRC § 61(a)(8).
  - Strike IRC § 71.
  - Strike IRC § 62(a)(10) [AGI].

Husband	Wife
~~215: deduction for alimony~~	~~61 & 71: GI = alimony~~

Tax Cuts and Jobs Act of 2017

- Sec. 11051 (cont'd). Effective Date – The amendment made by this section shall apply to:
  - (1) any divorce or separation instrument executed after December 31, **2018**, and
  - (2) any divorce or separation instrument executed on or before such date *and* modified after such date if the modification expressly provides that the amendments made by this section apply to such modification.

Tax Cuts and Jobs Act of 2017

- Implication For 2018:
  - Rush to the courthouse – if alimony treatment is wanted, then need to execute divorce instrument in 2018.

Tax Cuts and Jobs Act of 2017

- Implications For 2019 and Later Years:
  - Two tax treatments – "Grandfathered" Deductible vs. Nondeductible.
  - Because nondeductible:
    - Spousal support payments will be more burdensome to payor spouse;
    - Spousal support payments will probably be smaller; and
    - Payor spouse will probably be less likely to agree to spousal support payments in Texas.
  - Pay extra attention if modifying a divorce instrument after 2018.

Six short months we went together
Decided it should be forever
Two paychecks are better than one
A diamond ring and it was done
Bought her a house like I said I would
In sub-divided neighborhood
The fuse got short and the nights got long
It was over long gone
Before I knew
Where I was headed to

PROPERTY SETTLEMENTS

Nonrecognition

- IRC § 1041(a): No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) –
  - A spouse, or
  - A former spouse, but only if the transfer is incident to the divorce.

- Section 1041 is mandatory for property settlements. No opt-out provision like section 71 for alimony.

No gain or loss for transfer of property to:

- Spouse; or
- Former spouse, if incident to divorce

Incident To Divorce

- IRC § 1041(c)(1): A transfer of property is incident to divorce if such transfer:
  - Occurs within 1 year after the date on which the marriage ceases, or
    - Treas. Reg. § 1.1041-1T, A-6. Thus, a transfer of property occurring not more than one year after the date on which the marriage ceases need not be related to the cessation of marriage to qualify for section 1041 treatment.
  - Is related to the cessation of the marriage.

Incident To Divorce

- Treas. Reg. § 1.1041-1T, Q&A 7:
  - Q-7. When is a transfer of property "related to the cessation of the marriage?"
  - A-7. A transfer of property is treated as related to the cessation of the marriage if:
    - The transfer is pursuant to a divorce or separation instrument, as defined in section 71(b)(2), and
    - the transfer occurs not more than **6 years** after the date on which the marriage ceases.

Incident To Divorce

- Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is *presumed* to be not related to the cessation of the marriage.
- This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage.
  - Such as legal or business impediments to transfer, or disputes concerning the value of the property owned at the time of the cessation of the marriage, and
  - The transfer is effected promptly after the impediment to transfer is removed.

"incident to divorce":

- Occurs within 1 year after date on which marriage ceases; or
- Related to cessation of marriage:
  - Occurs not more than 6 years after date on which marriage ceases;
  - If more than 6 years, then rebut presumption

Carryover Basis

- IRC § 1041(b): In the case of any transfer of property described in IRC § 1041(a):
  - The property shall be treated as acquired by the transferee by gift, and
  - The basis of the transferee in the property shall be the adjusted basis of the transferor.

- IRC § 1015(e): In the case of any property acquired by gift in a transfer described in section 1041(a), the basis of such property in the hands of the transferee [wife] shall be determined under section 1041(b)(2) and not this section.

AB of wife = carryover basis from husband

Husband – Nonrecognition

- Treas. Reg. § 1.1041-1T, Q&A 10:
  - Q-10. How is the transferor [husband] of property under section 1041 treated for income tax purposes?
  - A-10. The transferor [husband] under section 1041 recognizes no gain or loss on the transfer even if the transfer was in exchange for the release of marital rights or other consideration. This rule applies regardless of whether the transfer is of property separately owned by the transferor or is a division (equal or unequal) of community property.

Wife – Nonrecognition and Carryover Basis

- Treas. Reg. § 1.1041-1T, Q&A 11:
  - Q-11. How is the transferee [wife] of property under section 1041 treated for income tax purposes?
  - A-11.
    - The transferee [wife] recognizes no gain or loss upon receipt of the transferred property.
    - In all cases, the basis of the transferred property in the hands of the transferee [wife] is the adjusted basis of such property in the hands of the transferor [husband] immediately before the transfer.

Wife – Nonrecognition and Carryover Basis

- Even if the transfer is a bona fide sale, the transferee [wife] does not acquire a basis in the transferred property equal to the transferee's [wife's] cost (the fair market value).
- This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer (or the value of any consideration provided by the transferee) and applies for purposes of determining loss as well as gain upon the subsequent disposition of the property by the transferee.
- Thus, this rule is different from the rule applies in section 1015(a) for determining the basis of property acquired by gift.

Husband	Wife
1041(a): no gain or loss	1041(a): no gain or loss 1041(b): carryover basis

Reporting Requirements

- Treas. Reg. § 1.1041-1T, Q&A 14:
  - Q-14. Does the transferor [husband] of property in a transaction described in section 1041 have to supply, at the time of the transfer, the transferee [wife] with records sufficient to determine the adjusted basis and holding period of the property at the time of the transfer?

Reporting Requirements

- A-14. Yes. A transferor [husband] of property under section 1041 must, at the time of the transfer, supply the transferee [wife] with records sufficient to determine the adjusted basis and holding period of the property as of the date of the transfer.

Incentives For Husband And Wife

- For tax purposes, husband and wife should generally want to allocate highly appreciated property to the spouse with lower tax rates. The transferee will receive a carryover basis, and recognize the built-in gain on subsequent sale.

- The determination of the amount of property allocated to each spouse should take into account built-in gain.


DOGBERT: EXECUTIVE COACH
YOU NEED TO FOCUS ON YOUR CAREER OR YOUR FAMILY. YOU CAN'T DO BOTH.

CHILD SUPPORT

Not Included In Gross Income

- IRC § 71(c)(1): Section 71(a) shall not apply to that part of any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of children of the payor spouse [husband].

GI of wife ≠ child support

Contingency

- IRC § 71(c)(2): If any amount specified in the instrument will be reduced:
  - On the happening of a contingency specified in the instrument relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency), or
  - At a time which can clearly be associated with a contingency of such kind,

An amount equal to the amount of such reduction will be treated as an amount fixed as payable for the support of children of the payor spouse.

Contingency

- Treas. Reg. § 1.71-1T, Q&A 15 through 18.
  - 2 presumptions:
    - Where payments are to be reduced not more than 6 months before or after the date the child is to attain the age of 18, 21, or local age of majority.
    - Where payments are to be reduced on two or more occasions which occur not more than one year before or after a different child of the payor spouse [husband] attains a certain age between the ages of 18 and 24, inclusive.

Contingency

- Prevents disguising a child support as alimony.

EXCESS FRONT LOADING

Definition of Excess Alimony Payments

- IRC § 71(f)(2): The term "excess alimony payments" mean the sum of:
  - The excess payments for the 1st post-separation year, and
  - The excess payments for the 2nd post-separation year.

- IRC § 71(f)(6): The term "1st post-separation year" means the 1st calendar year in which the payor spouse [husband] paid to the payee spouse [wife] alimony.

Definition of Excess Alimony Payments

- IRC § 71(f)(4): The amount of excess payments for the 2nd post-separation year is the excess (if any) of –
  - The amount of the alimony paid by the payor spouse [husband] during the 2nd post-separation year, over
  - The sum of:
    - The amount of alimony paid by the payor spouse [husband] during the 3rd post-separation year, plus
    - $15,000.

2^{nd} year excess payments = 2^{nd} year alimony – (3^{rd} year alimony + 15,000)

Definition of Excess Alimony Payments

- IRC § 71(f)(3): The amount of excess payments for the 1st post-separation year is the excess (if any) of –
  - The amount of the alimony paid by the payor spouse [husband] during the 1st post-separation year, over
  - The sum of:
    - The average of
      - The alimony paid by the payor spouse [husband] during the 2nd post-separation year, reduced by the excess payments for the 2nd post-separation year, and
      - The alimony paid by the payor spouse [husband] during the 3rd post-separation year, plus
    - $15,000.

2nd year excess payments = 2nd year alimony – (3rd year alimony + 15,000)

1st year excess payments = 1st year alimony – (((2nd year alimony – 2nd year excess payments) + 3rd year alimony) / 2 + 15,000)

Definition of Excess Alimony Payments

- NOTE: Treas. Reg. § 1.71-1T has not been updated to reflect the current excess front loading rules contained in IRC § 71(f).

Example 1(a)

Alimony:	Year 1 - $120,000 Year 2 - $120,000 Year 3 - $120,000
2^{nd} year excess payments	= 120,000 – (120,000 + 15,000) = 120,000 – 135,000 = 0
1^{st} year excess payments	= 120,000 – (((120,000 – 0) + 120,000) / 2 + 15,000) = 120,000 – (240,000 / 2 + 15,000) = 120,000 – (120,000 + 15,000) = 120,000 – 135,000 = 0
Excess alimony payments	= 0 + 0 = 0

Example 1(b)

Alimony:	Year 1 - \$135,000 Year 2 - \$120,000 Year 3 - \$105,000
2nd year excess payments	= 120,000 – (105,000 + 15,000) = 120,000 – 120,000 = 0
1st year excess payments	= 135,000 – (((120,000 – 0) + 105,000) / 2 + 15,000) = 135,000 – (225,000 / 2 + 15,000) = 135,000 – (112,500 + 15,000) = 135,000 – 127,500 = 7,500
Excess alimony payments	= 7,500 + 0 = 7,500

Example 1(c)

Alimony:	Year 1 - $240,000 Year 2 - $60,000 Year 3 - $60,000
2nd year excess payments	= 60,000 – (60,000 + 15,000) = 60,000 – 75,000 = 0
1st year excess payments	= 240,000 – (((60,000 – 0) + 60,000) / 2 + 15,000) = 240,000 – (120,000 / 2 + 15,000) = 240,000 – (60,000 + 15,000) = 240,000 – 75,000 = 165,000
Excess alimony payments	= 165,000 + 0 = 165,000

Alimony Recapture

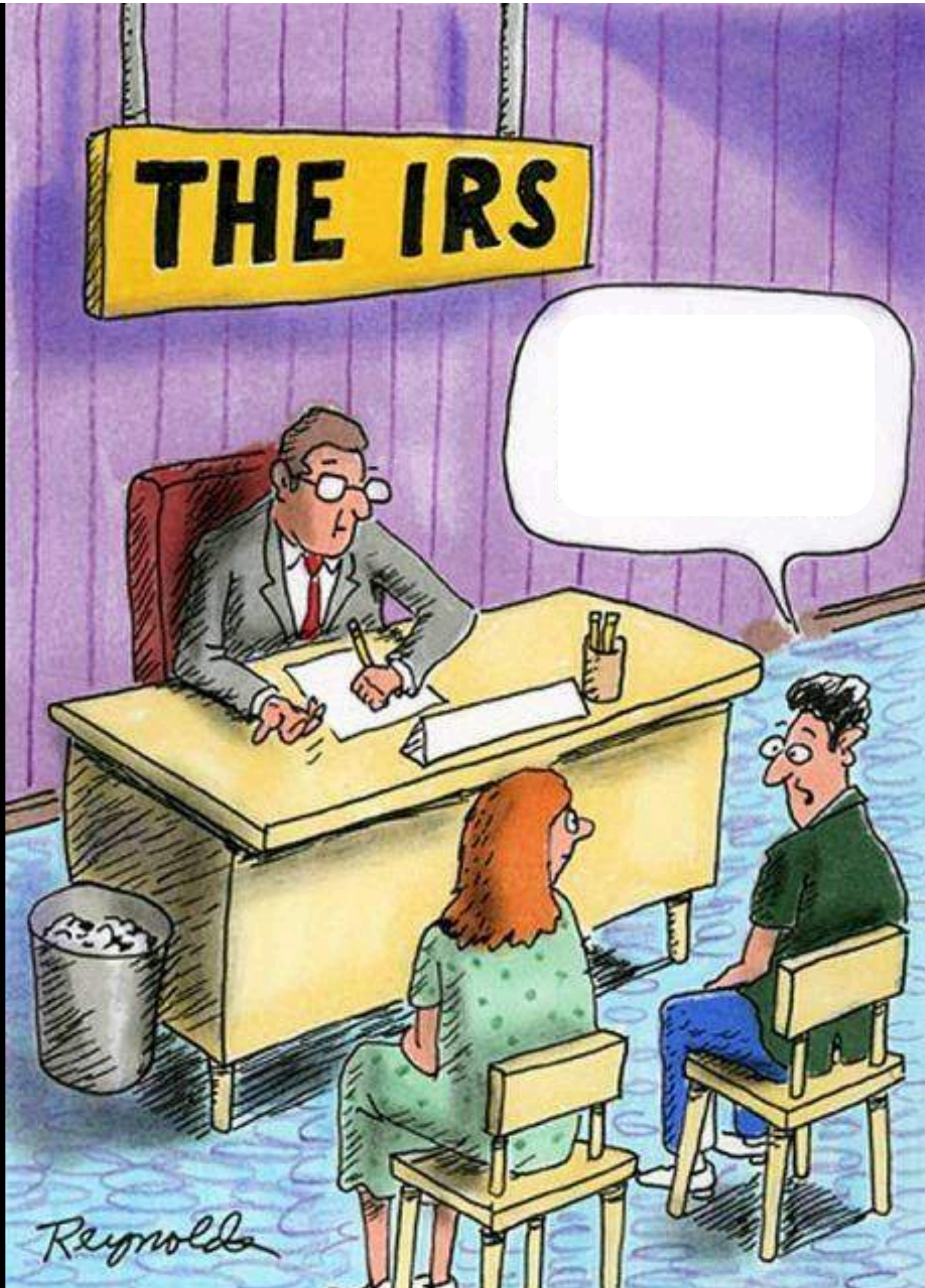
- IRC § 71(f)(1): If there are excess alimony payments, then
  - The payor spouse [husband] shall include the amount of such excess payment in gross income for the payor spouse's [husband's] taxable year beginning in the 3rd post-separation year; and
  - The payee spouse [wife] shall be allowed a deduction in computing adjusted gross income for the amount of such excess payments for the payee's [wife's] taxable year beginning in the 3rd post-separation year.

Alimony Recapture

- Prevents disguising a property settlement as alimony.

Exceptions

- IRC § 71(f)(5): Section 71(f)(1) shall not apply if:
  - Either spouse [husband or wife] dies before the close of the 3rd post-separation year, or the payee spouse [wife] remarries before the close of the 3rd post-separation year, and
  - Alimony ceases by reason of such death or remarriage.


THE IRS
Reynolds

TAX RETURNS

Definition of Married

- Treas. Reg. § 301.7701-18(a): For federal tax purposes, the terms spouse, husband, and wife mean an individual lawfully married to another individual. The term husband and wife means two individuals lawfully married to each other.

- Treas. Reg. § 301.7701-18(b)(1): A marriage of two individuals is recognized for federal tax purposes if the marriage is recognized by the state, possession, or territory of the United States in which the marriage is entered into, regardless of domicile.

Definition of Married

- IRC § 7703(a):
  - The determination of whether an individual is married shall be made as of the *close* of his taxable year.
  - Except that if his spouse dies during his taxable year such determine shall be made as of the time of such death.
  - An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

Definition of Married

- IRC § 7703(b): If
  - An individual who is married and who files a separate return maintains as his home a household which constitutes for more than one-half of the taxable year the principal place of abode of a child with respect to whom such individual is entitled to a deduction for the taxable year under section 151;
  - Such individual furnishes over one-half of the cost of maintaining such household during the taxable year; and
  - During the last 6 months of the taxable year, such individual's spouse is not a member of such household;

  Then, such individual shall *not* be considered as married.

married at end of year = married

married on date of death = married

separated under divorce decree ≠ married

married and separated ≠ married, if:

- married but files separate return
- maintains his home as the principal place of abode for a dependent child for more than ½ of year
- covers more than ½ of cost of maintaining household
- spouse is not a member of household for last 6 months of year

Definition of Married

- Form 1040 Instructions: If you changed your name because of divorce, be sure to report the change to the Social Security Administration *before* filing your return. This prevents delay in processing your return and issuing refunds. It also safeguards your future social security benefits.

Filing Status

- IRC § 6013; Form 1040 Instructions:
  - Filing Status Options. The status that will usually give you the lowest tax are listed last.
    - Married filing separately
    - Single
    - Head of household
    - Married filing jointly
    - Qualifying widower with dependent child

Filing Status

- 1040 Instructions:
  - Married [includes pending divorce]
    - Married filing separately
    - Head of household
    - Married filing jointly [joint and several liability]
      - NOTE: IRC § 71(e): IRC §§ 71 and 215 shall not apply if spouses make a joint return.
  - Not married
    - Single
    - Head of household

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return 2016
OMB No. 1545-0074 | IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2016, or other tax year beginning , 2016, ending , 20 | See separate instructions.

Your first name and initial	Last name	**Your social security number**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).		**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Foreign country name	Foreign province/state/county	Foreign postal code

Filing Status

Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

Exemptions

6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**

Boxes checked on 6a and 6b

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see instructions)
			☐
			☐
			☐
			☐

No. of children on 6c who:
• lived with you
• did not live with you due to divorce or separation (see instructions)
Dependents on 6c not entered above

If more than four dependents, see instructions and check here ▶ ☐

d Total number of exemptions claimed

Add numbers on lines above ▶

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7
8a	**Taxable** interest. Attach Schedule B if required		8a
b	**Tax-exempt** interest. **Do not** include on line 8a	8b	
9a	Ordinary dividends. Attach Schedule B if required		9a
b	Qualified dividends	9b	
10	Taxable refunds, credits, or offsets of state and local income taxes		10
11	Alimony received		11
12	Business income or (loss). Attach Schedule C or C-EZ		12
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13
14	Other gains or (losses). Attach Form 4797		14
15a	IRA distributions 15a	b Taxable amount	15b
16a	Pensions and annuities 16a	b Taxable amount	16b
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17
18	Farm income or (loss). Attach Schedule F		18
19	Unemployment compensation		19
20a	Social security benefits 20a	b Taxable amount	20b
21	Other income. List type and amount		21
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22

Adjusted Gross Income

23	Educator expenses	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	Deductible part of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN ▶	31a	
32	IRA deduction	32	
33	Student loan interest deduction	33	
34	Tuition and fees. Attach Form 8917	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 35		36
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37

Filing Status

Check only one box.

1 ☐ Single

2 ☐ Married filing jointly (even if only one had income)

3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶

4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶

5 ☐ Qualifying widow(er) with dependent child

Filing Status Check only one box.	1 ☐ Single 2 ☐ Married filing jointly (even if only one had income) 3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶	4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ 5 ☐ Qualifying widow(er) with dependent child

Exemptions

- IRC § 151; Form 1040 Instructions: If you became divorced or legally separated in the tax year, you can't take an exemption for your former spouse.

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return **2016** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2016, or other tax year beginning , 2016, ending , 20 | See separate instructions.

Your first name and initial	Last name	**Your social security number**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).		**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Foreign country name	Foreign province/state/county	Foreign postal code

Filing Status

Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

Exemptions

6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**

Boxes checked on 6a and 6b

c **Dependents:** (1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see instructions)
			☐
			☐
			☐
			☐

If more than four dependents, see instructions and check here ▶ ☐

No. of children on 6c who:
• lived with you
• did not live with you due to divorce or separation (see instructions)
Dependents on 6c not entered above

d Total number of exemptions claimed

Add numbers on lines above ▶

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	
8a	**Taxable** interest. Attach Schedule B if required		8a	
b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
9a	Ordinary dividends. Attach Schedule B if required		9a	
b	Qualified dividends	9b		
10	Taxable refunds, credits, or offsets of state and local income taxes		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions 15a	b Taxable amount	15b	
16a	Pensions and annuities 16a	b Taxable amount	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation		19	
20a	Social security benefits 20a	b Taxable amount	20b	
21	Other income. List type and amount		21	
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	

Adjusted Gross Income

23	Educator expenses	23			
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24			
25	Health savings account deduction. Attach Form 8889	25			
26	Moving expenses. Attach Form 3903	26			
27	Deductible part of self-employment tax. Attach Schedule SE	27			
28	Self-employed SEP, SIMPLE, and qualified plans	28			
29	Self-employed health insurance deduction	29			
30	Penalty on early withdrawal of savings	30			
31a	Alimony paid b Recipient's SSN ▶	31a			
32	IRA deduction	32			
33	Student loan interest deduction	33			
34	Tuition and fees. Attach Form 8917	34			
35	Domestic production activities deduction. Attach Form 8903	35			
36	Add lines 23 through 35			36	
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶			37	

Exemptions	**6a** ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a				Boxes checked on 6a and 6b	
	b ☐ **Spouse**				No. of children on 6c who: • lived with you	
	c Dependents: (1) First name Last name	**(2)** Dependent's social security number	**(3)** Dependent's relationship to you	**(4)** ✓ if child under age 17 qualifying for child tax credit (see instructions)	• did not live with you due to divorce or separation (see instructions)	
				☐		
If more than four dependents, see instructions and check here ▶ ☐				☐		
				☐	Dependents on 6c not entered above	
				☐		
	d Total number of exemptions claimed				Add numbers on lines above ▶	

Tax Cuts and Jobs Act of 2017

- Sec. 11041: Suspension of Deduction for Personal Exemptions.
  - In the case of a taxable year beginning after December 31, 2017, and before January 1, 2026, the term “exemption amount” means zero.


WHY DO DIVORCES COST SO MUCH?
LAWYER.

TAX ADVICE

Deduction

- General Rule: IRC § 262(a): Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living or family expenses.

- Exception: IRC § 212(3): In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in connection with the determination, collection, or refund of any tax.
  - IRC § 67(a): Subject to 2% floor as misc. item. ded.

Deduction

- Treas. Reg. § 1.262-1(b)(7):
  - Generally, attorney's fees and other costs paid in connection with a divorce, separation, or decree for support are not deductible by either the husband or the wife.
  - However, the part of an attorney's fee and the part of the other costs paid in connection with a divorce, legal separation, written separation agreement, or a decree for support, which are properly attributable to the production or collection of amounts includible in gross income under section 71 are deductible by the wife under section 212.

Deduction

- Treas. Reg. § 1.212-1(l):
  - Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, whether the taxing authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible.
  - Thus, expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of his tax liability or in contesting his tax liability are deductible.

Examples Provided By IRS

- Rev. Rul. 72-545:
  - Situation (1): The taxpayer at the time of his divorce engaged a law firm to advise him of the Federal income tax consequences of a proposed property settlement agreement in which he transferred his interest in certain properties to his wife in exchange for the transfer to him of her interest in other properties, and the release by her of marital rights in certain other property owned by him. The law firm limits its practice to matters involving state and federal taxation.

Examples Provided By IRS

- In this situation, there exists a reasonable basis for allocating to tax counsel a portion of the legal fees incurred in connection with the divorce proceedings.
- Accordingly, it is held that the expense for tax advice to determine the tax consequences to the taxpayer incident to divorce is deductible under section 212(3) for the year in which the expenses is paid, provided the taxpayer elects to itemize his deductions.

Examples Provided By IRS

- Situation (2): The taxpayer at the time of his divorce engaged tax counsel to advise him of Federal income, gift, and estate tax consequences to him. The law firm also handled certain non-tax aspects of the divorce, but the tax matters were referred to and were handled by a department in the firm that specializes in taxation.

- The firm's statement to the taxpayer allocated a portion of the total fee to tax matters. The allocation was based primarily upon the time required, the difficulty of the tax questions presented, and the amount of taxes involved.

Examples Provided By IRS

Same result:

- In this situation, there exists a reasonable basis for allocating to tax counsel a portion of the legal fees incurred in connection with the divorce proceedings.
- Accordingly, it is held that the expense for tax advice to determine the tax consequences to the taxpayer incident to divorce is deductible under section 212(3) for the year in which the expenses is paid, provided the taxpayer elects to itemize his deductions.

Examples Provided By IRS

- Situation (3): The taxpayer, for an agreed fee engaged a practitioner to represent him in connection with his divorce. The legal services included tax counsel concerning the right of the taxpayer to claim the children as dependents for Federal income tax purposes in years subsequent to the divorce.

- The practitioner's statement to the taxpayer allocated the fee between the tax advice and other non-tax matters, based primarily on the amount of the attorney's time attributable to each, the fee customarily charged in the locality for similar services, and the results obtained in the divorce negotiations.

Examples Provided By IRS

Same result:

- In this situation, there exists a reasonable basis for allocating to tax counsel a portion of the legal fees incurred in connection with the divorce proceedings.

- Accordingly, it is held that the expense for tax advice to determine the tax consequences to the taxpayer incident to divorce is deductible under section 212(3) for the year in which the expenses is paid, provided the taxpayer elects to itemize his deductions.

attorney and CPA fees for tax advice = deductible

(subject to 2% floor as miscellaneous itemized deduction)

other attorney fees ≠ deductible

Conflict of Interest

Example 1

- In 2018, Husband and Wife want to divorce.
- Attorney wants to represent only Husband in the divorce.
- Is there a conflict of interest?

Conflict of Interest

Example 2

- In 2018, Husband and Wife want to divorce.
- Attorney wants to represent both Husband and Wife in the divorce.
- Is there a conflict of interest?

Conflict of Interest

- Rule 1.06(a): A lawyer shall not represent opposing parties to the same litigation.

Conflict of Interest

<u>Example 3</u>

- In 2018, Husband and Wife want to divorce, and agree to all terms.
  - the “friendly divorce”
- Attorney wants to represent both Husband and Wife in the divorce.
- Is there a conflict of interest?

Conflict of Interest

- Rule 1.06(a): A lawyer shall not represent opposing parties to the same litigation.

Conflict of Interest

- Ethics Opinion No. 583 (September 2008):
  - The preparation of documents to implement an agreement for divorce reached in a mediation clearly involves the provision of legal services by the lawyer/mediator.
  - If a lawyer who is also a mediator chooses to act solely as a lawyer with respect to a particular divorce, the lawyer may represent only *one* of the two parties in preparing documents to implement an agreement for divorce.

Conflict of Interest

- A divorce, no matter how amicable or uncontested, is a litigation proceeding under Texas law.
- Representation of parties in a divorce is governed by Rule 1.06(a).

Conflict of Interest

Example 4

- In 2012, Attorney represents only Husband for the preparation of his estate planning documents.
- In 2018, Husband and Wife want to divorce.
- Attorney wants to represent only Husband in the divorce.
- Is there a conflict of interest?

Conflict of Interest

Example 5

- In 2012, Attorney represents both Husband and Wife for the preparation of their estate planning documents.
- In 2018, Husband and Wife want to divorce.
- Attorney wants to represent only Husband.
- Is there a conflict of interest?

Conflict of Interest

- Rule 1.09(a): Without prior consent, a lawyer who personally has formerly represented a client in a matter shall not thereafter represent another person in a matter adverse to the former client:
  - (1) in which such other person questions the validity of the lawyer's services or work product for the former client;
  - (2) if the representation in reasonable probability will involve a violation of Rule 1.05; or
  - (3) if it is the same or substantially related matter.

Conflict of Interest

- Rule 1.05(b)(2): Except as permitted by Rule 1.05(c) and (d), a lawyer shall not knowingly use confidential information of a client to the disadvantage of the client unless the client consents after consultations.

Conflict of Interest

- Rule 1.05(b)(3): Except as permitted by Rule 1.05(c) and (d), a lawyer shall not knowingly use confidential information of a former client to the disadvantage of the former client after the representation is concluded unless the former client consents after consultation or the confidential information has become generally known.

Conflict of Interest

- Rule 1.05(b)(4): Except as permitted by Rule 1.05(c) and (d), a lawyer shall not knowingly use privileged information of a client for the advantage of the lawyer or of a third person, unless the client consents after consultation.

Conflict of Interest

- Rule 1.05(c)(2): A lawyer may reveal confidential information when the client consents after consultation.

Conflict of Interest

- Rule 1.09, Comment 3: Although 1.09(a) does not absolutely prohibit a lawyer from representing a client against a former client, it does provide that the latter representation is improper if any of three circumstances exists, except with prior consent.

Conflict of Interest

- Rule 1.09, Comment 3 (cont'd): The first circumstance is that the lawyer may not represent a client who questions the validity of the lawyer's services or work product for the former client.
  - Thus, for example, a lawyer who drew a will leaving a substantial portion of the testator's property to a designated beneficiary would violate Rule 1.09(a) by representing the testator's heirs at law in an action seeking to overturn the will.

Conflict of Interest

- Rule 1.09, Comment 4: Rule 1.09(a)'s second limitation on undertaking a representation against a former client is that it may not be done if there is a reasonable probability that the representation would cause the lawyer to violate the obligations owed the former client under Rule 1.05.

Conflict of Interest

- Rule 1.09, Comment 4 (cont'd):
  - Thus, for example, if there were a reasonable probability that the subsequent representation would involve either an unauthorized disclosure of confidential information under Rule 1.05(b)(1) or an improper use of such information to the disadvantage of the former client under Rule 1.05(b)(3), that representation would be improper under Rule 1.09(a). Whether such a reasonable probability exists in any given case will be a question of fact.

Conflict of Interest

- Rule 1.09, Comment 4A: The third situation where representation adverse to a former client is prohibited is where the representation involves the same or a substantially related matter.
- The "same" matter aspect of this prohibition prevents a lawyer from switching sides and representing a party whose interests are adverse to a person who sought in good faith to retain a lawyer.
- It can apply even if the lawyer declined the representation before the client had disclosed any confidential information.

Conflict of Interest

- Rule 1.09, Comment 4A (cont'd): Although "substantially related" is not defined in the Rule, it primarily involves situations where a lawyer could have acquired confidential information concerning a prior client that could be used either to that client's disadvantage or for the advantage of the lawyer's current client or some other person. It thus largely overlaps the prohibition contained in Rule 1.09(a)(2).

Conflict of Interest

- Ethics Opinion No. 494 (February 1994):
  - Is an attorney disqualified from representing a client in a situation where Husband had a brief consultation with Attorney in 1986, and Wife consulted Attorney in a subsequent divorce action in 1992?
  - Attorney's representation of Wife would be in violation of the Texas Disciplinary Rules of Professional Conduct.

Conflict of Interest

- In 1986, Husband met with Attorney regarding the possibility of divorcing Wife. Husband paid a $250 fee for the consultation, but did not engage Attorney. Attorney did not open a file for Husband.
- In 1989, Wife filed for divorce.
- In 1992, Wife retained Attorney to obtain legal representation in her pending divorce case.
- Attorney had no independent recollection and no memory that, during the consultation, Husband gave him any facts with respect to Husband's marital or domestic situation.

Conflict of Interest

- ISSUE TWO: Were the factual matters involved in the representation (of Husband) so related that there is a genuine threat the confidences gained in the former representation will be divulged to Attorney's present client (Wife)?
- Yes. Wife seeks to have Attorney represent her in a divorce from her Husband, after Husband consulted with Attorney about a possible divorce from Wife. Obviously, this factor is met.
- The committee reasons that an attorney's duty to preserve a client's confidence outlasts his or her employment, and employment which involves the disclosure or use of these confidences to the disadvantage of the client.

Matthew S. Beard

Partner

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Mr. Beard's practice spans two broad areas of taxation: estate planning and probate, and income tax and business planning.

In his estate planning and probate practice, Mr. Beard designs and implements estate and business succession plans with an emphasis on federal tax issues. He often works closely with accountants, bankers and financial advisors in this process. Mr. Beard also represents fiduciaries in all facets of estate and trust administration. This typically includes court proceedings, tax matters, administration and transfer of assets, and matters before the IRS. Mr. Beard is the author of *"An Introductory Guide to Tax and Estate Planning,"* which provides an introduction to estate planning under Texas law and planning for federal estate, gift, and generation-skipping transfer taxes.

On transactional matters, Mr. Beard advises clients with a focus on tax issues. He works with a broad range of entities, such as partnerships, limited liability companies, and publicly traded "C" corporations. Transactions include formations, acquisitions/mergers, and liquidations. Mr. Beard is the author of *"Annotated Tax Provisions for Limited Liability Companies,"* which includes tax provisions for company agreements with explanations of how the provisions operate and provide pass-through taxation.

Mr. Beard is an adjunct professor at SMU, Dedman School of Law, for federal income taxation. Prior to joining the firm in 2012, he was an associate with one of the largest Texas-based law firms. Mr. Beard was admitted to practice in Texas in November 2005.

DISCLAIMER

The information included in these slides is for discussion purposes only and should not be relied on without seeking individual legal advice.

Tax Relief for Victims of Hurricane Harvey

Tax-Law-in-a-Day
February 9, 2018

Jeffry Blair
Hunton & Williams LLP

View of Hurricane Harvey from Space

Measured approximately 350 miles across when it made landfall on August 29^{th} as a category 3

Hurricane Harvey

Flooding in Port Arthur on August 31, 2017

<u>National Hurricane Center Report</u>
(released January 26, 2018)

- Ended a 12 year drought for major land-falling hurricanes (last was Wilma in 2005)
    - 3 separate landfalls in 6 days

- One of the most expensive hurricanes on record
    - Estimated Damage -- $125 billion (ranging from $90 billion to $160 billion)
    - Katrina Damage -- $125 billion

- Broke all records for most rainfall in any tropical system
    - Large sections of Southeastern Texas receiving 3 feet or more of rainfall from August 17 to September 1)
    - Some receiving over 5 feet (highest was near Nederland, Texas receiving 60.58 inches)
    - One third of Houston was underwater.

National Hurricane Center Report
(released January 26, 2018)

- Accounted for over 100 deaths (68 direct and 35 indirect)
- Over 300,000 structures flooded
- Over 500,000 cars flooded
- 336,000 customers lost power
- Estimated 40,000 flood victims were evacuated to or took refuge in shelters across Texas or Louisiana
- FEMA reported about 30,000 water rescues were conducted during Harvey

Tax Relief
General Overview

Disaster Declaration Process

- All emergency and major disaster declarations are made solely at the discretion of the President of the United States.
- All requests for a declaration by the President that a major disaster exists shall be made by the Governor of the affected State. The Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. §§5121- 5207 (the "Stafford Act"), §401.
  - "State" includes the District of Columbia, Puerto Rico, the Virgin Islands, Guam, American Samoa and the Commonwealth of the Northern Mariana Islands.
  - The Republic of the Marshall Islands and the Federated States of Micronesia are also eligible.

Recent Major Disasters in Texas

- ***Hurricane Harvey*** (multiple counties – throughout much of Eastern Texas)
  - Incident Period - August 23, 2017 – September 15, 2017
  - Major Disaster Declaration – August 25, 2017

- ***Severe Storms and Flooding*** (multiple counties – mostly in Houston area)
  - Incident Period -- May 22, 2016 – June 24, 2016
  - Major Disaster Declaration – June 11, 2016

- ***Severe Storms and Flooding*** (multiple counties – mostly close to Texas – LA border)
  - Incident Period - April 17, 2016 to April 30, 2016
  - Major Disaster Declaration declared on April 25, 2016

- ***Severe Storms and Flooding*** (multiple counties – mostly close to Texas – LA border)
  - Incident Period – March 7, 2016 to March 29, 2016
  - Major Disaster Declaration declared on March 19, 2016

- ***Severe Winter Storms, Tornadoes, Straight-line Winds and Flooding*** (multiple counties – Panhandle and Northern Texas)
  - Incident Period – December 26, 2015 to January 22, 2016
  - Major Disaster Declaration declared on February 9, 2016

Presidential Declaration

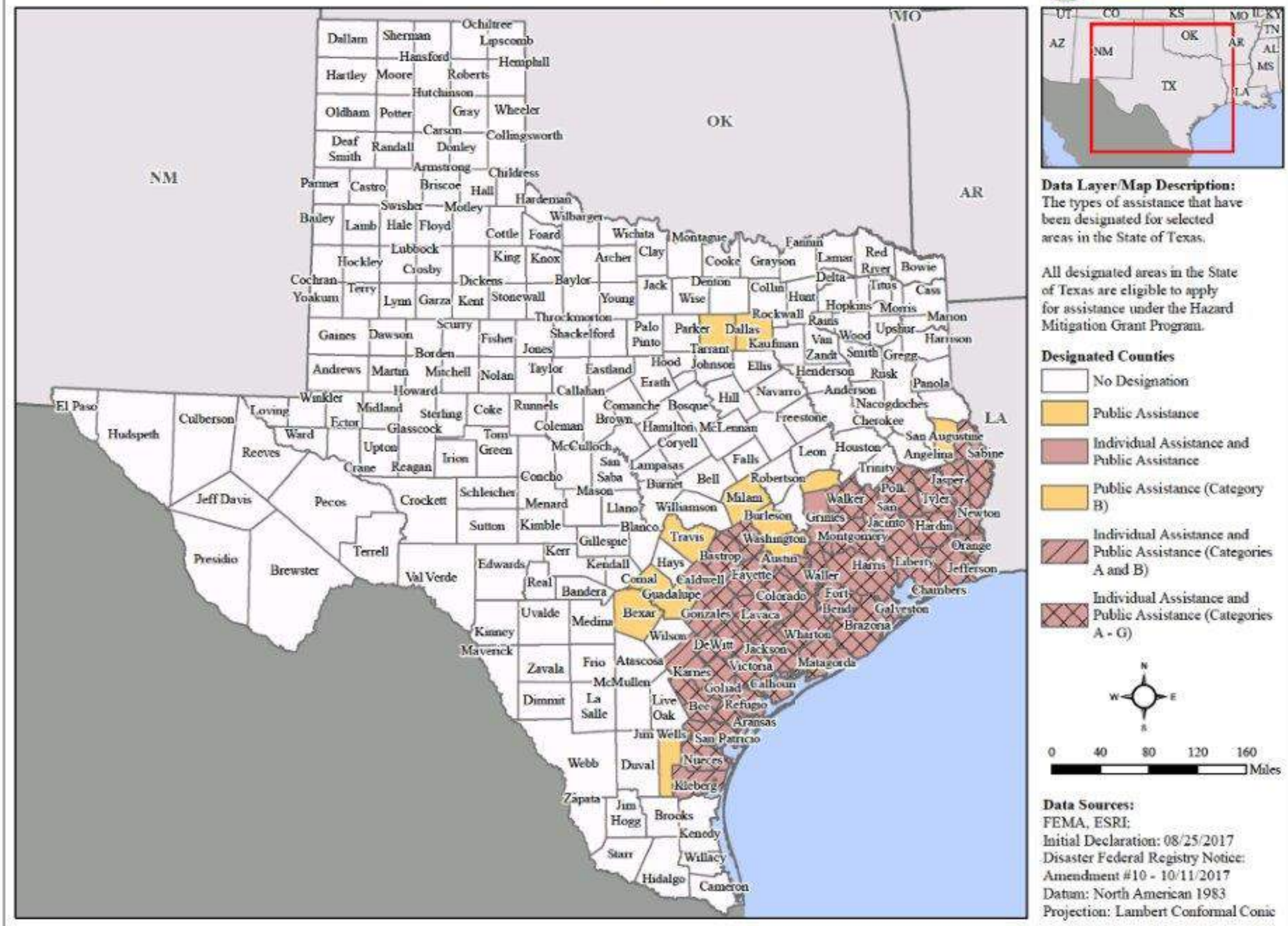
- Friday, August 25, 2017 – Governor Greg Abbott of Texas sent a letter to President Donald Trump requesting a Presidential Disaster Declaration as Hurricane Harvey was set to make landfall.

- Friday, August 25, 2017 -- President Donald Trump signed a disaster declaration with respect to certain areas within the State of Texas.

FEMA Designations

- FEMA initially designated 8 Texas counties as federal disaster areas qualifying for individual assistance. 21 other counties were later added to the list:
  - Initially designated - Aransas, Bee, Brazoria, Calhoun, Chambers, Fort Bend, Galveston, Goliad, Harris, Jackson, Kleberg, Liberty, Matagorda, Nueces, Refugio, San Patricio, Victoria and Wharton
  - Added – Austin, Bastrop, Colorado, DeWitt, Fayette, Gonzales, Hardin, Jasper, Jefferson, Karnes, Lavaca, Lee, Montgomery, Newton, Orange, Polk, Sabine, San Jacinto, Tyler, Walker and Waller.
- FEMA also designated the following Texas counties for public assistance:
  - Bexar, Burleson, Dallas, Grimes, Tarrant, Travis and Washington.

FEMA-4332-DR, Texas Disaster Declaration as of 10/11/2017



MapID ead96c4eeef1011171451hqprod

Volunteers and officers from the neighborhood security patrol help to rescue residents in the upscale River Oaks neighborhood after it was inundated with flooding from Hurricane Harvey on August 27, 2017, in Houston

Tax Relief

Exclusion of Certain Items from Income

Disaster Loans

- Most federal assistance to individual disaster victims comes through low interest, federally subsidized loans.
- IRC Section 7872 imposes additional income and additional interest expense on certain low interest loans.
- Proposed Treasury Regulation §1.7872-5(b)(5) exempts from IRC Section 7872 loans subsidized by the federal, state, and municipal governments that are made under a program of general application to the public.

Gifts – General Rule

General rule – Gross income does not include the value of property received by gift.

IRC Section 102(a).

To be a gift, a payment "must proceed from a detached and disinterested generosity …. out of affection, respect, admiration, charity or like impulses." *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960).

Gifts – Charities

- Payments to disaster victims for medical, temporary housing and transportation expenses incurred by individuals as a result of a flood are generally gifts because such payments:
  - do not proceed from any moral or legal duty
  - are motivated by detached and disinterested generosity.

Rev. Rul. 2003-12, 2003-1 C.B. 283.

Gifts – Third Parties

- Payments from a fund formed with public donations in response to the outpouring of public support for victims of a tragedy and their families treated as gifts to recipients because:
  - payment made out of concern for the victims' needs
  - payments not from any moral or legal duty.

Information Letter 2013-0020 (May 22, 2013)

Exceptions -- Not Gifts

- Government grants will not qualify as gifts:
  - Government is acting out of duty rather than generosity. *See, e.g.*, Rev. Rul. 2005-45, 2005-2 C.B. 120; Rev. Rul. 2003-12, 2003-1 C.B. 283.
- Employer payments to employees in connection with a disaster:
  - Payments do not proceed from a detached and uninterested generosity. Rev. Rul. 2003-12, 2003-1 C.B. 283.
- To be excluded from income, government and employer payments must qualify under IRC Section 139.

IRC Section 139

- Excludes “qualified disaster relief payments” from the taxable income of individuals.

- In general, government grants and payments from employers <u>must meet the requirements of IRC Section 139</u> to be excluded from an individual’s taxable income.

Qualified Disaster Relief Payments

The term “qualified disaster relief payment” is defined as any amount paid to for the benefit of an individual:

- to reimburse or pay reasonable and necessary personal, family, living or funeral expenses incurred as a result of a qualified disaster;
- to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation or replacement is attributable to a qualified disaster;
- by a person engaged in the furnishing or sale of transportation as a common carrier by reason of the death or personal physical injuries incurred as a result of a qualified disaster; or
- if such amount is paid by a Federal, State or local government or agency or instrumentality thereof, in connection with a qualified disaster in order to promote general welfare.

But only to the extent that any expense compensated by such payment is not otherwise compensated for by insurance or otherwise.

Qualified Disaster

- The term “qualified disaster” includes any disaster determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. IRC Section 139(c)(2).

- Hurricane Harvey qualifies as a “qualified disaster” under this definition.

Tax Consequences of Qualifying under IRC Section 139

- Individuals – Reimbursements or payments received by individuals who are victims of Hurricane Harvey are exempt from taxation to the extent that such payments are not otherwise compensated by insurance or otherwise.

- Employers – Permitted a deduction for these payments even though the employee does not recognize as income.

See Joint Committee on Taxation Staff, Technical Explanation of Victims of Terrorism Tax Relief Act of 2001 (JCX-93-01), Dec. 21, 2001, p.16.

Limitations and Exceptions -- IRC Section 139

- Only applies to individuals.
- Excludes only the portion of any such payment that represents the reimbursement of covered expenses that are not reimbursed by insurance or otherwise.
- Individuals cannot claim a tax deduction or tax credit for, or by reason of, an expenditure to the extent of the amount excluded from income under IRC Section 139.
- Excludes payments received in lieu of lost compensation or lost profits.

Texas – Certain Taxes Suspended or Waived

- ***State and Local Hotel and Occupancy Taxes***
  - Temporarily suspended for victims of Hurricane Harvey and personnel participating in hurricane relief efforts for the period August 23, 2017 through October 23, 2017.
  - Also for government personnel, non-profit entity and for-profit entity personnel participating in relief operations for victims of Hurricane Harvey (e.g. disaster relief volunteers, law enforcement officers; insurance adjusters, construction workers, utility workers; and sanitation workers).
- ***International Fuel Tax Agreement***
  - Temporary waiver of the International Fuel Tax Agreement until September 30, 2017.
  - Also temporary suspension for the same period on taxes on motor fuel and on certain licensing requirements in connection with delivering relief supplies and fuel into the state.
- ***Motor Vehicle Tax***
  - Temporary suspension of tax collection, titling, registration and inspection in counties affected by Hurricane Harvey. Suspension until October 14, 2017 or November 15, 2017 depending on the county.
  - Certain late payment penalties waived for tax payments made by the end of the suspension period.

Michael Boyd passes his son Skylar over to a rescue worker as they are evacuated on an airboat from their apartment complex after it was inundated with water following Hurricane Harvey on August 30, 2017 in Houston, Texas. It was Skylar's first birthday

Tax Returns

Extension of Due Dates on Tax Returns

- IRC Section 7508A permits the Treasury to extend tax return filing and tax payment deadlines for a period of up to one year for taxpayers affected by a federal declared disaster.

- On August 28, 2018, the IRS announced extensions for filing certain tax returns and paying certain taxes with due dates falling on or after August 23, 2017 for victims of Hurricane Harvey (in counties in Texas designated by FEMA as federal disaster areas qualifying for individual assistance).

  IR-News Re. 2017-135 (Aug. 28, 2017).

Extension of Due Dates on Tax Returns

Federal relief available only for “affected taxpayers” who are defined as:

- individuals whose principal residence and business entities or sole proprietorships whose principal place of business is located in the counties designated as disaster areas;

- individuals who are relief workers assisting in a covered disaster area, regardless of whether he or she is affiliated with recognized government or philanthropic organizations

- individuals whose principal residence or business entities or sole proprietorships show principal places of business are not located in a covered disaster area but whose records necessary to meet a filing or payment deadline are maintained in a covered disaster area;

- estates and trusts that have records necessary to meet a filing or payment deadline in a covered disaster area; and

- any spouse of an affected taxpayer solely with regard to a joint return of the husband and wife.

Extension of Due Dates on Tax Returns

Tax returns extended include:

- income tax returns for individuals, corporations, and estates and trusts;
- partnership and S corporation and trust tax returns
- generation-skipping transfer tax returns;
- employment tax returns
- excise tax returns.

In general, the relief does not apply to information returns on Forms W-2, 1098 or 1099 or to IRS Forms 1042 or 8027.

Taxpayers may still seek relief from penalties for failure to timely file by establishing a “reasonable cause” for the delay.

Extension of Due Dates on Tax Returns

Taxpayer	Type of Return	Originally Due	Extension
Individuals	Estimated Tax Payments	September 15, 2017 and January 15, 2018	January 31, 2018
	Validly Extended 2016 Federal 1040	October 15, 2017	January 31, 2018
Businesses	Quarterly Payroll and Excise Tax Returns	On or after August 23, 2017 and before September 7, 2017	October 31, 2017
	Validly Extended 2016 Federal Income Tax Return	September 15, 2017	January 31, 2018

Extension of Due Dates on Tax Returns – Texas Returns

Taxpayer	Type of Return	Originally Due	Extension
Businesses	2017 Franchise Tax Returns with valid extensions until November 15, 2017	November 15, 2017	January 5, 2018
	Sales and Use tax reports for August 2017	September 20, 2017	October 20, 2017 (automatic 30 day extension)
	Sales and Use tax quarterly reports	October 20, 2017	November 20, 2017 (automatic 30 days extension)
	Mixed Beverage Sales Tax and Mixed Beverage Gross Receipts Tax for August 2017	September 20, 2017	October 20, 2017 (automatic 30 day extension)
	Mixed Beverage Sales Tax and Mixed Beverage Gross Receipts Tax quarterly reports	October 20, 2017	November 20, 2017 (automatic 30 days extension)

Extension of Due Dates on Tax Returns

IRS automatically provides filing and penalty relief to taxpayers with an IRS address located in the disaster area.

Taxpayers outside the disaster area but whose records necessary to meet a deadline occurring during the postponement period are located in the affected area and workers assisting the relief area should contact the IRS at 866 562-5227

Extension of Due Dates for Pension Plans

Federal relief also provided to single employer and multiemployer pension plans affected by Hurricane Harvey. Notice 2017-49, 2017-40 IRB.

Relief was provided for "affected plans" which are defined as a plan with any of the following in an "affected area" (i.e. a federally declared disaster area):

- the principal place of business of the employer that maintains the plan;
- the principal place of business of employers that employ more than 50% of the active participants covered by the plan;
- the relevant office of the plan or the plan administrator;
- the relevant office of the primary record keeper serving the plan; or
- the office of the enrolled actuary or other advisor that previously had been retained by the plan or the employer to make funding determinations or certifications for which the due date falls between August 23, 2017 and January 31, 2018.

Extension of Due Dates on Tax Returns
Single Employer Defined Benefit Plan
(other than a CSEC)

Item Extended	Originally Due	Extended Date
Contribution date for a plan year under IRC Section 430(j)(1) or IRC Section 430(j)(3)	On or after September 23, 2017 and on or before January 31, 2018	January 31, 2018
Election date relating to the plan's prefunding balance or funding standard carryover balance to offset minimum contribution	On or after September 23, 2017 and on or before January 31, 2018	January 31, 2018
Date in IRC Section 436(h)(2) or IRC Section 436(h)(3) for certification of the adjusted funded target attainment percentage	On or after September 23, 2017 and on or before January 31, 2018	January 31, 2018

Extension of Due Dates on Tax Returns
Single Employer Defined Benefit Plan
Cooperative and Small Employer Charity (CSEC)

Item Extended	Originally Due	Extended Date
Contribution date for a plan year under IRC Section 433(c)(9) or IRC Section 433(f)	On or after September 23, 2017 and on or before January 31, 2018	January 31, 2018
Date described in IRC Section 433(j)(4) by which the plan actuary must make the required certification	On or after September 23, 2017 and on or before January 31, 2018	January 31, 2018
Deadline described in IRC Section 433(j)(3) by which a plan sponsor of an affiliated plan that is in funding restoration status must adopt a funding restoration plan	On or after September 23, 2017 and on or before January 31, 2018	January 31, 2018

Extension of Due Dates on Tax Returns Multiemployer Defined Benefit Plans

Item Extended	Originally Due	Extended Date
Date described in IRC Section 432(b)(3)(A) by which the actuary must make any funding status certification required under IRC Section 432(b)(3)(A)	On or after September 23, 2017 and on or before January 31, 2018	January 31, 2018
Deadline described in IRC Section 432(c)(1) by which a plan sponsor of an affected plan that is in endangered or critical status must adopt or update a funding improvement plan or a rehabilitation plan.	On or after September 23, 2017 and on or before January 31, 2018	January 31, 2018

Extension of Due Dates on Tax Returns Applying for a Waiver for an Affected Plan

Item Extended	Originally Due	Extended Date
Deadline described in IRC Section 412(c)(5) for applying for a waiver of minimum funding for an affected plan	On or after September 23, 2017 and on or before January 31, 2018	January 31, 2018

Copies of Prior Tax Returns

- File IRS Form 4506 to get copies of tax returns for prior years.

- File IRS Form 4506-T to get prior four (4) years of transcripts of taxpayers prior tax returns.

- Write "Hurricane Harvey" in red at the top of the forms to receive expedited processing and waiver of normal use fees.

Andrew White helps a neighbor down a street after rescuing her from her home in his boat in the River Oaks neighborhood after it was inundated with flooding from Hurricane Harvey on August 27, 2017

Casualty Losses

Casualty Losses – General Rules

- IRC Section 165(c)(3) permits noncorporate taxpayers a deduction for losses of property not connected with a trade or business or a transaction entered into for profit if such losses arose from fire, storm, shipwreck or other casualty.

- Taxpayers must deduct the loss in the tax year in which the loss is incurred.

Casualty Losses – Disaster Victims

- IRC Section 165(i)(1) permits affected taxpayers in a federally declared disaster area to elect to take disaster related casualty losses into account on their federal income tax return for the preceding tax year in which the disaster occurred.

- Permits victims of Hurricane Harvey to amend their 2016 federal income tax returns and get a tax refund.
  - Report casualty losses on IRS Form 4684.
  - Put "Texas, Hurricane Harvey" at the top of the form so that the IRS can expedite the processing of the return.

Casualty Losses – Limitations

- General Limitations:
  - Personal casualty losses allowed only to the extent each casualty loss exceeds $100.
  - Net personal casualty losses (i.e. personal casualty losses in excess of personal casualty gains) must exceed 10% of the taxpayer's adjusted gross income.

- Disaster Tax Relief and Airport and Airway Extension Act of 2017 ("Disaster Tax Relief Act of 2017") revised these limits for victims of Hurricane Harvey.
  - The $100 per casualty floor was increased from $100 to $500.
  - Net personal casualty losses are not subject to the 10% of taxpayer adjusted gross income limitation.
  - Taxpayer's standard deduction is increased by the amount of the taxpayer's net disaster loss.

Casualty Losses – Condemned Residences

- IRC Section 165(k) permits taxpayer-owners of residences that are rendered unsafe by a Presidentially declared disaster to treat the demolition or relocation costs as a casualty loss under IRC Section 165(i).

- To qualify for this treatment:
  - taxpayer must be ordered by the government of the state or any political subdivision thereof in which the residence is located to demolish or relocate such residence; and
  - the residence must have been rendered unsafe for use as a residence by reason of the disaster.

Casualty Losses – Businesses

<u>More Favorable</u>

- Not subject to $100 per casualty or 10% of adjusted gross income limitations.
- Not subject to itemized deduction limitations.
- Businesses are also permitted to deduct casualty losses in preceding tax year.
  - For Hurricane Harvey losses in 2017, could be reported on the 2016 tax return and then carried back 2 additional years (effective 3 year carryback from 2017)
  - Two year carryback eliminated starting in 2018 under recent tax act.

<u>Less Favorable</u>

- Must determine each business casualty loss separately for each identifiable piece of property.
- Losses may be subject to passive loss limitations.

Casualty Losses – Recent Guidance

<u>Rev. Proc. 2018-08</u>

- Provides safe harbor methods that individuals may use in determining the amount of their casualty and theft losses for their homes and belongings.
- Three of the four methods are specifically limited to losses incurred as a result of a Federally declared disaster.

<u>Rev. Proc. 2018-09</u>

- Provides a safe harbor method under which individuals may use one or more cost indexes to determine the amount of loss to their home as a result of Hurricane Harvey.
- Cost indexes provides tables with cost per square foot for Texas disaster areas.

A Texas National Guardsman carries a resident from her flooded home following Hurricane Harvey in Houston, Aug. 27, 2017.

Casualty Gains

Casualty Gains – Recognition of Income

- If the receipt of insurance compensation or other taxable consideration exceeds the taxpayer's tax basis, the taxpayer will realize taxable gain.

- If personal casualty gains exceed personal casualty losses for a tax year, then all of the taxpayer's personal casualty gains and losses are treated as capital gains and capital losses. IRC Section 165(h)(2)(B).
  - Potential for favorable lower tax rate on net long-term capital gains on net personal casualty gains.

Casualty Gains – Exclusion of Gain on Home

- IRC Section 121 permits taxpayers who live in their principal residence for at least two of the last five years to exclude up to $250,000 ($500,000 for married filing jointly) of the gain realized on the sale of that house from gross income.

- Not limited to disaster victims.

- The recent tax act changed these rules for 2018 and later tax years.

Casualty Gains – Involuntary Conversion

- IRC Section 1033 permit taxpayers to defer gains for properties that are compulsorily or involuntarily converted (as a result of its destruction in whole or in part, theft, seizure or requisition or condemnation or threat of imminence thereof) into property similar or related in service or use to the property so converted.

- Includes the temporary conversion into cash where the taxpayer within a limited time period purchases qualified replacement property.

- Special rules apply to properties damaged by federally declared disasters.

Casualty Gains – Involuntary Conversion in a Federally Declared Disaster Area

- No gain is recognized on the receipt of insurance proceeds for personal property that was part of the principal residence that was damaged even where the personal property was not scheduled. IRC Section 1033(h)(1)(A)(i).
  - Under the general rules, taxpayers would have to recognize gains on personal property.
  - Relieves taxpayers from having to try to establish their tax basis with respect to personal property.
  - Permits any gain with respect to such personal property to escape immediate gain recognition regardless of whether the insurance proceeds with respect to the personal property regardless of the use to which the taxpayer puts those proceeds. *See* Rev. Rul. 95-22, 1995-1 C.B. 145.
  - Personal property is treated as a “single item of property” permitting taxpayers flexibility in replacing destroyed property.

Casualty Gains – Involuntary Conversion in a Federally Declared Disaster Area

- Replacement period for this single item of property is extended to 4 years after the close of the taxable year during which the gain is first realized (i.e. over the normal 2 year period).

- Flexibility for businesses. If property is held for use in a trade or business or for investment located in a disaster area is involuntarily converted, then any tangible property of a type held for productive use in a trade or business is treated as property similar or related in service or use to the property so converted.

  IRC Section 1033(h)(2).

Volunteers and officers from the neighborhood security patrol help to rescue residents and their dogs in the River Oaks neighborhood on August 27, 2017, in Houston.

Retirement Plans

Profit Sharing and Stock Bonus Plans – General Rules

- Profit sharing and stock bonus plans impose limits on the permissibility of loans and distributions.
  - Distributions may only be made upon the occurrence of certain events (e.g., after a fixed number of years, reaching a certain age, severance of employment, etc.)
  - Plans may permit distributions or acceleration of distributions in the case of hardship
- Loans or distributions from such plans require the plans to contain language authorizing the loan or distribution.
- Except for distributions of already-taxed amounts, distributions are includable in the gross income of the recipient.
- Distributions prior to the employee attaining age 59½ subject to a ten percent (10%) additional tax.
- Plan provisions and regulations require that a plan must establish verification procedures that must be followed before loans and distributions can be made under the plan and procedures must be in place to confirm that applicable criteria have been satisfied.

Profit Sharing and Stock Bonus Plans – Disaster Relief

- Announcement 2017-11 provided certain relief for victims of Hurricane Harvey:
  - Distributions from "qualified employer plans" will not be treated as failing to satisfy the requirements for such distribution merely because the plan makes a loan or a hardship distribution for the need arising from Hurricane Harvey
  - To qualify, the distribution must be to an employee or former employee whose principal residence or place of employment on August 23, 2017 was in one of the federally designated disaster areas for Hurricane Harvey.
  - The distribution may also be made to lineal ascendants or descendants or the spouse of the employee.
  - For purposes of this exception, a "qualified employer plan" would generally include a profit sharing plan or stock bonus plan (including a Section 401(k) plan).
- If a qualified employer plan does not provide for the applicable hardship distribution, then the plan must be amended no later than the end of the first plan year beginning after December 31, 2017.
- Hardship distributions must be made on or after August 23, 2017 and no later than January 31, 2018.

Profit Sharing and Stock Bonus Plans – Disaster Relief

- Disaster Relief Act of 2017 provided additional tax relief for victims of Hurricane Harvey that was not provided by Announcement 2017-11, specifically:
  - qualified hurricane distributions are not subject to the ten percent (10%) early retirement plan withdrawal penalty;
  - taxpayers receiving qualified hurricane distributions can either spread the income inclusion out over a three (3) year period beginning with the year that the income would otherwise first be required to be included into income or elect out and include the income all in the year of the distribution;
  - taxpayers are permitted to recontribute any qualified hurricane distribution to any eligible retirement plan of which they are a beneficiary at any time over a 3 year period beginning with the date after the distribution was received and receive tax-free rollover treatment;
  - qualified hurricane distributions are not subject to the mandatory twenty percent (20%) withholding rule that would normally apply to eligible rollover distributions;

Profit Sharing and Stock Bonus Plans – Disaster Relief

- Disaster Relief Act of 2017 relief (continued):
  - retirement plan withdrawals for home purchases or construction received after February 28, 2017 and before September 21, 2017 where the home purchase or construction was cancelled due to Hurricane Harvey may be recontributed;
  - additional flexibility in structuring loans from retirement plans for qualified hurricane relief provided by:
    - Increasing the maximum amount that a particular participant or beneficiary can borrow from a qualified employer plan under IRC Section 72(b)(2)(A) increased from $50,000 to $100,000;
    - removing the "one half of present value" limitation; and
    - allowing a longer repayment term for victims of Hurricane Harvey, if the due date for any repayment for the loan occurs during the period beginning on August 23, 2017 and ending on December 31, 2018, by delaying the due date of the first repayment by one year (and adjusting the due dates of subsequent repayments accordingly).
- These provisions provide taxpayers greater access to their retirement funds without penalizing them for having to withdraw these funds early due to Hurricane Harvey.

All types of wild animals were also displaced by the flood waters of Hurricane Harvey.

Additional Tax Relief

Leave-Based Donation Programs

- General rule – if an employee gives their accrued vacation to another employee or the employer (at the request of an employee) pays either the employee or another party an amount in lieu of that accrued vacation, the employee receiving the accrued vacation would recognize income on the receipt or deemed receipt of the vacation.

- Notice 2017-48 (issued on September 5, 2017) indicated the IRS ***<u>will not assert</u>*** that:

  – cash payments an employer makes to IRC Section 170(c) organizations in exchange for vacation, sick or personal leave that its employees elect to forego constitute gross income or wages of the employee if the payments are:

    - made to IRC Section 170(c) organizations for the relief of victims of Hurricane Harvey and Tropical Storm Harvey and
    - paid to the Section 170(c) organizations before January 1, 2019.

  – employee is in constructive receipt of such payments; or

  – the employers' deduction of such payments is subject to the limitations of IRC Section 170.

Charitable Deduction Limitations

- General limitations:
  - Individuals who choose to itemize their deductions are subject to limitations of 50%, 30% and 20% of their adjusted gross income on their charitable deductions depending on the type of property contributed and the type of the donee. IRC Section 170(b)(1).
  - Corporations are subject to the limitation that the total charitable deductions of each corporation cannot exceed 10% of its taxable income. IRC Section 170(b)(2).
- Tax Relief Act of 2017 suspends these limitations for "qualified contributions."
- Qualified contributions are defined for purposes of Hurricane Harvey as any charitable contribution (within the meaning of IRC Section 170(c)) that was:
  - paid during the period August 23, 2017 and December 31, 2017;
  - in cash;
  - to an organization described in IRC Section 170(b)(1)(A); and
  - is made for relief efforts in the Hurricane Harvey disaster area.

Employee Retention Tax Credit for Disaster Zone Employees

Tax Relief Act of 2017 added an employee retention income tax credit for employers affected by Hurricane Harvey. The tax credit is a general business credit under IRC Section 38.

- *Amount of Tax Credit.* An eligible employer can receive a federal income tax credit equal to forty percent (40%) of up to $6,000 of the qualified wages with respect to each eligible employee of such employer for the tax year (i.e. maximum credit of $2,400 per employee).

- *Eligible Employer.* An eligible employer is any employer which conducted an active trade or business on August 23, 2017 in the Hurricane Harvey disaster zone and such business was inoperable on any day after August 23, 2017 and before January 1, 2018 as a result of damage sustained by reason of Hurricane Harvey.

- *Eligible Employee.* An eligible employee means, with respect to an eligible employer, an employee whose principal place of employment on August 23, 2017 with such eligible employer was in the Hurricane Harvey disaster zone.

- *Qualified Wages.* Qualified wages are wages paid or incurred by an eligible employer with respect to an eligible employee on any day after August 23, 2017 and before January 1, 2018 which occurs during the period beginning on the date on which the applicable trade or business first becomes inoperable at the principal place of employment where the eligible employee worked immediately before August 23, 2017 and ending on the date on which such trade or business has resumed significant operations at such principal place of business.

Earned Income Credit / Child Care Credit

- In general, eligible individuals may qualify for an earned income tax credit under IRC Section 32 and a childcare tax credit under IRC Section 24. The calculation is based in part on the amount of the individual's earned income for that taxable year.

- Tax Relief Act of 2017 "qualified individuals" are permitted to calculate their earned income and childcare credits for 2017 using their 2016 earned income.

- *Qualified Individual.* A qualified individual is defined as an individual whose principal place of abode on August 23, 2017 was:
  - located in either the Hurricane Harvey disaster zone or the Hurricane Harvey disaster area; and
  - the individual was displaced from their principal place or abode by reason of Hurricane Harvey.

Section 179 Expensing and Additional First Year Depreciation

- In general, IRC Section 179 permits businesses to expense up to $500,000 of their purchases for any taxable year for tangible property and certain computer software that is IRC Section 1245 property and used in an active trade or business. The $500,000 limit is reduced (not below zero) on a dollar for dollar basis to the extent by which the cost of similar property placed in service for the taxable year exceeds $2,000,000.

- For qualified Section 179 disaster assistance property:
  - The $500,000 limit is increased by the lesser of $100,000 or the cost of qualified Section 179 disaster assistance property; and
  - The $2,000,000 amount is increased by the lesser of $600,000 or the cost of qualified Section 170 disaster assistance property placed in service during the tax year.

- *Qualified Section 179 Disaster Assistance Property.* Qualified Section 179 Disaster Assistance Property is property that meets the seven requirements of IRC Section 168(n)(2).
  - These requirements include a requirement that the property must rehabilitate property damaged by or replace property destroyed or condemned as a result of a federally declared disaster and is similar in nature to, and located in the same county as, the property being rehabilitated or replaced.

- Under IRC Section 168(n), the 50% additional bonus depreciation is also available for qualified disaster assistance property.

Alexandre Jorge evacuates Ethan Colman, 4, from a neighborhood inundated by floodwaters from Tropical Storm Harvey on August 28, 2017, in Houston.

2017 Tax Cuts and Jobs Act

2017 Tax Cut and Jobs Act

Personal casualty and theft losses:

- For taxable years beginning after December 31, 2017, and before January 1, 2026, allowed as a deduction only to the extent it is attributable to a federally declared disaster.
- Net disaster losses from 2016 federally declared disaster areas with respect to 2016 and 2017 tax returns (retroactively):
  - eliminates 10% of taxpayer AGI threshold;
  - increases $100 per-casualty floor on deduction to $500;
  - non-itemizers are allowed to deduct (i.e. added to standard deduction).

2017 Tax Cut and Jobs Act

Qualified Plans:

- Qualified 2016 disaster distributions:
  - May be included in income ratably over three years;
  - 10% additional tax on early distributions under IRC Section 72(t) is inapplicable;
  - continued deferral of the income realized from a qualified 2016 disaster distributions for amounts that are recontributed to an eligible retirement plan
- A "qualified 2016 disaster distribution" is any distribution:
  - from an "eligible retirement plan:
  - made on or after January 1, 2016 and before January 1, 2018;
  - to an individual whose principal place of above at any time during calendar year 2016 was in the 2016 disaster area, and
  - who sustained an economic loss by reason of that 2016 disaster.

2017 Tax Cut and Jobs Act

Qualified Plans (continued):

- For purposes of the definition of a "qualified 2016 disaster distribution," an "eligible retirement plan" is:
  - an IRA
  - an individual retirement annuity under IRC Section 408(b), other than an endowment contract;
  - an IRC Section 401(a) qualified trust;
  - an IRC Section 403(a) qualified annuity plan;
  - an IRC Section 457(b) eligible deferred compensation plan maintained by a governmental employer, and
  - an IRC Section 403(b) annuity contract.

2017 Tax Cut and Jobs Act

Qualified Plans (continued):

- Aggregate qualified 2016 disaster distributions received by an individual may not exceed $100,000. (amounts > $100,000 subject to 10% tax on early withdrawals).

- No withholding on qualified 2016 disaster distributions.

- Most qualified 2016 disaster distributions may be recontributed within three years of the date of the distribution tax-free (i.e. treated as a rollover contribution).

- Amendments to qualified plans to incorporate the changes from the 2017 Tax Cut and jobs Act must be done by the end of the first plan year beginning on or after January 1, 2018. A governmental plan has until the last day of the first plan year beginning after January 1, 2020.

Tax Relief – Help Information

- Internal Revenue Service
  - IRS webpages:
    - https://www.irs.gov/newsroom/help-for-victims-of-hurricane-harvey (Hurricane Harvey)
    - https://www.irs.gov/newsroom/tax-relief-in-disaster-situations (disaster relief in general)
    - https://www.irs.gov/businesses/small-businesses-self-employed/disaster-assistance-and-emergency-relief-for-individuals-and-businesses-1 (disaster relief in general)

- Other Government Sources
  - https://www.disasterassistance.gov/
  - FEMA Helpline – 800 621-3362 (voice, 711, or VRS)
    – 800 462-7585 (TTY)
  - State of Texas -- https://gov.texas.gov/news/post/commission-to-rebuild-texas-after-hurricane-harvey-update-issue-16

- Research
  - BNA Portfolio #597 – Tax Incentives for Economically Distressed Areas


REEF

Questions?

Navigating the Differences Between Charities, Social Welfare Organizations, and Business Leagues

Thompson & Knight Impact®

February 9, 2018

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IRC Section 501(c)(3) Charitable Organizations

- "Corporations, and any community chest, fund, or foundation, ***organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition*** (but only if no part of its activities involve the provision of athletic facilities or equipment), ***or for the prevention of cruelty to children or animals***, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office."

- A charity **MUST** apply for recognition of exemption on IRS Form 1023

Charitable Organizations
Public Charities v. Private Foundations

- IRC Section 501(c)(3) organizations are further classified under IRC Section 509(a) as: (i) public charities; or (ii) private foundations.

- Categories of public charities include:
  - Churches or conventions or associations of churches;
  - Schools, colleges, and universities;
  - Hospitals and medical research organizations that carry out research in conjunction with a hospital;
  - Governmental units;
  - Charitable organizations meeting the public support test; and
  - Agricultural research organizations engaged in continuous and active research in conjunction with a land grant college or university.

Public Support Test
IRC Section 509(a)(1) v. IRC Section 509(a)(2)

- An organization is "publicly supported" if it meets either the public support test of IRC Section 509(a)(1) or IRC Section 509(a)(2).
- The tests apply on an aggregate five year basis including the current year and the immediately preceding four years.
- The tests does not have to be met during the first five years that the organization is recognized as tax-exempt under IRC Section 501(c)(3) as long as the charity has a good faith belief that they will meet the test in the sixth year.
- A Section 509(a)(3) "supporting organization" of a public charity does not need to meet the public support test.

Public Support Test
IRC Section 509(a)(1) 1/3 Public Support Test

- IRC Section 509(a)(1) – the 1/3 test

  - Must receive at least 1/3 of financial support from contributions and membership fees from the general public, government, or other charitable organizations.

    - Gifts from donors other than government grants or publicly funded public charities are subject to a 2% limitation – these donations only count toward the 1/3 public support to the extent the donation does not exceed 2% of the organization's overall support.

    - Purpose of the rule is to ensure that the charity is truly being supported by a wide range of donors.

  - As always, the devil is in the details, *e.g.*, program related revenues such as ticket sales and other services revenue received in furtherance of the organization's charitable purposes are not included in the numerator or denominator. Investment income is included only in the denominator.

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Public Support Test
IRC Section 509(a)(1) 10% and Facts and Circumstances Test

- IRC Section 509(a)(1) – the 1/10 & facts and circumstances test
  - An organization that fails to meet the 1/3 test may still qualify as a publicly supported public charity under IRC Section 509(a)(1) if:
    - It receives at least 10% of its financial support from contributions from the general public, government, or other charitable organizations; AND
    - Based on all the facts and circumstances the organization was organized to attract public support.
  - Good factors: (i) how close it is to meeting the 1/3 test; (ii) having a representative governing body including public officials, subject matter experts and community leaders; (iii) the availability of public facilities or services along with public participation in programs of the organization; and (iv) a robust fundraising program.

Public Support Test
IRC Section 509(a)(2) Public Support Test

- Must receive at least 1/3 of financial support from contributions from the general public, government, or other charitable organizations, membership fees, and gross receipts from ***admissions, sales of merchandise, performance of services or furnishing of facilities in an activity that is not an unrelated trade or business***; and

- Must not receive more than 1/3 of financial support from investment income.

  - ALL amounts received from "disqualified persons" as defined in IRC Section 4946 are excluded from the numerator of the public support test.

  - Gross receipts from admissions, sales, etc. from any person in excess of the greater of $5,000 or 1% are excluded from the numerator.

Tax-Deductibility of Donations to IRC Section 501(c)(3) Charitable Organizations

- Contributions to IRC Section 501(c)(3) charitable organizations generally are tax-deductible under IRC Section 170. The deduction is only available for taxpayers who itemize their deductions. The new tax bill increased the standard deduction to $12,000 and $24,000 for individuals and married couples, respectively.

- The charitable contribution deduction is limited to varying percentages of adjusted gross income ("AGI") depending on the type of gift and the classification of the charitable organization:

  - Contributions to public charities, operating private foundations, and certain other private foundations making qualifying distributions by March 15th equal to 100% of the contributions received in the prior year are limited to 50% of AGI, except cash contributions to these organizations made between 2018 and 2025 are limited to 60% of AGI.

  - Contributions to private foundations are limited to 30% of AGI.

  - Contributions of capital gain property are subject to further limitation: a contribution to a 50% limit organization is subject to a 30% AGI limit and a contribution to a 30% limit organization is subject to a 20% AGI limit.

Prohibited Political Activities for IRC Section 501(c)(3) Charities

"Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), **<u>and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office</u>**."

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Legislative History – The Johnson Amendment

- The prohibition on political activities in IRC Section 501(c)(3) was introduced by then Senator Lyndon B. Johnson in a floor amendment on July 2, 1954. Senator Johnson was motivated in part by attacks that had been made on him by certain charitable organizations that were alleging the Senator was a communist sympathizer.

- At the time Senator Johnson stated ". . . [t]his amendment seeks to extend the provisions of section 501 of the House bill, denying tax-exempt status to not only those people who influence legislation but also to those who intervene in any campaign on behalf of any candidate for public office." 100 Cong. Rec. 9,604 (1954). The amendment was accepted without debate or discussion and included in the Internal Revenue Code of 1954, enacted on Aug. 16, 1954. The Conference Report (H.R. Conf. Rep. No. 83-2543, 83d Cong., 2d Sess. (1954)) contains no further discussion of the amendment.

Scope of the Johnson Amendment

- It applies to all IRC Section 501(c)(3) organizations, *e.g.*, charities, universities, hospitals.
- This is an absolute prohibition on any intervention in political campaigns and support (or opposition) of political candidates. There is no *de minimis* exception.
- There has been a lot of talk about a repeal (or modification) of the Johnson Amendment in recent years but one such proposal was ultimately dropped from the final tax reform bill.
- The proposals that have been introduced in the House have been limited to political speech that does not result in the charity incurring more than *de minimis* expenditures.

First Amendment Issues

- Does the prohibition in IRC Section 501(c)(3) infringe on the First Amendment rights of Section 501(c)(3) organizations?

First Amendment

"Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances".

- Two issues arise. First, is the Johnson Amendment prohibition impermissibly restricting the free speech of IRC Section 501(c)(3) organizations? Second, with respect to churches in particular is the Johnson Amendment violating the establishment clause?

First Amendment Issues

- As a general matter, political speech is at the heart of First Amendment protection.
- *See, e.g., Buckley v. Valeo*, 424 U.S. 1, 14 (1976) ("debate on the qualifications of candidates" is among "the most fundamental First Amendment activities"); *Mills v. Alabama*, 384 U.S. 214, 218 (1966) ("Whatever differences may exist about interpretations of the First Amendment, there is practically universal agreement that a major purpose of that Amendment was to protect the free discussion of governmental affairs. This of course includes discussions of candidates . . . .").
- This is the heart of the issue in *Citizens United v. Federal Election Commissioner*, 558 U.S. 310 (2008), except that case was brought by an IRC Section 501(c)(4) social welfare organization.

First Amendment Issues – Supreme Court law regarding lobbying limits for Section 501(c)(3)s

- In *Reagan v. Taxation Without Representation of Washington*, an IRC Section 501(c)(3) organization argued the prohibition against substantial lobbying (i) violated the organization's First Amendment Rights and (ii) violated the equal protection clause because it did not apply to IRC Section 501(c)(19) veterans organizations, which also qualify to receive tax-deductible donations.

- The Supreme Court held that the prohibition does not violate the First Amendment because Congress has not infringed any First Amendment rights or regulated any First Amendment activity, it has simply chosen not to subsidize it with public funds (*i.e.*, tax-deductible donations). Applying a rational basis standard, it also held that the prohibition does not violate the equal protection clause.

First Amendment Issues – Supreme Court law regarding lobbying limits for Section 501(c)(3)s

- TWR was an organization that was formed as a result of a merger of two related organizations, an IRC Section 501(c)(3) charitable organization focused on publishing and litigation and an IRC Section 501(c)(4) social welfare organization focused on attempting to influence legislation.

- The opinion, written by Justice Rehnquist, explained that the provision of tax-exempt status and the allowance of tax-deductible donations are both a form of government subsidy administered through the tax system.

- Congress has chosen to provide the first type of subsidy to IRC Section 501(c)(4) social welfare organizations, and an additional subsidy to charities not engaging in substantial lobbying (tax-deductible donations).

First Amendment Issues – The Penalty Argument

- In *Speiser v. Randall*, 357 U.S. 513 (1958), the Supreme Court ruled that a California rule requiring anyone who sought to take advantage of a property tax exemption had to sign a declaration stating that he did not advocate the forcible overthrow of the U.S. Government was unconstitutional, stating that to deny an exemption to claimants who engage in free speech is in effect to penalize them for the same speech.
- TWR argued that refusing IRC Section 501(c)(3) status to organizations that engage in substantial lobbying was an impermissible penalty for exercising free speech. The Supreme Court rejected the argument. Congress was not denying TWR the right to receive deductible contributions to support its non-lobbying activity and did not deny TWR any independent benefit on account of its lobbying. Congress simply refused to subsidize substantial lobbying by allowing tax-deductible donations for such purposes.

First Amendment Issues – The Segregation Principal

- A footnote in the *Reagan* opinion notes that TWR and some amici briefs raised concerns that the IRS may impose stringent restrictions making it impossible for an IRC Section 501(c)(3) organization to establish an IRC Section 501(c)(4) lobbying affiliate.
- Justice Rehnquist noted that there is no such requirement in the IRC or regulations. The IRS only requires that the two groups be separately incorporated and keep records adequate to show that tax deductible contributions are not used to pay for lobbying.
- This has raised the question whether a prohibition against such tandem structures, which are commonly used, would be held unconstitutional.

Legislative Lobbying and the IRC Section 501(h) Election

- An IRC Section 501(c)(3) charity can engage in legislative lobbying as long as such activities are insubstantial. There is no clear guidance on what is "insubstantial."

- To avoid uncertainty, a charitable organization can make an election under IRC Section 501(h) to apply the expenditure test.

- Under the expenditure test, the extent of an organization's lobbying activity will not jeopardize its tax-exempt status if its expenditures related to such activity do not normally exceed a specified amount. The limit generally is based on the size of the organization.

- Churches, conventions, or associations of churches, church supporting organizations, and private foundations are prohibited from making this election.

Direct Lobbying v. Grassroots Lobbying

- Lobbying activities are divided between (i) direct lobbying, and (ii) grassroots lobbying.
- Direct lobbying is any communication with a legislator that expresses a view about specific legislation.
- Grassroots lobbying is any communication with the public that expresses a view about specific legislation and includes a call to action.
- A **communication** is any conversation (in person or by phone), letter, fax, or other mechanism to convey a message. A **legislator** is a member of a legislative body or his or her staff. Executive branch officials who participate in the formulation of legislation are also considered legislators (e.g., governors, mayors, or an agency secretary who helps write a bill). The **public** is anyone but a legislator or member of an organization. Communications to an organization's own members are treated as direct lobbying. A **member** is someone who has given more than a small amount of time or money to the organization.

Direct Lobbying v. Grassroots Lobbying

- **Specific legislation** is any bill or resolution that has been introduced in a legislative body or a specific proposal to solve a problem, including budget appropriations, taxes, attempts to influence the confirmation of judicial and executive branch nominees. A **proposal** may qualify as specific legislation even if it has not yet been introduced, written down, or even fully fleshed out.

- A **call to action** is a specific means of encouraging the communication's recipient to take lobbying action. It must include one of the following actions: (i) telling the recipient to contact a legislator; (ii) providing information on how a recipient can contact his legislator, such as providing the phone number or address; (iii) providing a mechanism for enabling the recipient to contact his legislator, such as a postcard, petition, or email form; or (iv) identifying a legislator who will vote on the applicable legislation or a member of a legislative committee who will vote on the legislation, or the recipient's legislator.

- Ballot measure activity is considered direct lobbying and are not impermissible electoral activity.

IRC Section 501(h) Election Expenditure Test

If the amount of exempt purpose expenditures is:	Lobbying nontaxable amount is:
≤ $500,000	20% of the exempt purpose expenditures
>$500,00 but ≤ $1,000,000	$100,000 plus 15% of the excess of exempt purpose expenditures over $500,000
> $1,000,000 but ≤ $1,500,000	$175,000 plus 10% of the excess of exempt purpose expenditures over $1,000,000
>$1,500,000 but ≤ $17,000,000	$225,000 plus 5% of the exempt purposes

The separate sliding scale for grassroots lobbying expenditures (*i.e.*, efforts aimed at the public) is one-quarter of the above amounts.

IRC Section 501(c)(4) Social Welfare Organizations

- Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes, but only to the extent that no part of the net earnings of such entity inures to the benefit of any private shareholder or individual.

- A social welfare organization may "self-declare" its qualification for exemption under IRC Section 501(c)(4) by filing IRS Form 990 returns.

- However, they may apply for recognition of exemption on IRS Form 1024, and it generally is advisable to do so.

IRC Section 501(c)(4) Notice Requirement

- A new IRS "notice" requirement was enacted under IRC Section 506 on December 18, 2015. The notice must include the organization's name, address, EIN, date of formation, and statement of purpose. The IRS must acknowledge receipt within 60 days.

- The notice is filed online at: https://www.irs.gov/charities-non-profits/electronically-submit-your-form-8976-notice-of-intent-to-operate-under-section-501c4

- The notice requirement applies to organizations formed after December 18, 2015 (must file within 60 days of formation) AND organizations formed before that date if they had not yet filed a Form 990 annual return or a Form 1024 request for recognition of tax-exempt status (must file within 180 days from date of enactment).

- There is a $20 per day penalty for the failure to file by the due date, which is capped at $5,000. There is a reasonable cause exception to the penalty.

IRC Section 501(c)(4)
Lobbying and Political Activities

- The Treasury Regulations under IRC Code Sec. 501(c)(4) clarify that "[a]n organization is operat[ing] exclusively for the promotion of social welfare if it is ***primarily*** engaged in promoting in some way the common good and general welfare of the people of the community."
- Key difference from an IRC Section 501(c)(3) charity: (1) may engage in ***unlimited lobbying*** related to the organization's exempt purposes; and (2) may engage in political campaign activities on behalf of, or in opposition to, candidates for public office, as long as the campaign activity is ***not*** the organization's ***primary*** activity.

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IRC Section 501(c)(4)
Limitation on Political Activities

- Under IRC Section 6033(e), a social welfare organization must provide notices to its members regarding the amounts of dues allocable to non-deductible lobbying expenditures or pay a proxy tax on the amount of the expenditures.

- When are political campaign activities not the "primary" activity of an organization? It is unclear what proportion of an organization's activities must promote social welfare and how to measure the activities of organizations seeking to qualify under IRC Section 501(c)(4) (*e.g.*, expenditures, activities, both?)

- The most aggressive interpretation – an organization's political campaign activities can be 49% of its activities and it will still be primarily organized and operated for social welfare purposes. Many organization's choose to limit their political activities to a much lower level (*e.g.*, 15%).

The Tea Party Scandal and the Need for Guidance

- At a 2013 meeting of the ABA Tax Section Lois Lerner revealed to attendees that the IRS had been pulling certain applications for exemption for increased scrutiny and apologized for "inappropriate" actions by lower-level personnel in the Cincinnati office.
- It was subsequently revealed that the IRS had been pulling applications for exemption on IRS Form 1023 and Form 1024 for closer scrutiny if they had certain "buzz" words such as "Tea Party", "Patriots", "9/12", "Progressive", "Occupy", and "Israel".
- Applications weren't necessarily being denied but they were being held up for long periods, sometimes over two years.

The Tea Party Scandal and the Need for Guidance

- While both right leaning and left leaning organizations were chosen for special scrutiny there was a perception that right leaning organizations were being specifically targeted by a Democratic Administration.
- Many Americans were not aware of the "scandal" but it was given significant attention by lawmakers and political commentators, and it continues to be a controversial subject.
- A Treasury Inspector General for Tax Administration report revealed that the IRS agents began pulling these applications in 2010 and by December 17, 2012, 108 had been approved, 28 were withdrawn, none were denied, and 106 were open from 206 to 1,138 calendar days.

Citizens United v. Federal Election Commission

- Many commentators and politicians felt that the targeting was part of a backlash against the U.S. Supreme Court 2010 decision in *Citizens United v. Federal Election Commission*.
- In 2008, the plaintiff organization released a documentary critical of Hillary Clinton and planned to make it available on cable television through video-on-demand within 30 days of the primary elections. Expenses were incurred to advertise the documentary in advance.
- Citizens United sought declaratory relief, arguing that certain limitations on independent political expenditures enacted by the Bipartisan Campaign Reform Act of 2002("BCRA") were unconstitutional as applied to the documentary.

First Amendment Issues – BCRA Prohibitions

- Federal law (as amended by the BCRA) prohibited corporations and unions from using general treasury funds to make ***independent expenditures*** for speech that is an "***electioneering communication***" or for speech that expressly advocates the election or defeat of a candidate.

- An ***electioneering communication*** meant: (i) any "publicly distributed"; (ii) "broadcast, cable, or satellite communication"; (iii) that "refers to a clearly identified candidate for Federal office"; (iv) is made within 30 days of a primary election; and (v) that is "publicly distributed."

- "***Publicly distributed***" meant a communication that could be received by 50K or more persons in a state where a primary is being held within 30 days.

- Civil and criminal penalties could apply to violators of the BCRA.

First Amendment Issues – Case law prior to *Citizens United*

- In *Buckley v. Valeo*, 519 F.2d 821 (1976), the Supreme Court upheld limited on contributions to candidates, but had struck down limits on expenditures by candidates and limits on independent expenditures by other groups or individuals.
  - Less than two years later, the Supreme Court upheld this principle in *First Nat. Bank of Boston v. Bellotti*, 435 U.S. 765 (1978) holding that corporations have speech protections extending beyond material commercial interests, reversing the decision made by the Massachusetts Supreme Court.
- In *Austin* v. *Michigan Chamber of Commerce*, 494 U. S. 652 (1990), the Supreme Court held limits on independent expenditures by corporations, recognizing a new governmental interest in preventing "the corrosive and distorting effects of immense aggregations of [corporate] wealth . . . that have little or no correlation to the public's support for the corporation's political ideas."

First Amendment Issues – The *Citizens United* decision

- In a 5 v. 4 opinion, the Supreme Court overruled *Austin v. Michigan Chamber of Commerce*.
- Confronted with conflicting lines of precedent: a pre-*Austin* line forbidding speech restrictions based on the speaker's corporate identity and a post-*Austin* line permitting them, the majority ruled that *Austin's* anti-distortion rationale and the Government's argument in *Citizens United* that the corporate political speech can be banned to avoid corruption or its appearance was not sufficient to justify the restrictions on corporate speech imposed by the BCRA.

The Takeaway

- Since *Citizens United* there has been significant concern that IRC Section 501(c)(4) status would be abused. These organizations typically do not have to disclose their donors in the same manner as PACs.

- The lack of guidance on how much political campaign activity is "too much" and how to measure an organization's political activity has created confusion among social welfare organizations and the IRS agents responsible for reviewing their applications for exemption.

- Proposed Regulations were issued on November 29, 2013 to provide more definitive rules regarding IRC Section 501(c)(4) political activities and reduce the need for a detailed factual analysis. The IRS received over 150,000 comments on the proposed rules and they were eventually withdrawn.

IRC Section 501(c)(6) Business Leagues

- Business leagues, chambers of commerce, real estate boards, boards of trade, and professional football leagues, which are not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

- A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried out for profit.

- Qualifying activities include: promoting higher business standards and better business methods, educating the public in the use of credit, establishing and maintaining integrity of a local commercial market, operating a trade publication primarily to benefit an entire industry, lobbying to influence legislation germane to the common business interests of the members.

IRC Section 501(c)(6) Business Leagues – Lobbying and Political Campaign Activities

- A business league may engage in ***unlimited lobbying*** as long as the legislation they attempt to influence is germane to the common business interest of its members.

- Like an IRC Section 501(c)(4) social welfare organization, an IRC Section 501(c)(6) business league may engage in political campaigns on behalf of or in opposition to candidates for public office as long as such activities do not constitute the organization's ***primary activity***. See G.C.M. 34233 (Dec. 3, 1969).

- IRC Section 501(c)(6) organizations are also subject to IRC Section 6033(e) and must provide notices to their members regarding the amounts of dues allocable to non-deductible lobbying expenditures or pay a proxy tax on the amount of the expenditures.

IRC Section 501(c)(6) Business Leagues – *Citizens United*

- The Supreme Court ruling in *Citizens United* also applies to IRC Section 501(c)(6) business leagues. Like IRC Section 501(c)(4) social welfare organizations, business leagues generally are not required to disclose their donors.

- In the wake of *Citizens United* there has been concern about increased political expenditures by IRC Section 501(c)(6) business leagues as well although they have not received as much attention in the press and among politicians as IRC Section 501(c)(4) social welfare organizations.

IRC Section 501(c)(6) Business Leagues – Private Inurement

- The prohibition on private inurement does not preclude members from receiving certain benefits from the organization such as newsletters and similar informative material. Moreover, the profitability of the members' individual enterprises may be enhanced by the successful promotion of the common business interest.

- Inurement results from "an expenditure of organizational funds resulting in a benefit which is beyond the scope of the benefits which logically flow from the organization's performance of its exempt functions." G.C.M. 38559 (Nov. 9, 1980).

- An organization may return dues to its members without loss of exemption as long as they represent a mere reduction in dues or contributions previously paid and are in proportion to the dues paid or contributions made. Rev. Rul. 81-60, 1981-1 C.B. 335.

Unrelated Business Income Tax

- Organizations exempt from income tax under IRC Section 501(c)(3), 501(c)(4), and 501(c)(6) may still be subject to tax on their unrelated business taxable income (“UBTI”).
- An unrelated trade or business is a (1) trade or business, (2) that is regularly carried on, and (3) is not substantially related to the organization’s tax-exempt purposes.
- An exception generally applies for passive investment income such as interest, dividends, royalties, certain rental income, and gains or losses from the disposition of property. However, if the assets that produce these categories of income are debt-financed, the debt-financed portion of the income is treated as UBTI and subject to tax.
- Additional exceptions apply for income arising from volunteer labor and sales of donated merchandise.

Unrelated Business Income Tax

- Historically organizations could offset income from one line of unrelated business activity against losses from another line of unrelated business activity.
- The tax bill enacted in December 2017 contained a provision that requires UBTI to be calculated separately with respect to each unrelated trade or business. These new rules will apply for tax years beginning after December 31, 2017.
- Guidance is needed regarding how a line of trade or business is defined and should also address the treatment of trades or businesses carried out through pass-through organizations such as partnerships or limited liability companies treated as partnerships for federal tax purposes.
- These rules will likely increase an organization's UBTI.

IRC Section 4958 – Excess Benefit Rules

- IRC Section 4958 imposes excise taxes on "excess benefits" received by disqualified persons of an "applicable tax-exempt organization." An excess benefit is a benefit received by the disqualified person that exceeds the fair market value of any goods or services provided by the disqualified person in exchange for the benefit.
  - For example, it would not include payment of a reasonable salary to an officer. But it would include an officer's receipt of $1,000 for the sale of property that is only worth $500. The excess $500 constitutes an "excess benefit".
- "Applicable tax-exempt organizations" include Section 501(c)(3) organizations that are classified as public charities and Section 501(c)(4) social welfare organizations, but do not include Section 501(c)(6) business leagues. Section 501(c)(3) private foundations are subject stricter prohibitions on transactions between disqualified persons and the organizations under IRC Section 4941.

Excise Taxes Applicable to Private Foundations

- IRC Section 501(c)(3) charitable organizations that are classified as private foundations are subject to several additional excise tax provisions. The reason for these more stringent rules generally arises from the "closely controlled" nature of most private foundations as compared to public charities.

- These include a 2% excise tax on net investment income under IRC Section 4940, excise taxes on transactions between disqualified persons and the private foundation under IRC Section 4941, excise taxes on certain excess business holdings under IRC Section 4943, excise taxes on jeopardizing investments under IRC Section 4944, and excise taxes on certain impermissible "taxable expenditures" under IRC Section 4945.

Q&A

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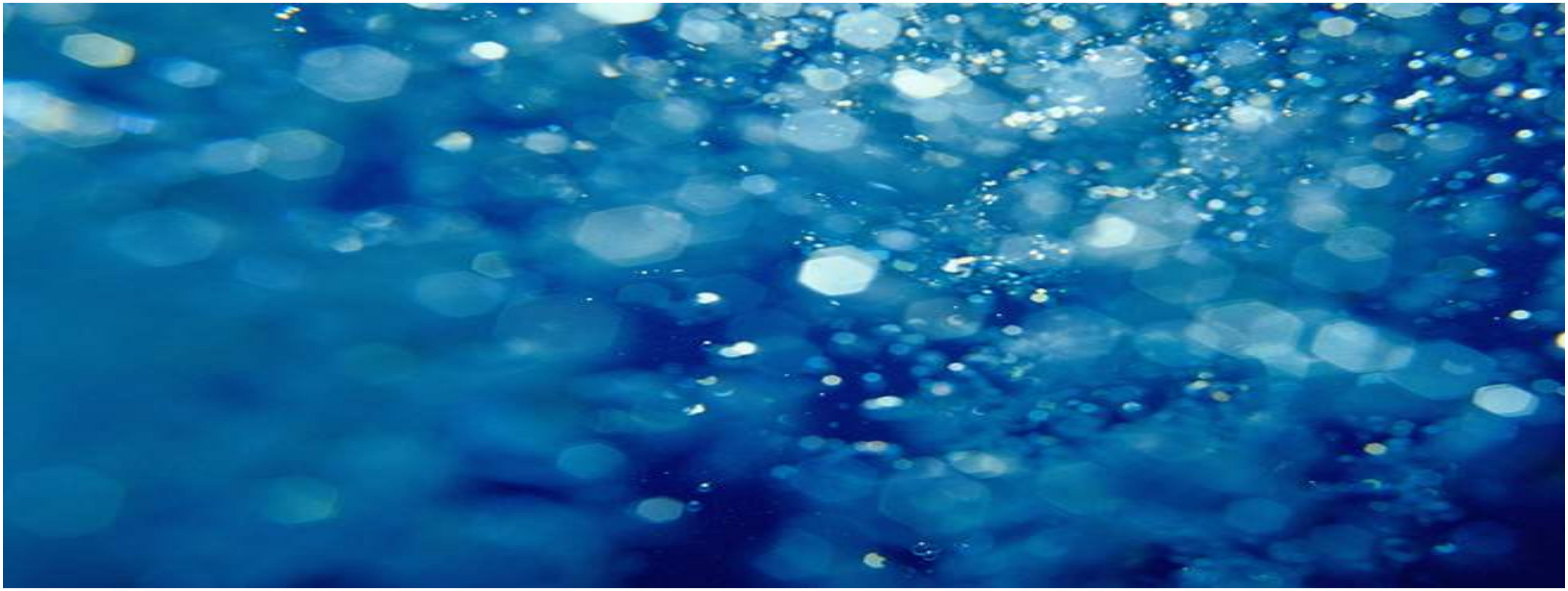

So, you have a tax dispute with the Texas Comptroller. Now what?

Tax Law in a Day
February 9, 2018

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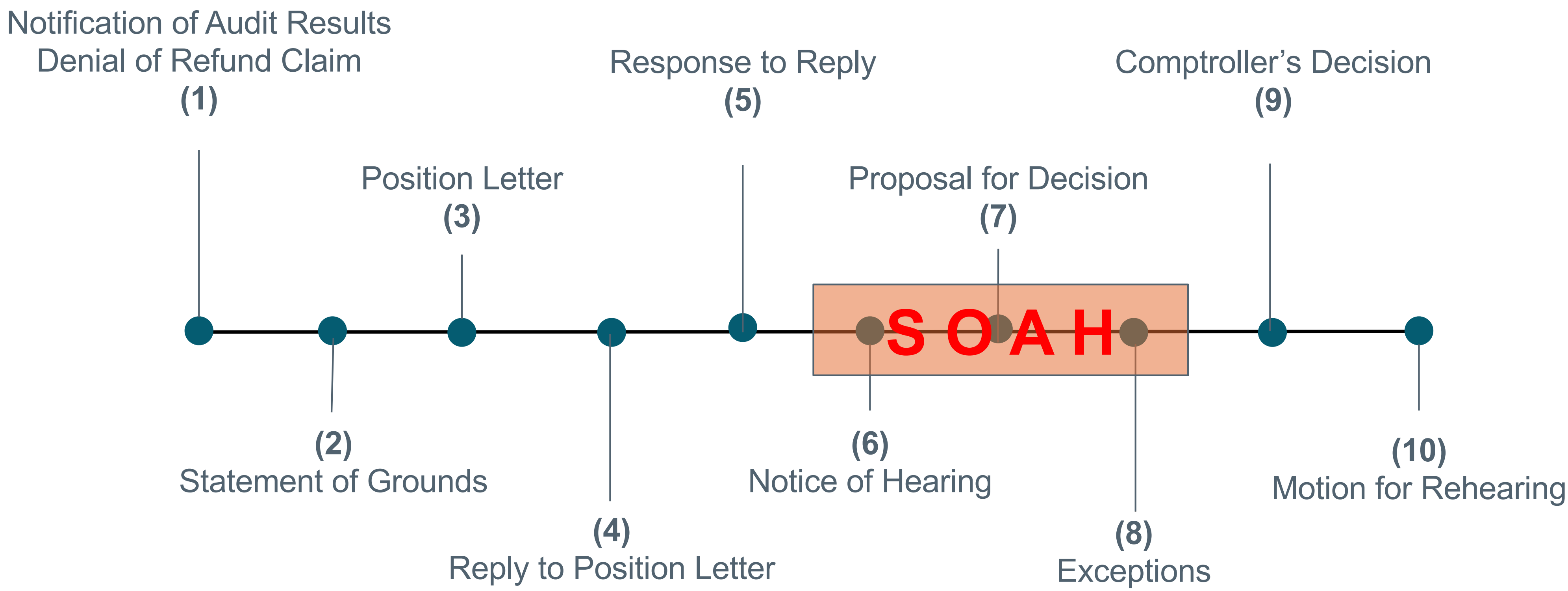
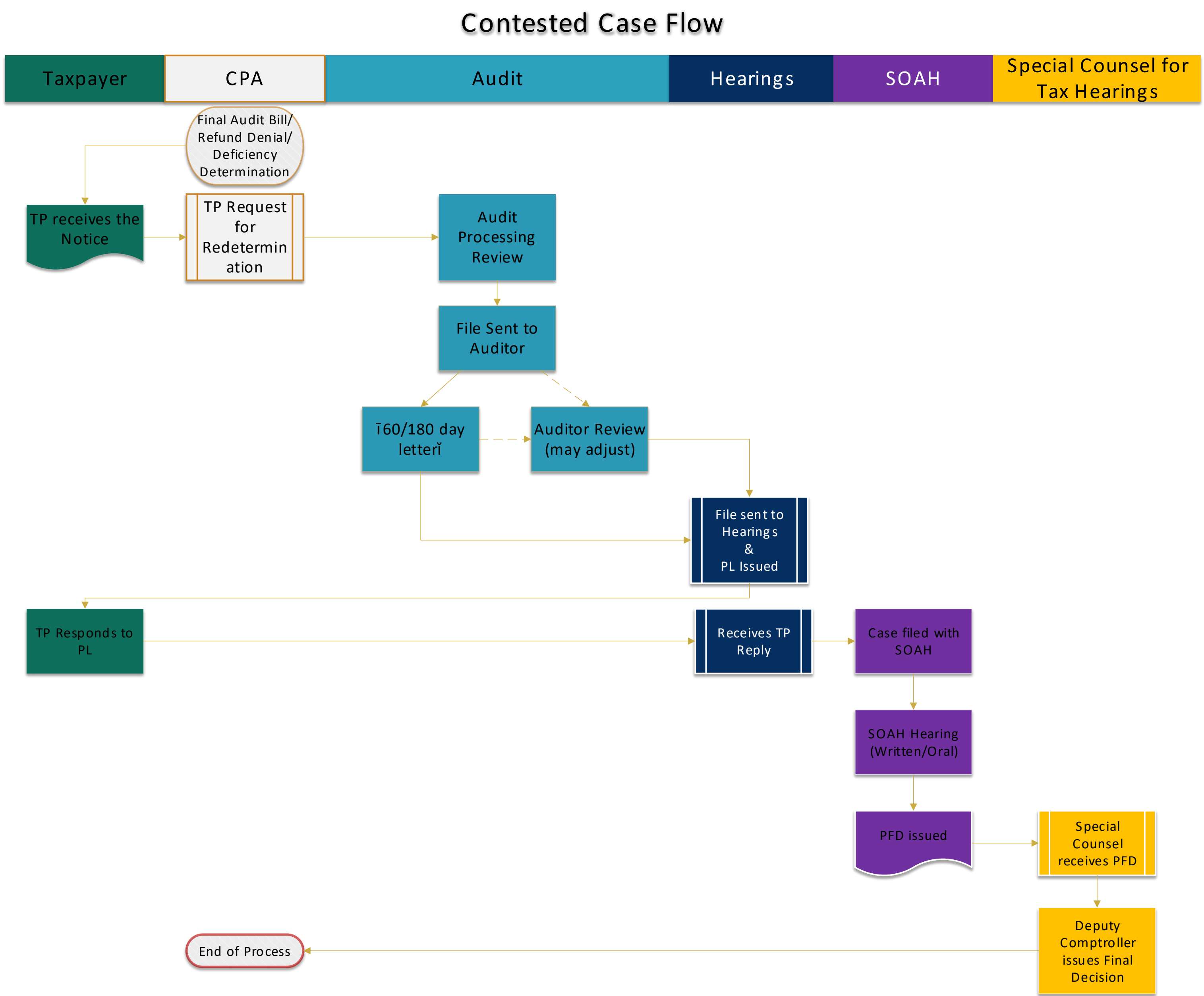
An Overview of the Contested Case Process

From 10,000 Feet…



Comptroller View…



Key Procedural Provisions

- Texas Tax Code Chapter 111, esp. § § 111.009 (Redetermination) & 111.105 (Tax Refund: Hearing)
- 34 Texas Administrative Code § § 1.1 – 1.42

And when before SOAH:

- Texas Government Code Chapters 2001 & 2003
- 1 Texas Administrative Code Chapter 155

Other provisions:

- Texas Rules of Civil Procedure
- Texas Rules of Evidence

Where to File and Serve

- **Statement of Grounds** – Comptroller’s office address indicated on notification of audit results or refund denial
- **Reply to Position Letter** – Assistant General Counsel
- **Exceptions** – SOAH; service on AGC
- **Motion for Rehearing** – Comptroller’s Office of Special Counsel; service on AGC

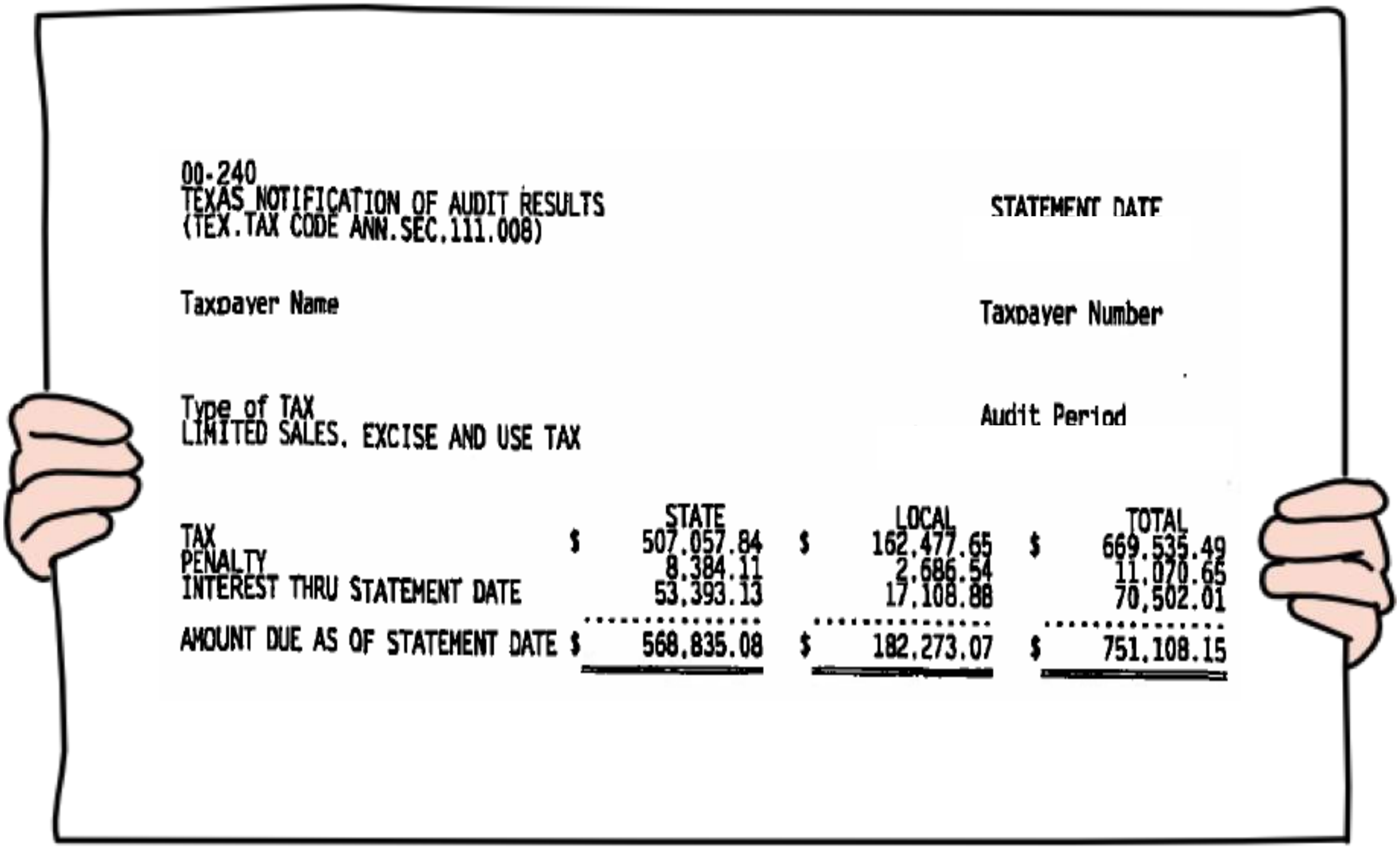
The Process in More Detail…

But First, Several Preliminary Considerations…

Assess the process's fit to the taxpayer's issues:

- Is it a refund claim?
- Can the taxpayer pay the audit assessment?
- Does it involve detrimental reliance, insolvency, etc.?
- Is there settlement possibility?
- What factual/legal issues are in dispute, and what is the likelihood of success?
- What are the taxpayer's goals?

Taxpayer Notice



00-240
TEXAS NOTIFICATION OF AUDIT RESULTS
(TEX.TAX CODE ANN.SEC.111.008)

STATEMENT DATE

Taxpayer Name

Taxpayer Number

Type of TAX
LIMITED SALES, EXCISE AND USE TAX

Audit Period

		STATE		LOCAL		TOTAL
TAX	$	507,057.84	$	162,477.65	$	669,535.49
PENALTY		8,384.11		2,686.54		11,070.65
INTEREST THRU STATEMENT DATE		53,393.13		17,108.88		70,502.01
AMOUNT DUE AS OF STATEMENT DATE	$	568,835.08	$	182,273.07	$	751,108.15

Taxpayer Options

Request for Redetermination

Make a Payment

Statement of Grounds

Due 60 days* from date of deficiency determination (shorter if jeopardy determination) or refund denial

- Reasons the taxpayer disagrees with Comptroller action
- List disagreed items
- Factual basis and legal grounds for taxpayer position
- SOG may be amended up to time that Reply to Position Letter is due
- Don't forget Power of Attorney

**But see* 34 Tex. Admin. Code § 1.5 (not yet updated to reflect 60-day period).

Request for Redetermination and Statement of Grounds

RE: [redacted]	§	BEFORE THE COMPTROLLER
	§	
	§	
TAXPAYER NO. [redacted]	§	OF PUBLIC ACCOUNTS
	§	
FRANCHISE TAX	§	
	§	OF THE STATE OF TEXAS
AUDIT PERIOD [redacted]	§	
	§	

PETITIONER'S PETITION FOR REDETERMINATION AND STATEMENT OF GROUNDS

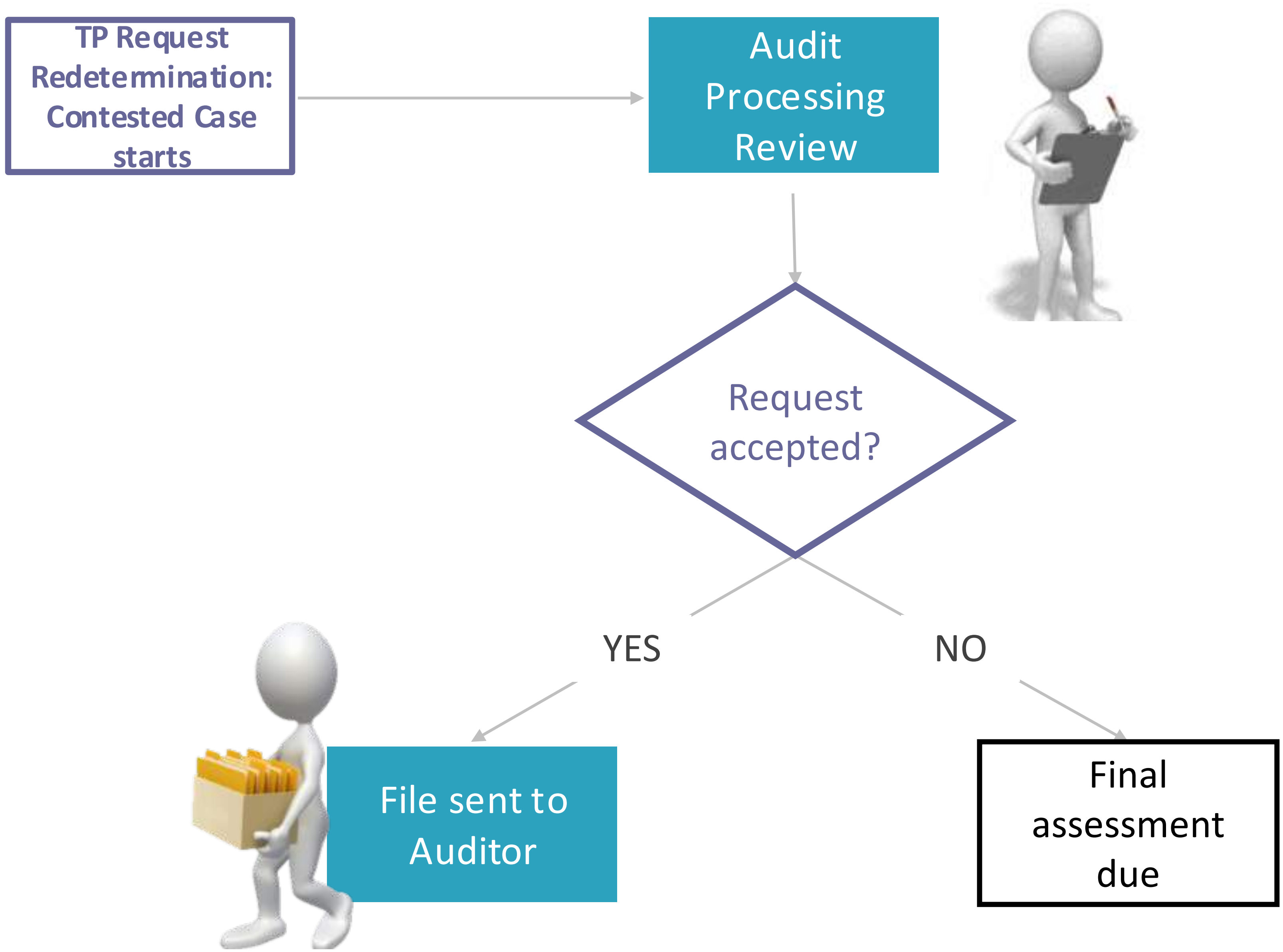
Petitioner, [redacted], located at [redacted], hereby makes and files this, its Petition for Redetermination and Statement of Grounds setting forth Petitioner's disagreement with the Comptroller's assessment of Texas Franchise Tax, and the interest thereon, in the total amount of [redacted] plus any additional interest accruing on the unpaid tax balance of [redacted] for the period [redacted] as more particularly set out in the Texas Notification of Audit Results dated [redacted], and attached hereto as **Exhibit A**. In support thereof, Petitioner submits the following:

I.

SUMMARY OF AUDIT DISPUTE

Petitioner filed a separate return for the [redacted] report year as did Petitioner's related corporations, [redacted] and [redacted]. Petitioner and the related corporations calculated taxable margin by deducting cost of goods sold ("COGS"). The auditor combined the reports for the three entities and disallowed portions of Petitioner's and [redacted] COGS deductions.

Audit Processing Review



Audit

File sent to Auditor → "60/180 day letter" → Dispute resolved?

YES → Final assessment due

NO → File sent to Hearings

Tips for Dealing with Audit

Practitioners' Corner

- Be prepared
- Be mindful
- Be responsive

CPA Advice

- Taxpayer at Entrance Conference
- Auditor work space
- Records / Honesty
- Communicate
- Deadlines
- Be collaborative

Administrative Hearing Section

File sent to Hearings

Position Letter sent to TP

TP replies to PL

YES

Case filed with SOAH

NO

~~(or agrees with PL)~~

Final assessment due

Reply to Position Letter

Due 45 days after Position Letter is dated

- AGC provides taxpayer a “Selection Form” on which to indicate whether taxpayer agrees/disagrees with Position Letter.

- If taxpayer disagrees, include in Reply any additional facts, legal arguments, or documents, and address unresolved contentions.

Tips for Dealing with Administrative Hearings

Practitioners' Corner

- Be proactive
- Keep track of deadlines
- Make a record of important discussions
- Be mindful of audience

CPA Tips

- Know SOAH and AHS rules
- Ask questions
- Keep the attorney informed
- Be patient
- Use the pro se guide
- Options: settle, penalty waiver, insolvency…

Oral or Written Hearing?

Several considerations:

- What are the taxpayer’s goals?
- What is the amount at issue?
- Does the case involve complex legal or factual issues?
- Is the taxpayer’s intent at issue?
- Does Tax Division have the burden of proof?

SOAH

Case filed with SOAH

SOAH hearing (Oral or Written)

PFD issued

SOAH DOCKET NO. [redacted]
TCPA DOCKET NO. [redacted]

[redacted] Taxpayer No. [redacted]	§	BEFORE THE STATE OFFICE
v.	§	OF
TEXAS COMPTROLLER OF PUBLIC ACCOUNTS	§	ADMINISTRATIVE HEARINGS

PROPOSAL FOR DECISION

[redacted] (Claimant) is a [redacted] corporation that filed a refund claim as an assignee of [redacted]. The Tax Division (Staff) of the Texas Comptroller of Public Accounts (Comptroller) denied the entire claim because Claimant failed to provide any supporting documentation. Claimant requested a refund hearing, but it failed to submit any contested case evidence. In this Proposal for Decision, the Administrative Law Judge (ALJ) recommends that Staff's refund denial be affirmed.

I. PROCEDURAL HISTORY, NOTICE, AND JURISDICTION

Staff referred this case to the State Office of Administrative Hearings (SOAH) and, on [redacted] issued a Notice of Hearing by Written Submission. On June 1, 2016, ALJ Victor John Simonds issued Order No. 1, which set the written submission hearing. Staff was represented by Assistant General Counsel Robert E. Scott, and Claimant was represented by [redacted] The contested case record closed on [redacted]. There are no issues of notice or jurisdiction; therefore, those matters are set out in the Findings of Fact and Conclusions of Law without further discussion.

Exceptions

Due 15 days after service of PFD

Reply to Exceptions due 15 days after Exceptions filed

- Submitted to SOAH to express any disagreements with the PFD

- ALJ will review and notify the Comptroller’s office and parties if he/she recommends any changes to the PFD.

Deputy Comptroller & Special Counsel

SOAH DOCKET NO. [redacted]
CPA HEARING NO. [redacted]

RE: [redacted]	§	BEFORE THE COMPTROLLER
	§	OF PUBLIC ACCOUNTS
	§	OF THE STATE OF TEXAS
	§	
TAXPAYER NO: [redacted]	§	GLENN HEGAR
AUDIT OFFICE:	§	Texas Comptroller of Public Accounts
	§	
AUDIT PERIOD: [redacted]	§	SHANNON BRANDT
	§	Representing Tax Division
	§	
	§	[redacted]
Sales And Use Tax/RFD	§	Representing Claimant

COMPTROLLER'S DECISION

For a hearing under the APA set by SOAH *on and after* September 1, 2015:

This decision is considered final on Sept. 12, 2019 **unless a motion for rehearing is timely filed; this date of finality is calculated based on the Administrative Procedure Act (APA).**[1] *See attached:* "Frequently Asked Questions Related to Motions for Rehearing." **The failure to timely file a motion for rehearing may result in adverse legal consequences.**

Administrative Law Judge (ALJ) Peter Brooks of the State Office of Administrative Hearings (SOAH) issued a Proposal for Decision (PFD) that includes Findings of Fact and Conclusions of Law. SOAH served the PFD on each party and each party was given an opportunity to file exceptions and replies with SOAH in accordance with SOAH's rules of procedure. The ALJ recommended that the Comptroller adopt the PFD as written.

After review and consideration, IT IS ORDERED that the PFD is adopted as written.

The result from this Decision is Attachment A. The ALJ's letter to the Comptroller is Attachment B. The PFD as written is Attachment C. Attachments A, B and C are incorporated by reference.

Attachment A reflects a zero amount due.

- PFD issued
- Special Counsel for Tax Hearings receives PFD
- Audit Processing issues Final Figures
- Deputy Comptroller issues Final Decision

Motion for Rehearing

Due 25 days after Comptroller's Decision is signed

Reply to Motion due by 40th day after decision is signed

- Prerequisite for tax refund lawsuit
- Identify with particularity FOFs and COLs with which taxpayer disagrees and any evidentiary or legal ruling claimed to be erroneous
- Legal and factual basis for claimed error
- With respect to refund claim, each specific ground of error and state amount of refund sought

Now What Else?

Comptroller is not required to act on Motion for Rehearing.

Motion for Rehearing is overruled by operation of law on the 55th day (or 100th day if extension was granted) after Decision is signed, and Comptroller's Decision becomes final.

- If audit assessment, payment due
  - Payment under protest followed by suit in district court
- If refund claim, suit in district court within 30 days of Motion for Rehearing denial

Some Takeaways and Final Thoughts

- Assess the process's fit to the taxpayer's issues
- Know which procedural rules apply at each stage
- Make sure you're using up-to-date procedural rules
- Settlement or stipulations?
- Texas Tax Code Chapter 112

Questions?

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Personal Liability for Tax Assessments of a Business

2018

This teaching manual provides information on general tax issues and is not intended to provide advice on any specific legal matter or fact situation. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this information without seeking professional counsel.

Instructor

Jimmy Martens, trial and appellate attorney, is the founding partner

of Martens, Todd, Leonard & Ahlrich, a boutique tax litigation law firm located in downtown Austin, Texas. Mr. Martens has handled the trial of tax cases and related appeals all the way through both the Texas Supreme Court and the U.S. Supreme Court.

His recent Texas Supreme Court cases include: *Combs v. Roark Amusement & Vending*, L.P., 422 S.W.3d 632 (Tex. 2013); *In re: AllCat Claims Service, L.P.*, 356 S.W.3d 455 (Tex. 2011); and *Titan Transportation, L.P. v. Combs*, 433 S.W.3d 625 (Tex. App.—Austin 2014, pet. denied).

His recent appellate cases include: *Combs v. Newpark Resources, Inc.*, 422 S.W.3d 46 (Tex. App.—Austin 2013, no pet.); *Hegar v. CGG Veritas Services (U.S.), Inc.*, No. 03-14-00713-CV, 2016 Tex. App. LEXIS 2439 (Tex. App.—Austin Mar. 9, 2016, pet. withdrawn); *Graphic Packaging Corp. v. Hegar*, 471 S.W.3d 138 (Tex. App.—Austin 2015, pet. filed); *Hegar v. Gulf Copper & Manufacturing Corporation*, No. 03-16-00250-CV, 2017 WL 3471064 (Tex. App.—Austin Aug. 11, 2017, pet. filed); and *OGCI Training, Inc. v. Hegar*, No. 03-16-00704-CV (Tex. App.—Austin Oct. 27, 2017, no pet. h.).

He limits his law practice to Texas tax and multi-state tax controversies and litigation. He is board certified by the Texas Board of Legal Specialization in Tax Law.

Mr. Martens is vice-chair of the Texas State Bar Tax Controversies Committee, a former council member of the Tax Section for the State Bar of Texas and the former chair of the CLE Committee. He is also a CPA and teaches for the Texas Society of CPA's statewide courses on Texas franchise and sales tax. Mr. Martens received his B.B.A. and J.D. from The University of Texas at Austin, both with honors.

Mr. Martens may be reached by e-mail at **jmartens@textaxlaw.com** or by telephone at **(512) 542-9898**. Visit www.texastaxlaw.com for blog post updates regarding trending issues in Texas tax law.

Table of Contents

I. Is Mr. Moore Personally Liable for the Corporation's Tax Assessment?

Bill Moore walks into your office and hires you to defend a lawsuit. The State of Texas has sued him personally, seeking to recover over $500,000 in sales taxes, penalties, and interest supposedly owed by Coastal Furnishings, Inc., a corporation for which he served as CFO. The now-defunct corporation sold specialty furniture until it closed its doors at the end of 2010 and filed for bankruptcy. You read the assessment certificate attached to the State's petition and learn that the sales tax liability period spanned 2011-2014, which is ***after*** the business closed its doors.

Further, you find a letter from the State dated July 1, 2011, notifying Coastal Furnishings of its failure to file its 2011 Texas franchise tax report. Upon further investigation, you learn that Coastal Furnishings failed to file its 2011 report when due on May 15, 2011. The bankruptcy trustee filed the report exactly one year later.

You file an Open Records Act request and learn that in 2015, the Comptroller's auditor went to Coastal Furnishings' former location and saw that the business was gone. Following agency procedure, the auditor created an estimated assessment under which the auditor multiplied Coastal Furnishings' highest monthly sales by 120%. The highest monthly sales occurred in September of 2009, when business was booming. It was easy for the auditor to find this amount because it was shown on Coastal Furnishings' sales tax report that it filed for September of 2009.

The auditor then presumed that this level of sales had occurred each month of the three-year period spanning 2011-2014. The auditor further assumed that Coastal Furnishings had collected taxes at 8.25% on these estimated sales and failed to pay them over to the Comptroller. The auditor prepared an assessment notice for $500,000: $300,000 sales tax, $150,000 penalty (for failing to pay the $300,000 to the Comptroller) and another $50,000 interest. The auditor then mailed the assessment notice to Coastal Furnishings' former location, as required by the rules.

Since no one was there to receive the assessment notice, the 30-day period for challenging it lapsed. The assessment became final against Coastal Furnishings. When the Comptroller realized that both Coastal Furnishings' assets and shareholders were gone, the State filed suit against Mr. Moore demanding that he personally pay the full $500,000 plus attorney's fees.

Unfortunately, this fact pattern is all too common. The Comptroller has several grants of statutory authority to impose personal liability for Texas sales and use tax otherwise owed by a business. This paper addresses the most common statutory vehicles for personal state tax liability, including those relevant to Mr. Moore.

II. Challenging the Underlying Assessment

A taxpayer cannot directly lower a delinquent corporate tax assessment by presenting proof that taxes are not owed.[1] However, our firm has found that the state's attorneys will often consider the defendant's evidence on this point. In one recent case, we were able to show that the alleged tax liability had, in fact, been fully paid by another individual. As a result, the state's attorney agreed to remove the assessment.

Moreover, as we discuss below, challenges to the underlying assessment are available as a defense to some of the laws invoked to impose personal liability.

Statute of Limitations. In general, the Comptroller has four years from the date a tax becomes due and payable to assess a deficiency tax liability.[2]

However, the statute of limitations does not apply if:[3]

- The taxpayer files a false or fraudulent sales tax return with the intent to evade the tax;
- The taxpayer fails to file a sales tax return; or
- The taxpayer files a sales tax return that has gross error.

In these three circumstances, the Comptroller may assess and collect taxes, penalties, and interest against a taxpayer at *any time*- even if a business has ceased operations.

III. Franchise Tax Reporting and Payment Failures.

Corporate officers, directors, managing members of LLCs, and others may become personally liable for the debts of a corporation, including taxes, in several circumstances. The same is true for managing members of LLCs and other persons serving in similar capacities for other types of business entities.[4]

Types of Entities. The Texas Tax Code defines a "taxable entity" broadly, extending the list of entities that could forfeit privileges to include partnerships, limited liability partnerships, corporations, banking corporations, savings and loan associations, limited liability companies,

[1] Comptroller Hearing No. 105,174 (STAR No. 201308771H) (August 29, 2013) (Petitioner's redetermination hearing is limited to issues of personal liability).

[2] 34 Tex. Admin Code § 3.339(a)(1).

[3] 34 Tex. Admin Code § 3.339(a)(2) ("Gross Error" exists when the amount of tax due and payable, after the correction of error, exceeds the amount of tax reported on the return by at least 25%).

[4] Tex. Tax Code § 171.2515.

business trusts, professional associations, business associations, joint ventures, joint stock companies, holding companies, or other legal entities.[5]

However, the definition of "taxable entity" does not include sole proprietorships, general partnerships entirely composed of natural persons, passive entities, and some exempt organizations.[6]

> ***Note:*** Prior to 2008, the provisions of Texas Tax Code § 171.251 only extended to corporations and LLCs.[7] However, the revised statute expands the scope of § 171.251 to the broad list of entities above.[8]

Forfeiting Entity Privileges. A taxable entity may forfeit its privileges for (1) failing to file a franchise tax report, (2) failing to pay a tax or penalty when due, or (3) failing to allow the Comptroller to examine its books and records. [9]

Under the franchise tax statute, a business entity's state law privileges may be forfeited in three instances:

- The business entity fails to *file* its franchise tax report within 45 days after the Comptroller sends notice of forfeiture,
- The business entity fails to *pay* its franchise tax and any penalty within 45 days after the Comptroller sends notice of forfeiture, or
- The business entity does not allow the Comptroller to examine its records when requested to do so.[10]

Notice of Forfeiture. The Comptroller must give notice of its intent to forfeit the privileges, but the notice has to be sent only to the corporation's last known address.[11]

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5 Tex. Tax Code § 171.0002(a).

6 Tex. Tax Code § 171.0002(b).

7 *See Bruce v. Freeman Decorating Servs.*, 2011 Tex. App. LEXIS 6451 (Tex. App.–Houston [14th Dist.], pet. denied) (Noting that both the former and current versions of Chapter 171 impose liability on officers and directors of both corporations and LLCs).

8 *Id.;* Tex. Tax Code § 171.0002(a).

9 Tex. Tax Code § 171.251.

10 *Id.*

11 Tex. Tax Code § 171.256.

No Notice Required for Officer & Director Liability. The Comptroller is not required to provide notice before imposing liability on directors or officers for debts of a corporation incurred during a period of forfeiture of corporate privileges.[12]

The Third Court of Appeals has held that the statutory notice requirements under Texas Tax Code § 171.256 are not conditions precedent to imposing officer and director liability under Texas Tax Code § 171.255 for debts of a corporation incurred during a period of forfeiture of corporate privileges.

In *Greene*, Third Court of Appeals held that the sole officer and director of a bankrupt jewelry business was personally liable for the business's unpaid Texas sales tax liability incurred during periods of time when the business's corporate privileges were forfeited because it failed to report and pay franchise taxes. The Third Court of Appeals rejected Greene's argument that the Comptroller could not hold him personally liable for the unpaid sales taxes because the Comptroller did not provide copies of the notices it sent and the addresses to which the Comptroller sent the notices.

Effect of Forfeiture. If corporate privileges are forfeited, then each director or officer of the corporation is jointly and severally liable for each debt of the corporation that is created or incurred after the date the report or tax is due.[13] This creates the same effect as though the officers and directors were each partners in a partnership.

***Note*:** Under Texas Tax Code § 171.2515, it would seem that the same rule would apply to managing members of LLCs and persons serving in similar capacities of other entities like LPs and LLPs. However, the scope of this provision is unclear at this time.

This period of personal liability continues through the date the corporate privileges are revived, but not for debts incurred thereafter.[14]

Jeff Kaiser, PC v. State. In *Jeff Kaiser, PC v. State*, an attorney was held liable for the franchise tax debts of his defunct PC, for which he served as the sole officer and director.[15] Kaiser operated his law practice as a professional corporation ("PC") until 2003, when he forfeited its business privileges by failing to file Texas franchise tax reports. After 2003, he filed for Chapter 7 bankruptcy and continued to practice law as a sole proprietorship. In 2008, during his bankruptcy proceedings, Kaiser filed franchise tax reports for the defunct PC for report years 2004-2008 reporting income from his solo

[12] *Greene v. State of Texas*, 324 S.W.3d 276 (Tex. App.—Austin, August 26, 2010).

[13] Tex. Tax Code § 171.255(b).

[14] Texas Tax Code § 171.255(a).

[15] *Jeff Kaiser PC, et. al v. Texas*, 2016 Tex. App. LEXIS 4074 (Tex. App.−Austin Apr. 20, 2016, pet. denied).

law practice after the PC's charter was forfeited. In 2013, the state filed suit to collect the franchise tax owed from 2004-2008.

The Court held that Kaiser's obligation to pay the taxes is imposed by the state and written into the tax code. Kaiser was held personally liable for the franchise tax debts of the defunct PC.

Consequences. If the entity's privileges are forfeited, each director or officer of the entity is liable for each debt of the entity that is created or incurred after the date of forfeiture. This period of personal liability continues through the date the entity privileges are revived,[16] but not for debts incurred thereafter.

The Comptroller must prove that the tax liability arose after the franchise tax forfeiture occurred.[17]

Comptroller Policy. In Comptroller Hearing No. 102,745, the Comptroller assessed the Petitioner for sales tax obligations incurred by a business entity during periods where corporate privileges were forfeited.[18] The Petitioner argued that the liability should be paid by the current owners of the business, not a prior officer or director. The Comptroller rejected this argument and held that Petitioner did not meet his burden of proof to show that the assessment should be dismissed.

When is a Debt "Incurred"? Debt is not "incurred" for purposes of officer/ director liability until it is liquidated.[19]

Defenses. An officer or director is not liable for the corporation's debt if that debt was created or incurred without his knowledge and the exercise of reasonable diligence would not have revealed the intention to create the debt.[20] However, the officer or director has the burden of proof.[21]

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[16] Texas Tax Code § 171.2515.

[17] *In re Cooley*, 166 B.R. 85 (Bankr. S.D. Tex. 1993).

[18] Comptroller Hearing No. 102,745 (STAR No. 201003365H) (Mar. 29, 2010).

[19] *Cain v. State*, 882 S.W.2d 515 (Tex. App.−Austin 1994, no pet.).

[20] Tex. Tax Code § 171.255(c).

[21] Tex. Tax Code § 171.255(c)(1) & (2).

***Hovel v. Batzri*.** The Court of Appeals in Houston recently held that the sole manager of a limited liability company could not be held personally liable for the company's debt that was created or incurred before the limited liability company failed to pay its Texas franchise taxes.[22] The Hovels hired a contractor (the "LLC") to build a custom home, and then sued for its breach when the LLC delivered the home late and with construction defects. While the breach of contract suit was pending, the LLC failed to pay its franchise taxes which resulted in the forfeiture of its corporate privileges. In a subsequent suit, the Hovels contended that the sole manager of the LLC was personally liable for the judgment that they had obtained against the LLC. Thus, the Houston Court of Appeals had to determine when the debt was incurred. The Court held that the debt was incurred at the time the parties entered into the contract, which was executed before the LLC forfeited its corporate privileges. As a result, the sole manager was not personally liable for the amount of the judgment versus the LLC.

Comptroller Policy. In Comptroller Hearing No. 100,437, the Comptroller issued an assessment against a taxpayer personally for the outstanding mixed beverage gross receipts tax liability of a company after its entity privileges were forfeited.[23] Comptroller Staff was unable to present sufficient evidence to prove that the taxpayer was an officer or director during the relevant period of forfeiture. The evidence presented showed that the taxpayer was an officer or director of the entity in prior years, but not during the period of forfeiture. As a result, the Comptroller held that the taxpayer was not personally liable for the gross receipts tax liability of the business.

Reviving Privileges. Corporate privileges may be revived by filing the applicable franchise tax report and paying the tax, penalty or interest due before the corporate charter or certificate of authority is forfeited.[24]

Revival Does Not Cure Interim Liability. Even if the corporate privileges are revived, the liability for debts incurred during the interim period is not affected.[25] Because personal liability is severe and essentially penal in nature, the courts show a tendency to strictly construe the wording and interpretation of the statutes in favor of the officer or director.[26]

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[22] *Hovel v. Batzri*, 2016 Tex. App. LEXIS 2127 (Tex. App.–Houston [1st Dist.] 2016, no pet. h.).

[23] Comptroller Hearing No. 111,437 (STAR No. 200912245H) (Dec. 9, 2009).

[24] Tex. Tax Code § 171.258.

[25] Tex. Tax Code § 171.255(d).

[26] *See McKinney v. Anderson*, 734 S.W.2d 173 (Tex. App.–Houston [1st Dist.] 1987, no pet.).

Resigning Officers and Directors. In the case of the resignation of a director or officer, the resigning director or officer remains personally liable for sales tax incurred prior to the date of the resignation but not after the resignation date.

IV. Failing to Pay Over Collected Taxes

A. Responsible Individual Liability. When a business collects taxes, but does not pay them over to the Comptroller, Texas law imposes personal liability on the individual who collected the taxes.[27] A person who receives or collects money that the payor represents to be a tax holds the amount in trust for the benefit of the state. This 'trustee' relationship creates personal liability for the amount collected, until that amount is remitted to the state.[28] Personal liability applies to any money represented to be a tax, as well as to penalties and interest.

Personal liability may also be attributed to anyone who supervises or controls the collection, accounting, or payment of a tax.[29] The Comptroller is not required to show that a responsible person converted taxes for his own personal use in order to be held personally liable for the funds collected by a business entity.[30]

Broad Scope. The statute broadly defines a person "responsible for the collection of the tax."[31] The definition includes any officer, manager, director or employee of a corporation, association or limited liability company or a member of a partnership, who is under a duty to perform an act with respect to the collection, accounting or payment of a tax or money.

Caution: This may include tax preparation professionals.

> *Example:* Brian owns a shoe store that sells fancy hiking boots. Brian oversees three employees, a salesperson, a manager, and a bookkeeper, who assist him in daily operations. The employees charge sales tax on each pair of shoes sold. The bookkeeper is responsible for filing the sales tax reports.
>
> Here, Brian and the bookkeeper are persons potentially responsible under these provisions.

[27] *See generally* Tex. Tax Code § 111.016.

[28] Tex. Tax Code § 111.016(a).

[29] Tex. Tax Code § 111.016(b).

[30] *State v. Mink*, 990 S.W.2d 779 (Tex. App.–Austin 1999, pet. denied).

[31] *See* Tex. Tax Code § 116.016(d)(1).

Caution. The current statute shifts the burden of proof when a person files, or causes to be filed, a return or report showing tax due. Filing a report that shows tax creates the presumption that the person received or collected a tax. The taxpayer can rebut the presumption by providing satisfactory documentation that the tax was not collected.[32]

This presumption is poorly worded, and could allow the Comptroller to presume tax was collected in circumstances that the Legislature likely did not intend.

If a company files a sales tax return showing tax due for some, but not all of its sales, the Comptroller could create the presumption that the company collected but did not remit the tax. This increases the possibility that officers and employees could be found personally liable for all sales tax assessments.

Also, the statute does not state that the burden of proof shifts when the company files a tax return or report showing *sales* tax due, but merely when a report is filed showing "tax due." The Comptroller and the courts could interpret this to mean that it can be presumed that sales tax was collected, even if the company files a franchise tax return showing tax due.

> *Example 1*
>
> Bob is the owner and officer of Bob's Grocery, a Texas retailer. Bob's Grocery sells food products, soft drinks, and household goods. It properly charges sales tax when it sells household goods, but Bob incorrectly believes that soft drinks are food products and therefore exempt from sales tax. Hence, he does not charge sales tax when he sells food products or soft drinks. Bob files a sales tax return showing tax due for the sales of household goods. He is eventually audited and assessed tax on the sales of soft drinks. The Comptroller can presume that Bob's Grocery collected, but did not remit, sales tax on the soft drinks. This means Bob could be personally liable for the tax deemed to be collected. To rebut the presumption, Bob must show satisfactory documentation that sales tax was not collected on the sale of soft drinks.
>
> *Example 2*
>
> Fred remodels office parks. He files a franchise tax return showing tax due, but incorrectly believes that he does not have to charge his customers sales tax. It is arguable under the new statute that the Comptroller could create the presumption that Fred collected and did not remit sales tax for his remodeling services simply because he filed a franchise tax return showing tax due.

[32] Tex. Tax Code § 111.016(a-1).

How Does the Comptroller Prove that an Individual is a "Responsible" Individual?

i. Tax Collected Not Remitted. First, it depends on whether the sales tax was actually collected from customers. Proof that a business charged a customer for tax may be shown by invoices, while proof that a customer paid sales tax may be shown by receipts and bank deposits. Proof that a business failed to remit collected taxes may be shown by the business's tax reports and bank records.

Note**:** A responsible individual must remit taxes collect on out-of-state sales, even where such collections were erroneous.[33]

ii. Controlling or Supervisory Role. Whether an individual can be held personally liable also depends on whether he had a controlling or supervisory role over the business's affairs. Anyone who supervises or controls the collection, accounting, or payment of a tax can be subject to personal liability.[34] This includes any directors, officers, or employees of a business who have *any* role in the company's financial affairs.

Several factors determine whether an individual's role was sufficient to subject him to personal liability. These factors include whether the individual (1) prepared tax returns, (2) signed tax returns, (3) had the authority to write checks on the corporation's account or accounts, (4) had the authority to enter into and/or approve contracts on behalf of the corporation, (5) had the authority to receive and disburse funds on behalf of the corporation, or (6) held an ownership interest in the corporation.[35]

For example, in *Ghashim v. State*, the Third Court of Appeals held that a corporate president was responsible for failing to pay over collected taxes because he was president of the corporation, had signed the sales tax returns for the liability period at issue, had signature authority on the corporation's checking account, and was an individual who made a decision on behalf of the corporation to pay the funds collected to other entities rather than remitting the tax to the state.[36]

iii. Defenses. An individual may have defenses available. To hold an individual personally liable, the State must prove the *actual amount* of taxes collected or received by the company.[37]

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[33] *Chambers v. State*, 2001 Tex. App. LEXIS 1253 (Tex. App.–Austin 2001, no pet.).

[34] *See* Tex. Tax Code § 111.016(a).

[35] *See* Comptroller Hearing No. 40,180 (STAR No. 200303182H) (Mar. 19, 2003).

[36] *Ghashim v. State*, 104 S.W.3d 184 (Tex. App.–Austin 2003, no pet.).

[37] *See* Comptroller Hearing No. 40,180 (STAR No. 200303182H) (Mar. 19, 2003).

For example, in *Parker v. State*, the Comptroller sought to recover past-due taxes owed by a corporation from Parker, individually.[38] Although the Comptroller's certificate is prima facie evidence of taxes owed, the state still has the burden of proof to establish the actual amount of taxes collected but not remitted in order to impose liability on a responsible individual. In this case, the state failed to satisfy its burden to prove how much money was actually collected, so the state could not recover taxes from Parker individually.

The State has the benefit of a legal presumption, which arises when a company files a tax report showing that tax is due.[39] In that instance, the law presumes that the company collected the tax due.[40]

In defense, an individual can argue that the company never collected tax from customers, which he may prove with financial records and invoices that show no tax was charged or collected.[41]

iv. Scope of Liability Limited to Amount Actually Collected or Received. An unrebutted certificate of delinquency only establishes liability against the corporation, not the individual. The Comptroller must prove the actual amount collected or received by the individual.[42]

Further, an individual's personal liability is limited to the amount actually received or collected by the company.[43] The State must prove the *extent* of the individual's liability; the State cannot simply rely on the amount stated in the tax assessment.[44]

In many of these cases, an auditor will estimate the company's sales and issue a tax assessment notice. While this may be sufficient to establish a tax liability against the business entity, it won't be sufficient to establish an individual's personal liability for

38 *Parker v. State*, 36 S.W.3d 616 (Tex. App.−Austin 2000, no pet.).

39 *See Khan v. State*, 2011 Tex. App. LEXIS 7270 (Tex. App.−Austin Aug. 31, 2011, no pet.) (mem. op.).

40 *See* Tex. Tax Code § 111.016(a-1).

41 *Id.*

42 *See N.S. Sportswear v. State*, 819 S.W.2d 230 (Tex. App.−Austin 1991, no pet.).

43 *See id.*; Comptroller Hearing No. 32,094 (STAR No. 9605H1418F01) (May 23, 1996).

44 *See N.S. Sportswear v. State*, 819 S.W.2d 230 (Tex. App.−Austin 1991, no pet.) (Proof by means of the comptroller's certificates, of the full amount of the corporate tax liability, is insufficient); Comptroller Hearing No. 32,094 (STAR No. 9605H1418F01) (May 23, 1996) (No evidence was presented indicating how much tax Petitioner collected or received on behalf of the state).

the corporate tax assessment. The State must prove the *actual amount* of tax collected by the company, or the assessment against the individual must be removed.[45]

In the alternative, even if taxes were collected by the company, an individual may be able to establish a defense using a corporation's accounting methods. Accrual basis taxpayers record sales when they occur, which is when products are shipped or services are performed. This may or may not coincide with the time that cash (which would include the tax) is collected. Therefore, it is difficult to trace these tax collections.

Statute of Limitations. The statute of limitations for the responsible individual is tolled until the first anniversary of the date that the employing entity's liability becomes final. If the entity is the subject of a federal bankruptcy proceeding, the statute of limitations for the responsible individual is stayed until the first anniversary of the date that the bankruptcy proceeding is closed or dismissed.[46]

B. Officer & Director Liability. Corporate officers and directors may also become personally liable for failing to pay over collected taxes. To determine whether an officer or director exercised the requisite financial control, a number of factors should be examined, including, but not limited to, the following:

- Preparation of returns or reports;
- Signing returns or reports;
- Authority to write checks on the corporation's account or accounts;
- Authority to enter into and/or approve contracts on behalf of the corporation;
- Authority to receive and disburse funds on behalf of the corporation; and
- An ownership interest in the corporation.[47]

Comptroller Policy. Comptroller policy shows that the Comptroller has the authority to make an assessment against an officer or director of a corporation that collects, but fails to remit, sales or use tax, based on the provisions of Texas Tax Code § 111.016.

However, the Comptroller does not have authority to make an assessment based on the common law tort of conversion.[48]

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[45] *See id.*

[46] Tex. Tax Code § 111.016(b-1).

[47] Notice of Related Cases, Nov. 1, 1996; Comptroller Hearing No. 31,968 (STAR No. 9605H1417E12) (May 23, 1998); Comptroller Hearing No. 40,180 (STAR No. 200303182H) (Mar. 19, 2003); Comptroller Hearing No. 32,094 (STAR No. 9605H1418F01) (May 23, 1996).

[48] Comptroller Hearing No. 31,968 (STAR No. 9605H1417E12) (May 23, 1998); Comptroller Hearing No. 40,180 (STAR No. 200303182H) (Mar. 19, 2003); Comptroller Hearing No. 32,094 (STAR No. 9605H1418F01) (May 23, 1996).

C. Employee Liability. Any person who receives or collects a tax (such as sales tax) or money that the payor represents to be a tax holds the amount collected in trust for the benefit of the state. As a result of this trustee relationship, the person becomes personally liable for the amounts collected until they are turned over to the state.[49]

V. Intentionally Failing to File a Report, Substantially Understating Tax & Records Misconduct

Personal liability may arise when a business intentionally fails to file a tax report, substantially understates tax on a filed report, or mishandles business records. In each of these circumstances, if an individual in a controlling or supervisory role takes any action that could be traced to a business' failure to file accurate tax reports, he or she may be held personally liable for the tax assessment against the business.[50] While the law states certain factors tending to show personal liability, Comptroller policy shows that alone, (1) the taxpayer's signature on company checks and franchise tax reports, or (2) the taxpayer's role as the sole officer in the company are insufficient to establish personal liability.[51]

A. Failing to File a Report. Personal liability may arise when a business is due to file its sales tax report, but the individual responsible for the report intentionally does not file it.[52]

> *Example:* Frank owns a specialty store, named Three Strikes, which sells signed baseballs as collector's items. Frank employs Wanda as a bookkeeper to maintain Three Strikes' business records. One of Wanda's responsibilities is to file a monthly sales tax report for Three Strikes. In September, Wanda was on vacation and did not file the report. The Comptroller issued an estimated assessment against Three Strikes. Frank may be personally liable for the assessed taxes, due to Wanda's failure to file the report.

B. Substantially Understating Tax. Personal liability may also arise when a business files a sales tax report, but understates the tax by more than 25%.[53] For an individual to incur personal liability, the report must contain an intentionally false statement.[54]

This does not necessarily mean that a business must have malicious intent to commit fraud. In fact, many sales tax reports contain intentional misstatements arising in these circumstances. Often, businesses will divide the amount of taxes they collected during the month by 8.25% and report the resulting figure as both taxable and total sales. In doing so, a business can substantially understate their actual sales, unless all of their sales were taxable. Like failing to

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[49] Tex. Tax Code § 111.016(a).

[50] *See* Tex. Tax Code § 111.0611(a).

[51] *See generally* Comptroller Hearing No. 103,412 (STAR No. 201412027H) (Dec. 12, 2014); Comptroller Hearing No. 105,174 (Star No. 201308771H) (Aug. 29, 2013); Comptroller Hearing No. 111,012 (Star No. 201505214H) (May 6, 2015).

[52] *See* Tex. Tax Code § 111.0611(b)(2).

[53] *See* Tex. Tax Code § 111.0611(b)(3).

[54] *Id.*

file a report, a person in a controlling or supervisory role may incur personal liability for a business' tax assessment if he or she takes any action that could be traced to a business' failure to file accurate tax reports.[55]

C. Records Misconduct. Personal liability may also arise if an individual alters, hides, or destroys records with intent to affect an audit.[56] These types of actions are the hallmarks of tax fraud. If an officer or director destroyed the corporation's records after learning of an audit, he may incur personal liability for the tax assessment against the company.[57]

The State Must Prove Liability. Fortunately for individuals, the State has the burden of proving personal liability in each of these three scenarios.[58] The State must establish that the individual is personally involved in the affairs of the business, and further, the State must present evidence demonstrating the extent of the individual's involvement in the administration of the company's financial activities.[59]

In addition, the State cannot immediately pursue an individual for a business's tax assessment. The Comptroller must first attempt to verify and secure unencumbered assets of the business before seeking to impose liability on an individual.[60] An individual's personal liability is limited to the amount that the tax assessment exceeds the business entity's assets.[61]

VI. Contributing to Tax Evasion

An officer, manager, director, or partner of a taxable entity may be held personally liable for taxes, interest, and penalties (including the 50% fraud penalty) if the individual "took an action or participated in a fraudulent scheme or fraudulent plan to evade the payment of taxes."[62]

Fraudulent Scheme or Plan. Actions that indicate the existence of a fraudulent scheme or plan include:[63]

- Filing a fraudulent return or report;
- Intentionally failing to file a return or report when a return or report is required;

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55 *See* Tex. Tax Code § 111.0611(a).

56 *See* Tex. Tax Code § 111.0611(b).

57 *See* Tex. Tax Code § 111.0611(a).

58 *See generally* Comptroller Hearing No. 105,174 (Star No. 201308771H) (Aug. 29, 2013) (Staff bears the burden of proving by clear and convincing evidence that the assessment of personal liability is warranted).

59 *See* Comptroller Hearing No. 103,918 (STAR No. 201101980H) (Jan. 11, 2011).

60 *See* Tex. Tax Code § 111.0611(c).

61 *Id.*

62 Tex. Tax Code § 111.0611.

63 Tex. Tax Code § 111.0611(b).

- Filing a return or report with an intentionally false statement that results in the amount of tax due exceeding the amount of tax reported by 25% or more;
- Altering, destroying, or concealing records or presenting an altered record to the Comptroller; or
- Otherwise engaging in fraudulent conduct with the intent to affect the course or outcome of a Comptroller investigation or proceeding.

Proving Liability. The Comptroller must first attempt to verify and secure unencumbered assets of the taxable entity before attempting to collect from an individual. The individual is only liable to the extent the total liability exceeds the value of the assets seized from the entity.

The Comptroller has to prove by *clear and convincing evidence* that the taxpayer should be held personally liable.[64] The taxpayer's involvement cannot be inferred. The Comptroller must establish taxpayer was *personally involved* in daily affairs the business and filing of the reports.[65]

This burden is a significant help to the taxpayer. These factors (alone) have been insufficient to establish contribution to a fraudulent scheme:[66]

- Signature on company checks and franchise reports; or
- Role as sole officer in company.

VII. Successor Liability

Successor liability may arise when an individual or a business entity purchases assets of an existing business, and unintentionally assumes the business's tax liability as a result of the purchase.[67] Successor liability could happen in one of two ways: (1) termination of a business entity through a sale or purchase, or (2) a fraudulent transfer of business assets.

General Rule. If an owner of a business owes sales or use tax and then sells the business, the purchaser may become liable for payment of the tax. The buyer of all or part of a business is required to withhold tax from the purchase price. The amount withheld must be sufficient to pay all sales tax, penalties and interest owed by the seller, including any amount that becomes

[64] Comptroller Hearing No. 103,918 (STAR No. 201101980H) (Jan. 11, 2011); Comptroller Hearing No. 111,036 (STAR No. 201405919H) (May 23, 2014).

[65] Comptroller Hearing No. 103,412 (STAR No. 201412027H) (Dec. 12, 2014); Comptroller Hearing No. 105,086 (STAR No. 201409075H) (Sept. 17, 2014); Comptroller Hearing No. 105,386 (STAR No. 201401865H) (Jan. 21, 2014); Comptroller Hearing No. 105,174 (STAR No. 201308771H) (Aug. 29, 2013).

[66] Comptroller Hearing No. 103,412 (STAR No. 201412027H) (Dec. 12, 2014); Comptroller Hearing No. 105,174 (STAR No. 201308771H) (Aug. 29, 2013); Comptroller Hearing No. 111,012 (STAR No. 201505214H) (May 6, 2015).

[67] Tex. Tax Code § 111.020.

due as a result of the sale, until the seller provides the purchaser with either a receipt of the payment from the Comptroller or a certificate stating no tax is due. To avoid liability, a buyer must ensure that the amount withheld is sufficient to fully satisfy the taxes that are due and the purchase price paid must be reasonably equivalent to the value of the business or assets the buyer acquires.[68]

What Constitutes a Business Sale? The sale of all or part of a "business" for purposes of successor liability depends on the parties' intentions and on the type of business involved. The conditions may be met when the sale is for:

- Building, land, furniture, fixtures, inventory and the right to use the seller's trade name;
- All of the business' capital assets;
- The business's name and goodwill;
- All of the business's inventory; or
- The fixed assets and realty necessary to operate a similar business at the same location.

A buyer may have difficulty determining what constitutes a business.[69] Generally, the buyer must look at the totality of the circumstances surrounding the transaction to determine what the parties intended to buy and sell.[70]

Intangibles Only. A taxpayer will not be liable for a prior business owner's tax liability based on the purchase of the previous business's trade name and procuring the former business's phone number from the phone company. This does not satisfy the elements of a purchase of the former business or its stock of goods.[71]

Tax Clearance Certificates. The seller can request that the Comptroller issue a certificate stating that no tax is due or the amount that must be paid before a certificate can be issued.[72] The Comptroller must issue the certificate or statement within 60 days after receiving the request or within 60 days after the records of the business seller are made available for audit, whichever period expires later, but no later than within 90 days after the date of receiving the request from the purchaser. If the Comptroller fails to mail the certificate or statement within the applicable period, the purchaser is released from the obligation to withhold from the purchase price the amount of state taxes due from the business seller.

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68 Tex. Tax Code § 111.020(a).

69 Comptroller Hearing No. 26,933 (STAR No. 9107H1119C11) (July 2, 1991).

70 Comptroller Hearing No. 28,813 (STAR No. 9205578H) (May 21, 1992).

71 Comptroller Hearing No. 30,262 (STAR No. 9403080H) (Feb. 2, 1994).

72 Tex. Tax Code § 111.020(c).

Buyer's Failure to Withhold. If the buyer fails to withhold the amount specified by the Comptroller, the buyer will be personally liable *up to the amount of the purchase price*, for the taxes of the seller.[73]

> **Agri-Plex Heating and Cooling, LLC v. Hegar**.[74] In this case, Agri-Plex purchased the assets of a small heating and air conditioning business. The buyer and seller were not aware of a potential sales tax liability at the time of sale and did not request a tax clearance certificate from the Comptroller. The Comptroller later conducted an audit of the seller's pre-sale business records and assessed a deficiency against the seller. The Comptroller did not collect the pre-sale tax liability from the seller, and instead assessed the liability against Agri-Plex, the buyer.
>
> The Comptroller argued that Texas Tax Code § 111.020 imposed a duty upon Agri-Plex to withhold the amount of the seller's sales tax liability from the purchase price at the time of closing. However, the seller and buyer were unaware of any potential sales tax liability at the time of the sale. At the trial court, both parties filed cross-motions for summary judgment.
>
> The Third Court of Appeals held that the purchaser (Agri-Plex) was liable for the pre-acquisition sales taxes, up to the amount of the purchaser price. The Court noted that the Tax Code provides mechanisms for innocent purchasers to use in order to avoid liability for sellers' taxes. Agri-Plex could have asked the seller to provide a receipt from the Comptroller stating that the amount had been paid, or a certificate stating that no amount was due.[75] Or, Agri-Plex could have exercised the safe harbor provision in § 111.020(c) and asked the Comptroller for a certificate of no tax due or a statement of the amount required to be paid.[76] If the Comptroller failed to provide the certificate or statement within 90 days, then Agri-Plex would have been released from liability.[77]
>
> Because Agri-Plex failed to request a receipt or certificate from the seller, or exercise its safe harbor option, the Court held that Agri-Plex could not escape liability under § 111.020.

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[73] Tex. Tax Code § 111.020(b).

[74] *Agri-Plex Heating and Cooling, LLC v. Hegar*, No. 03-15-00813-CV, 2017 Tex. App. LEXIS 386 (Tex. App.−Austin 2016, no pet. h.).

[75] *See* Tex. Tax Code § 111.020(a).

[76] *See* Tex. Tax Code § 111.020(c).

[77] *See* Tex. Tax Code § 111.020(b).

> ***Note:*** The buyer's assumption of the seller's debt is included in the amount of the purchase price.[78]

For example, in Comptroller Hearing No. 38,019, the buyer assumed several debts from the seller.[79] The buyer assumed debt payable to vendors, the seller's three year leasehold, as well as six trucks with outstanding payments. The Comptroller held that the seller should be assessed that liability to the extent of the value of the purchase price under Texas Tax Code § 111.020.

Foreclosure, Bankruptcy, and Probate. Buyers generally do not incur successor liability when purchasing assets at a foreclosure sale, from a bankruptcy trustee, or from the administrator, executor, or guardian in an estate or probate proceeding. The Comptroller will either not consider the sale a sale by a vendor or former owner, or the buyer will not be considered a "successor" under the liability provisions. Note, however, the underlying assets purchased may be subject to sales tax.

Joint and Several Liability. The sale of a business does not release the seller from sales tax liability; both the seller and buyer remain jointly liable until the tax is paid.

Contractual Indemnity for Tax. Parties cannot contract away tax liability. Even if the contract for sale of the business provides that the buyer is not responsible for the tax debts of the seller, this will not alter the buyer's liability under the statute for taxes owed by the seller.

Limitations Period. The Comptroller has four years to issue a deficiency notice to the buyer for taxes owed by the seller. The four-year period begins on the later of the date of the sale or on the date a determination becomes final.[80]

VIII. Fraudulent Transfer of a Business

A purchaser of a business can be held liable for the tax liabilities of the seller if the business or its assets are obtained in a fraudulent or sham transaction.[81]

Burden of Proof. The Comptroller has the burden of proof to establish that the transfer is fraudulent, as well as the amount of the tax deficiency owed. The notice of deficiency is prima

[78] 34 Tex. Admin. Code § 3.7(c).

[79] Comptroller Hearing No. 38,019 (STAR No. 9909805H) (Sept. 2, 1999).

[80] Tex. Tax Code § 151.504 and 34 Tex. Admin Code § 3.339(a).

[81] Tex. Tax Code § 111.024(a).

facie evidence of the due date of the assessment and the math used to calculate the assessment, but is *not* prima facie evidence of the assessment's validity.[82]

Defining a "Fraudulent" Transaction. A transfer is considered fraudulent if it was undertaken: (1) with intent to evade, hinder, delay, or prevent the collection of any tax, penalty, or interest owed under this title, or (2) without receiving a reasonably equivalent value in exchange for the business or business assets subject to the transfer or transaction.[83]

Proving Fraudulent Intent. The Texas Tax Code lists eight (8) factors that can be used to prove that a taxpayer displayed fraudulent intent. Consideration may be given, among other factors, to whether:[84]

- The transfer was to a current or former business insider, associate, or employee of the taxpayer or to a person related to the taxpayer within the third degree of consanguinity by blood or marriage;
- The transfer was to a third party who subsequently transferred the business or assets of the business to a current or former business insider, associate, or employee of the taxpayer or to a person related to the taxpayer within the third degree of consanguinity by blood or marriage;
- The taxpayer retained possession or control of the business or the assets of the business after the transfer or transaction;
- The taxpayer's business and the transferee's business are essentially operated as a single business entity at the same location;
- Before the transfer or the transaction occurred, the taxpayer had either been subjected to or apprised of impending collection action by the comptroller or the attorney general;
- The transfer or transaction was concealed;
- The taxpayer was insolvent at the time of the transfer or became insolvent not later than the 31st day after the date the transfer or transaction occurred; or
- The transfer or transaction involved all or substantially all of the taxpayer's assets.

There is not a bright line indicating how many factors are necessary to prove fraud.[85] Comptroller hearings indicate that meeting only two factors is insufficient, while four factors can be enough to establish fraud.[86]

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82 *In re Suppies*, 2014 Bankr. LEXIS 2431 (U.S. Bankr. S.D. Tex. June 4, 2014).

83 Tex. Tax Code § 111.024(b).

84 *Id.*

85 Comptroller Hearing No. 103, 468 (STAR No. 201408944H) (Aug. 1, 2014).

86 Comptroller Hearing No. 105,496 (STAR No. 201203400H) (Mar. 27, 2012); Comptroller Hearing No. 104,681 (STAR No. 201206522H) (June 21, 2012).

> **Comptroller Policy**. In regard to the fourth factor, the Comptroller has consistently held that the phrase "operated as a single business entity" entails more than simply operating the same type of business at the same location. Rather, the phrase means that the transferor and transferee have businesses that exist concurrently and operate as one.[87]

Exception. Transfer cannot be considered fraudulent (or impose derivative liability) if the business is transferred due to court order or distribution due to death of a taxpayer.[88]

Defense. If a buyer complies with the procedure for withholding an amount of the purchase price outlined in Texas Tax Code § 111.020(a), it may operate as a defense to an assessment of tax liability under Texas Tax Code § 111.024 as long as the buyer meets these requirements:[89]

- Amount withheld from purchase price is not sufficient to fully satisfy the liability of the seller of the business or stock of goods, and
- The purchase price paid to the seller for the business or stock of goods is not reasonably equivalent to the value of the business or stock of goods.

IX. Bankruptcy Trustee Liability

The Fifth Circuit has held that a bankruptcy trustee was personally liable for "willfully" failing to remit sales taxes held in trust when he knew that the sales taxes were due and used the money to pay other creditors, including suppliers and staff, notwithstanding his "good intentions" of maximizing the estate's value. [90]

X. Criminal Penalties

The Tax Code imposes stiff criminal penalties for collecting sales tax and not remitting it to the state, selling taxable items without a sales tax permit, or failing to file sales tax reports.[91]

Fraudulent Transfers. If the Comptroller determines that a buyer purchased a business or its assets through a fraudulent transfer or a sham transaction, the purchaser will be liable for any tax, interest or penalties the seller owed to the state. Fraudulent transfers and sham transactions are defined as those made with the intent to evade, hinder, delay or prevent tax collection

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87 Comptroller Hearing No. 107,343 (STAR No. 201311839H) (Nov. 20, 2013); Comptroller Hearing No. 102,707 (STAR No. 201003845H) (Mar. 15, 2010); Comptroller Hearing No. 111,306 (STAR No. 201505216H) (May 22, 2015).

88 Tex. Tax Code § 111.024(d).

89 Tex. Tax Code § 111.020(f).

90 *In re: Texas Pig Stands, Inc.*, 610 F.3d 937 (5th Cir. 2010).

91 Tex. Gov't Code § 411.109.

efforts of purchases where the seller didn't receive reasonably equivalent value in exchange for the business or assets involved in the transaction.[92]

Hindering Collections. State law makes knowingly obstructing or interfering with the Comptroller's seizure of a delinquent taxpayer's property a criminal offense (a Class A misdemeanor).[93] "Obstructing or interfering" includes trespassing on seized property, breaking a lock on a seized business, or removing or damaging seized inventory or property.[94]

Sales Suppression Devices and Phantom-ware. These devices are used to commit tax fraud by falsifying sales data on electronic cash registers so that retailers may collect the full amount of tax, but only remit a portion. It is a state jail felony to knowingly sell, purchase, install, transfer, use or possess an automated sales suppression device or phantom-ware.[95]

XI. Civil Penalties

The Comptroller imposes certain administrative requirements and civil penalties on taxpayers to prevent abuse of the taxing scheme.

Taxpayer Bonds. The Comptroller may require taxpayers who apply for permits or retailers who have been delinquent in paying sales and use tax to post bonds or other securities equal to the greater of $100,000 or four times the average monthly tax liability. In addition, traveling vendors may be required to post a minimum $500 bond.[96]

Unjust Enrichment. Retailers who erroneously collect tax on nontaxable transactions must either refund the erroneously-collected tax to the customers or remit it to the state. A retailer who refunds tax to its customers should maintain records showing the amount of tax refunded, the party from whom it collected tax, the party to whom it refunded the tax and other transaction details.[97]

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[92] *Id*.

[93] 34 Tex. Admin. Code § 3.327.

[94] Tex. Tax Code § 111.017(b) & (c).

[95] Tex. Bus. & Comm. Code § 326.001.

[96] 34 Tex. Admin. Code § 3.327.

[97] 34 Tex. Admin. Code § 3.300.

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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State Bar of Texas Tax Section
Tax Law in a Day
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RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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State Bar of Texas Tax Section
Tax Law in a Day
February 9, 2018

Note: This outline was prepared jointly with Cassady V. ("Cass") Brewer, Associate Professor of Law, Georgia State University College of Law, Atlanta, GA.

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"). This outline refers to the legislation in this manner and summarizes changes that, in our judgment, are the most important. The outline does not attempt to list the legislation's provisions comprehensively or to explain them in detail. For further explanation and details, the complete Conference Report accompanying TCJA may be found here. Finally, readers should note that many of the TCJA changes affecting individual taxpayers are temporary and sunset for taxable years beginning after December 31, 2025.

I. ACCOUNTING

A. Accounting Methods

1. The Tax Court sides with the taxpayer on application of the completed contact method of accounting to development of planned residential communities. Shea Homes Inc. v. Commissioner, 142 T.C. 60 (2/12/14). The taxpayer was a home builder using the completed contract method allowed by § 460(e) (which provides an exception to the percentage-of-completion method otherwise required); the taxpayer developed large, planned residential communities. The question was whether the subject matter of the contracts consisted only of the houses and the lots on which the houses are built, as argued by the IRS, or the home as well as the larger development, including amenities and other common improvements, as argued by the taxpayer. The contracts were home construction contracts under § 460(e)(6) because Reg. § 1.460-3(b)(2)(iii) provides the cost of the dwelling units includes "their allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements (e.g., sewers, roads, clubhouses) that benefit the dwelling units and that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land that contain the dwelling units." More specifically, the taxpayer's position was that the contracts were completed when they meet the test under Reg. § 1.460-1(c)(3)(i)(A) that the property was used by the customer for its intended purpose and 95 percent of the costs of the development had been incurred. Under this argument, final completion and acceptance pursuant to Reg. § 1.460-1(c)(3)(B) did not occur (excluding secondary items, if any, pursuant to Reg. § 1.460-1(c)(3)(B)(ii)) until the last road was paved and the final bond was released. The Tax Court (Judge Wherry), upheld the taxpayer's position. He rejected the IRS's argument that the common improvements were "secondary items." A key element in the holding was that the taxpayer was required by the contracts and by state law to complete common improvements, and that obligation was secured by "hefty performance bonds."

The decision might be narrower than it appears on its face. Footnote 24 of the opinion states as follows:

> We are cognizant that our Opinion today could lead taxpayers to believe that large developments may qualify for extremely long, almost unlimited deferral periods. We would caution those taxpayers a determination of the subject matter of the contract is based on all the facts and circumstances. If Vistancia, for example, attempted to apply the contract completion tests by looking at all contemplated phases, it is unlikely that the subject matter as contemplated by the contracting parties could be stretched that far. Further, sec. 1.460-1(c)(3)(iv)(A), Income Tax Regs., may prohibit taxpayers from inserting language in their contracts that would unreasonably delay completion until such a super development is completed.

a. And the Ninth Circuit says the Tax Court was correct in holding that homebuyers value amenities. Shea Homes, Inc. v. Commissioner, 834 F.3d 1061 (9th Cir. 8/24/16). In an opinion by Judge Fernandez, the Ninth Circuit affirmed the Tax Court's decision on the ground that the only issue on which the Tax Court's decision rested was a question of fact—what was the subject matter of the taxpayers' home construction contracts, that is, what were the taxpayers obligated to provide to the buyers—and that the Tax Court's fact finding was not clearly erroneous. The IRS's argument in the Tax Court was limited to "a dispute about the subject matter content of the contracts" and the IRS "took the very crabbed view that the subject matter was limited to the house and the lot." The Tax Court, however, "determined that, as a matter of fact, the subject matter included the house, the lot, "'the development ... and its common improvements and amenities.'" The Court of Appeals observed that "[t]his was not a simple case of buyers purchasing homes and having no substantial interest in whether the development would be and remain the kind of development that they wished to live in for some time in the future," adding that "[e]ach person in the planned community would, indeed, have an interest in the use of other property in the development, and that would include not only the common amenities but also the use that others in the development made of their own properties." Thus, the IRS's argument that "a buyer's contract cannot encompass more than the house and lot or, as a fall-back position, more than the house, the lot, and the common improvements" was rejected.

b. The Ninth Circuit got it wrong, says the IRS. A.O.D. 2017-03, 2017-15 I.R.B. 1072 (4/12/17). The IRS has nonacquiesced in the Ninth Circuit's decision in *Shea Homes*. "The Service disagrees with the court's conclusion that the 95-percent completion test can properly be applied with reference to the costs of an entire development or phase. Contract completion and the 95-percent completion test apply on a contract-by-contract basis." The IRS will follow the *Shea Homes* decision in cases appealable to the Ninth Circuit, but will continue to assert its positon in cases appealable to other U.S. Courts of Appeals.

2. It turns out that 6666, not 666, is the mark of the devil for the IRS. Burnett Ranches, Ltd. v. United States, 753 F.3d 143 (5th Cir. 5/22/14). Burnett Ranches, Ltd. operated two cattle and horse breeding operations and reported on the cash method. The principal owner, beneficial owner, and the manager, of Burnett Ranches, Anne Burnett Windfohr Marion, interposed an S corporation between herself and one of the two major ranch properties (6666, the Four Sixes) and had a direct interest in and was a beneficiary of a trust that held an interest in the other major ranch property (Dixon Creek). The IRS took the position that Burnett Ranches was a "farming syndicate" required by § 464 to use the accrual method of accounting. Speaking generally, § 464 requires farming partnerships to use the accrual method if they are a farming syndicate, which is generally defined as a partnership (or any other enterprise other than a corporation which is not an S corporation) engaged in the trade or business of farming if either (1) interests in the partnership or enterprise have been offered for sale in any securities offering or (2) more than 35 percent of losses are allocable to limited partners. But because it is targeted at late twentieth century tax shelters, it has a number of exceptions that cover "family farms." The taxpayer maintained that the exception in § 464(c)(2)(A) applied. This exception treats the following interests (among others) as not being held by a limited partner: "in the case of any individual who has actively participated (for a period of not less than 5 years) in the management of any trade or business of farming, any interest in a partnership or other enterprise which is attributable to such active participation. The government conceded that (1) Ms. Marion did "actively participate" in the management of Burnett Ranches' agricultural business for not less than five years previously, and (2) her interest in Burnett Ranches is "attributable to" her active participation, but argued that the interposition of the S corporation between the entity owning the ranch and Ms. Marion rendered the exception inapplicable. The District Court granted judgment in favor of the taxpayer, and, in an opinion by Judge Wiener, the Fifth Circuit affirmed. The court rejected the government's argument that the interest of the individual actively managing the farm or ranch had to be held by direct legal title for the exception to apply. Focusing on the language of § 464(h)(2)(A), which describes the excepted interest as "In the case of any individual who has actively participated (for a period of not less than five years) in the management of any trade or business of farming, any interest in a partnership or other enterprise which is attributable to such active participation," the court reasoned that by using the language "interest ... attributable to such active participation," "Congress did not restrict sub-subsection (A)'s particular exception to interests of which such an actively participating manager holds legal title in his or her name."

- The Tax Technical Corrections Act of 2014, Pub. L. No. 113-295, Division A, § 221(a)(58)(B)(i), moved the text of § 464(c) as in effect in the years involved in this case to § 461(j). Section 461(j) already existed, but through an apparent typographical error the text was moved to § 461(j) instead of § 461(k).

a. We're not giving up, says the IRS. A.O.D. 2017-01, 2017-7 I.R.B. 868 (02/14/2017). The IRS has nonacquiesced in the Fifth Circuit's decision in *Burnett Ranches, Ltd.* "[T]he statute excludes a partnership interest of "any individual" who meets the active participation requirement. The statute does not exclude a partnership interest held by an S corporation, even if the S corporation is owned by an individual who has actively participated." The IRS will follow the *Burnett Ranches* decision in cases appealable to the Fifth Circuit, but will continue to assert its positon in cases appealable to other U.S. Courts of Appeals.

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

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

Farming C Corporations. Under Code § 447(a), taxable income from farming of a C corporation (or a partnership with a C corporation as a partner) engaged in the trade or business of farming must be determined using the accrual method of accounting. Prior to amendment by the 2017 Tax Cuts and Jobs Act, § 447(c)(2) provided that 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.

4. 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.

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.

C. Installment Method

1. Can an installment sale between related parties ever *not* have the proscribed tax avoidance purpose requisite for denying installment reporting? Vest v. Commissioner, T.C. Memo. 2016-187 (10/6/16). The taxpayers owned 85 percent of Truebeginnings, LLC, which was an accrual basis partnership for federal tax purposes. According to the reported opinion, Truebeginnings in turn owned 100 percent interests in two other partnerships, H.D. Vest Advanced Systems, LLC (VAS), and Metric, LLC (Metric). (We do not understand how a 100 percent owned LLC can be a partnership rather than a disregarded entity or a corporation, but the opinion says they were partnerships and the issue could not have arisen if they were disregarded entities.) In consideration of

10-year promissory notes, Truebeginnings sold computer equipment to VAS and Metric and sold zero-basis intangible assets with an appraised value of $2,885,175 to VAS. Truebeginnings reported over $3 million of gain on the § 453 installment method. The Tax Court (Judge Lauber) upheld the IRS's conclusion that the sales did not qualify for installment sale treatment pursuant to § 453(g)(1), which disallows installment reporting for installment sales of depreciable property between related persons unless "it is established to the satisfaction of the Secretary that the disposition did not have as one of its principal purposes the avoidance of Federal income tax." I.R.C. § 453(g)(2). TB, VAS, and Metric were clearly "related persons," and the computer equipment and intangible assets that TB sold to VAS and Metric were "depreciable property." The taxpayer failed to carry the burden of proof that tax avoidance "was not among the principal purposes of the asset sale transaction." Judge Lauber reasoned that § 453(g)(2) "resembles other Code sections providing that certain tax treatment will be available only if the taxpayer establishes that the plan or transaction did not have 'as one of its principal purposes the avoidance of Federal income tax,' and that" Tax Court precedent establishes that "a taxpayer in such cases can satisfy his burden of proof only by submitting 'evidence [that] clearly negate[s] an income-tax-avoidance plan.'" *Tecumseh Corrugated Box Co. v. Commissioner*, 94 T.C. 360, 381-382 (1990) (addressing § 453(e)(7)), *aff'd*, 932 F.2d 526 (6th Cir. 1991). The taxpayer's burden in such cases is "a heavy one." *Pescosolido v. Commissioner*, 91 T.C. 52, 56 (1988) (addressing § 306(b)(4)), *aff'd*, 883 F.2d 187 (1st Cir. 1989). In ascertaining the true purpose of the transaction, Judge Lauber stated, the Tax Court accords "more weight to objective facts than to the taxpayer's 'mere denial of tax motivation.'" The enhanced depreciation deductions available to the related buyer is relevant in deciding whether the seller had a principal purpose of avoiding tax. *Guenther v. Commissioner*, T.C. Memo. 1995-280. In this case, the court stated, "[t]he substance of the transaction at issue clearly reveals a principal purpose of tax avoidance."

> Notwithstanding the asset sale, petitioner through TB retained full control over the ad-optimization business. By use of installment reporting, TB aimed to defer for 10 years virtually all the tax on its $3.2 million gain, while VAS and Metric would receive stepped-up bases in, and be able to claim correspondingly large depreciation or amortization deductions on, the assets transferred. ... This tax-avoidance purpose is particularly clear with respect to the intangible assets sold to VAS. Those assets had a zero cost basis in TB's hands, thus yielding zero amortization deductions to it. But VAS claimed a stepped-up basis in those assets of $2,885,175, yielding amortization deductions of $192,345 annually. The enhanced amortization deductions claimed by VAS and Metric, totaling $644,772 for 2008-2010 alone, dwarf the $29,798 gain that TB reported for 2008.

a. The Fifth Circuit affirms. Vest v. Commissioner, 690 Fed. Appx. 210 (5th Cir. 6/2/17). In a per curiam opinion, the U.S. Court of Appeals for the Fifth Circuit affirmed. In response to the taxpayer's argument that the sale of assets from Truebeginnings to the related partnerships had a business purpose, the court stated:

> Even if the sale was motivated by a business purpose, this fact would not necessarily mean that the sale did not also have a principal purpose of tax avoidance. Merely arguing that the sale had a business purpose is not inconsistent with it also having tax avoidance as one of its principal purposes. Accordingly, Vest has failed to demonstrate clear error on the Tax Court's part

D. Year of Inclusion or Deduction

1. Almost as rare as a total solar eclipse: a cash-method taxpayer is entitled to deduct estimated, future expenses. Gregory v. Commissioner, 149 T.C. No. 2 (7/11/17). The taxpayers, a married couple, held 80 percent of the stock of a cash-method S corporation that owned and operated a landfill in Texas. All landfills, regardless of size, must clean up and restore the site upon their inevitable closing. Closing a landfill and complying with federal, state, and local environmental regulations is an expensive endeavor. For this reason, § 468 generally permits a "taxpayer" owning and operating a landfill to deduct currently estimated "qualified reclamation or closing costs" anticipated in a future year or years. When the future costs actually are paid in a future year, § 468 disallows a deduction to the extent the costs do not exceed the taxpayer's previously established and annually calculated § 468 reserve. (Of course, § 468 is more complicated than the foregoing statements might lead one to believe, but the essence of the statute is to allow landfill owners like the taxpayers' S corporation to take a current deduction for future reclamation and clean-up costs.) From 1996 through 2007, the taxpayers' S corporation had utilized § 468 without challenge by the IRS. For tax years 2008 and 2009, however, the IRS contested the S corporation's § 468 deduction on the grounds that the term "taxpayer" in § 468 refers only to accrual-method taxpayers, not cash-method taxpayers. In a case of first impression, the Tax Court unanimously disagreed with the IRS. In a reviewed (and surprisingly long) opinion by Judge Holmes, the Tax Court held that the term "taxpayer" in § 468 does indeed refer to both accrual-method and cash-method taxpayers. The court relied primarily on the statutory language of § 468, which does not distinguish between cash-method and accrual-method taxpayers. The court also examined several other sources of guidance, including § 7701(a)(14), which defines the term "taxpayer" simply as "any person subject to any internal revenue tax," as well as the legislative history of § 468. Apparently, this was news to the IRS, which argued voluminously to the contrary, but to no avail. In a lengthy concurring opinion, Judge Lauber (joined by Judges Marvel, Gale, Nega, and Ashford) traced the legislative history of § 468 (and § 468A regarding nuclear decommissioning costs), which appeared in preliminary bills as exceptions to the § 461(h) economic performance requirement, and concluded that Congress likely had intended § 468 to be available only to accrual-method taxpayers. Judge Lauber also suggested that, if Treasury had issued regulations that defined "taxpayer" for purposes of § 468 as meaning an accrual-method taxpayer, the result in the case might have been different. In the absence of regulations, Judge Lauber concluded, the court "reasonably concludes that nothing in the text of section 468 necessitates giving the term "taxpayer" a meaning less comprehensive than the ordinary meaning it has elsewhere in the Code.

2. 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.

3. 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 an 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.

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.

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).

2. 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.

3. 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.

4. 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. New § 199A is intended to put owners of flow-through entities (but also including sole proprietorships) on par with C corporations that will benefit from the new reduced 21% corporate tax rate; however, in our view, the new provision actually makes many flow-through businesses even more tax-favored than they were under pre-TCJA law.

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

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

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

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

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

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

4. *Qualified business income—§ 199A(c).* One component of the § 199A deduction is 20 percent of the taxpayer's qualified business income, which is generally defined as the net amount from a qualified trade or business of items of income, gain, deduction, and loss included or allowed in determining taxable income. Excluded from the definition are: (1) income not effectively connected with the conduct of a trade or business in the United States, (2) specified investment-related items of income, gain, deduction, or loss, (3) amounts paid to an S corporation shareholder that are reasonable compensation, (4) guaranteed payments to a partner for services, (5) to the extent provided in regulations, payments to a partner for services rendered other than in the partner's capacity as a partner, and (6) qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income (because these three 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 three buckets, subject to two limitations. *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. *Bucket 3* is the lesser of (1) 20 percent of the taxpayer's qualified cooperative dividends, or (2) the taxpayer's taxable income reduced by net capital gain. *Limitation 1* is that the sum of Bucket 1 and Bucket 2 cannot exceed 20 percent of the amount by which the taxpayer's taxable income exceeds the sum of the taxpayer's net capital gain and qualified cooperative dividends. *Limitation 2* is an overall limitation and provides that the sum of Buckets 1, 2 and 3 (after application of Limitation 1) 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, applying Limitation 1, adding Bucket 3, and then applying Limitation 2.

6. *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.

7. *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.

5. 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 30 percent of "adjusted taxable income" (essentially earnings before interest, tax, depreciation and amortization (EBITDA) for the first 4 years, and then earnings before interest and taxes (EBIT) thereafter). 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).

6. 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.

7. Violations of law just became a little more expensive. The 2017 Tax Cuts and Jobs Act, § 13306, amended Code § 162(f) to disallow deductions:

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

Prior to amendment, § 162(f) stated simply that "[n]o deduction shall be allowed … for any fine or similar penalty paid to a government for the violation of any law." The intent of this provision appears to be to broaden the category of nondeductible items beyond those that might technically constitute a fine or penalty. The amended statute contains exceptions for (1) certain amounts for restitution or remediation (including remediation of property) or to come into compliance with law that are identified as such in a court order or settlement agreement, (2) amounts paid or incurred pursuant to a court order in a suit in which no government or governmental entity is a party, and (3) any amount paid or incurred as taxes due. Payments of restitution for failure to pay taxes that are assessed as restitution in the same manner as a tax qualify for the first exception just listed only if the amounts "would have been allowed as a deduction under this chapter if it had been timely paid." This rule appears to mean that a payment of restitution in a tax case qualifies for the exception only if the taxes would have been deductible if timely paid. The legislation also adds to the Code § 6050X, which requires government agencies to report to the 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.

8. 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 extent 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.

9. 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.

10. 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.

E. Depreciation & Amortization

1. Section 280F 2017 depreciation tables for business autos, light trucks, and vans. Rev. Proc. 2017-29, 2017-14 I.R.B. 1065 (3/24/17). The IRS has published depreciation tables with the 2017 depreciation limits for business use of small vehicles:

2017 Passenger Automobiles with § 168(k) first year recovery:	
1st Tax Year	$11,160
2nd Tax Year	$ 5,100
3rd Tax Year	$ 3,050
Each Succeeding Year	$ 1,875
2017 Trucks and Vans with § 168(k) first year recovery:	
1st Tax Year	$11,560
2nd Tax Year	$ 5,700
3rd Tax Year	$ 3,450
Each Succeeding Year	$ 2,075
2017 Passenger Automobiles (no § 168(k) first year recovery):	
1st Tax Year	$ 3,160
2nd Tax Year	$ 5,100
3rd Tax Year	$ 3,050
Each Succeeding Year	$ 1,875
2017 Trucks and Vans (no § 168(k) first year recovery):	
1st Tax Year	$ 3,560
2nd Tax Year	$ 5,700
3rd Tax Year	$ 3,450
Each Succeeding Year	$ 2,075

2. 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).

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

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

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

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

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

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.

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.

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).

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.

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.

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. IRS says the District Court for the Western District of Arkansas got it all wrong by allowing a taxpayer to claim passive losses against trade or business income due to taxpayer's "real estate professional" status. A.O.D. 2017-07, 2017-42 I.R.B. 311 (10/16/17). In this action on decision, the IRS announced that it will not follow in two separate respects the decision of the U.S. District Court for the Western District of Arkansas in the unreported decision of *Stanley v. United States*, 116 A.F.T.R.2d 2015-6766 (W.D. Ark. 11/12/15). First, the IRS will not follow the District Court's holding that S corporation stock subject to a substantial risk of forfeiture counts for purposes of the "5-percent owner" exception in § 469(c)(7)(D)(ii), which allows the personal services of certain owner-employees of real estate management companies to qualify as material participation with respect to rental real property. The taxpayer in *Stanley* held a restricted share certificate for 10 percent of the outstanding stock of an S corporation real estate management company in which he was an employee, but apparently his stock was not considered outstanding for subchapter S purposes because it was subject to a substantial risk of forfeiture under § 83 and he had not made a § 83(b) election with respect to the stock. Second, the IRS disagreed with the District Court's decision that a § 469(c)(7) "real estate professional" who meets the material participation test by grouping rental real estate activities with real estate management activities also may group rental real estate activities and those same real estate management activities for determining passive income and passive losses. The taxpayer in *Stanley* was permitted by the District Court to group his non-passive income from his employer, a real estate management company, with his passive rental real estate holdings, in order to claim excess passive losses that otherwise would be disallowed by § 469.

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. The IRS searched unsuccessfully for sale or exchange treatment on Monster.com. Estate of McKelvey v. Commissioner, 148 T.C. No. 13 (4/19/17). The decedent in this case was the founder and CEO of Monster Worldwide, Inc. (Monster), known for its job-search website, monster.com. In 2008, the decedent entered into variable prepaid forward contracts (VPFC) with two investment banks. Pursuant to the terms of each VPFC, the decedent received a cash payment from each investment bank in exchange for his agreement to deliver Monster shares or their cash equivalents over the course of several future settlement dates. The number of shares of Monster that the decedent was obligated to deliver varied and was determined by a formula that took into account the closing price of Monster shares on the settlement dates. In connection with each VPFC, the decedent pledged a specified number of shares of Monster stock to secure his obligations but could substitute other collateral with the bank's consent. In the same year, prior to the first settlement date, the decedent entered into an agreement with each investment bank pursuant to which the decedent made a cash payment to each bank in exchange for the bank's agreement to extend the settlement dates. Following the decedent's death, his estate delivered the requisite number of Monster shares to the banks. The IRS acknowledged that the initial VPFCs qualified for open transaction reporting under Rev. Rul. 2003-7, 2003-1 C.B. 363. However, the IRS took the position that the agreements pursuant to which the settlement dates were extended: (1) were taxable exchanges of the original VPFCs for the extended VPFCs that resulted in short-term capital gain of $88 million, and (2) resulted in constructive sales of the underlying Monster shares under § 1259 that gave rise to long-term capital gain of $112.8 million. The Tax Court (Judge Ruwe) held that the extension agreements did not result in taxable exchanges and that the extensions did not constitute constructive sales under § 1259. The court reasoned that, in order for the extensions to constitute taxable exchanges of the VPFCs, "two conditions must be satisfied: (1) the original VPFCs must constitute property to decedent at the time of the extensions and (2) the property must be exchanged for other property differing materially either in kind or in extent." The first condition, the court concluded, was not satisfied. The VPFCs were not property of the decedent, but rather obligations of the decedent. Once the decedent had received the cash payments under the VPFCs, the decedent had only the obligation to deliver a specified number of Monster shares or their cash equivalent. The court also rejected the government's argument that the extensions resulted in constructive sales of the underlying Monster shares under § 1259. Section 1259(a)(1) provides that, if there is a constructive sale of an appreciated financial position, the taxpayer must recognize gain as if that position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. Under § 1259(c)(1)(C), a constructive sale of an appreciated financial position occurs if a taxpayer "enters into a future or forward contract to deliver the same or substantially identical property," but according to the provision's legislative history, a forward contract does not result in a constructive sale of stock if it calls for the delivery of "an amount of property, such as shares of stock, that is subject to significant variation under the contract terms." The court reasoned that the IRS's acceptance of open transaction reporting for the initial VPFCs meant that the IRS acknowledged that the initial VPFCs did not trigger a constructive sale under § 1259. Accordingly, the IRS's argument that the extensions resulted in constructive sales under § 1259 "is predicated upon a finding that there was an exchange of the extended VPFCs for the original VPFCs," a finding that the court had already declined to make.

2. The taxpayers' "pump and dump" refund claim survives despite a bizarre interpretation of the § 165 theft loss regulations by the IRS and the Claims Court. Adkins v. United States, 856 F.3d 914 (Fed. Cir. 5/8/17), *rev'g* 125 Fed. Cl. 304 (2016). The taxpayers in this refund suit were victims of a so-called "pump and dump" investment scheme carried out between 1997 and 2001. The taxpayers' investment adviser, Donald & Co., would purchase stock on the public markets, advise its clients to do the same, and subsequently sell the artificially inflated stock without informing its clients. In 2000, the taxpayers had a $3.6 million investment portfolio with Donald & Co. By the end of 2001, their investment portfolio had declined in value to only $9,849. In February of 2002, the taxpayers uncovered their investment advisor's fraudulent scheme and instituted arbitration proceedings with the National Association of Securities Dealers (NASD). In 2004, criminal indictments were returned against the principals of Donald & Co. in the U.S. District Court for the Eastern District of New York, and in that same year, several of the principals of Donald & Co. pleaded guilty and were sentenced. Criminal proceedings against other Donald & Co. principals continued until as late as 2009, at which time the taxpayers' NASD arbitration claim concluded. Meanwhile, in 2006, the taxpayers filed a refund claim with the IRS asserting a § 165 theft loss deduction for 2004. The IRS denied the claim on the grounds that in 2004 the taxpayers could not show with "reasonable certainty" their losses would not be recovered in the arbitration proceeding. The U.S. Court of Federal Claims (Judge Sweeney) upheld the IRS's denial of the taxpayers' refund claim, reasoning that the regulations under § 165 require a greater evidentiary showing of no prospect of recovery ("reasonable certainty") in a year following the discovery of a theft loss than in the year of discovery itself ("reasonable prospect"). In her decision, Judge Sweeney relied upon a similar interpretation of the § 165 regulations (by another Claims Court judge) in *Johnson v United States*, 74 Fed. Cl. 360 (2006). Presumably, the Claims Court would have allowed the taxpayers a § 165 theft loss deduction in 2002 when the fraudulent "pump and dump" scheme was initially discovered, but disallowed the deduction in 2004 due to the pendency of the arbitration claim. Fortunately, the U.S. Court of Appeals for the Federal Circuit reversed and remanded the case to the Claims Court for further proceedings. In an opinion by Judge O'Malley, the Court of Appeals reasoned that the regulations under § 165 do not impose different evidentiary standards in the year of discovery of theft versus subsequent years but simply a showing that in the year the theft loss is claimed there is no reasonable prospect of recovery. Because the IRS and the Claims Court had misinterpreted the law, the case was remanded for further consideration of the taxpayers' refund claim for 2004.

3. 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 phrrhotite 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.

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.

D. Section 121

E. Section 1031

1. The Tax Court confirms that § 1031 is an exception to the principle that substance controls over form. Estate of Bartell v. Commissioner, 147 T.C. No. 5 (8/10/16). This case involved a reverse like-kind exchange structured before the promulgation of Rev. Proc. 2000-37, 2000-2 C.B. 308 (effective for qualified exchange accommodation arrangements entered into by an exchange accommodation titleholder on or after September 15, 2000). In 1999, Bartell Drug (an S corporation) entered into an agreement to purchase a property (Property #2). To further structuring the disposition of another property already owned by Bartell Drug (Property #1) as a § 1031 like-kind exchange, Bartell Drug assigned its rights in the purchase agreement to a third-party exchange facilitator (EPC) and entered into an agreement with EPC that provided for EPC to purchase Property #2 and gave Bartell Drug a right to acquire Property #2 from EPC for a stated period and price. EPC purchased Property #2 on August 1, 2000, with bank financing guaranteed by Bartell Drug. Bartell Drug then supervised construction of a drugstore on Property #2 using proceeds of the EPC financing guaranteed by Bartell Drug. Upon substantial completion of the construction in June 2001, Bartell Drug leased the store from EPC until Bartell Drug acquired Property #2 on December 31, 2001. In late 2001, Bartell Drug contracted to sell Property #1 to another party. Bartell Drug thereupon entered an exchange agreement with intermediary SS and assigned to SS its rights under the sale agreement and under the earlier agreement with EPC. SS sold Property #1, applied the proceeds of that sale to the acquisition of Property #2 from EPC and transferred Property #2 to Bartell Drug on December 31, 2001. The Tax Court (Judge Gale) held that the transactions qualified as a § 1031 like-kind exchange of Property # 1 for Property #2. The Court rejected the IRS's argument that under a "benefits and burdens" analysis Bartell Drug was the owner of Property #2 long before the formal transfer of title on December 31, 2001 and treated EPC as the owner of Property #2 during the period it held title to the property. *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963), *rev'g* 38 T.C. 215 (1962), and *Biggs v. Commissioner*, 69 T.C. 905 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980), were cited as precedent for the proposition that § 1031 is formalistic, and that the exchange facilitator does not bear the benefits and burdens of ownership during the period it holds title to the property for the purpose of facilitating a like kind exchange on behalf of a taxpayer who contractually does bear the benefits and burdens of ownership does not preclude § 1031 nonrecognition for the deferred exchange. "[G]iven that the caselaw has countenanced a taxpayer's pre-exchange control and financing of the construction of improvements on the replacement property while an exchange facilitator held title to it, *see J.H. Baird Publ'g. Co. v. Commissioner*, 39 T.C. 608, 610-611 (1962), we see no reason why the taxpayer's pre-exchange, temporary possession of the replacement property pursuant to a lease from the exchange facilitator should produce a different result."

a. If you wish to engage in a reverse like-kind exchange in which the exchange accommodation titleholder holds title to the replacement property for more than 180 days, proceed at your own peril, says the IRS. A.O.D. 2017-06, 2017-33 I.R.B. 194 (8/23/17). The IRS has nonacquiesced in the Tax Court's decision in *Bartell*. In its nonacquiescence, the IRS emphasized Rev. Proc. 2000-37, 2000-2 C.B. 308, which provides a safe harbor for reverse like-kind exchanges in which replacement property is parked with an exchange accommodation titleholder if certain requirements are met. If all of the requirements are met, then the exchange accommodation titleholder is considered the owner of the property to which it holds title regardless of who bears the benefits and burdens of ownership. One requirement is that the exchange accommodation titleholder must not hold the property for more than 180 days. If the requirements of the revenue procedure are not met, then the determination whether the taxpayer or the exchange accommodation titleholder is the owner of the property is made without regard to the provisions of the revenue procedure. In *Bartell*, the exchange accommodation titleholder held title to the property for 17 months. In this action on decision, the IRS stated:

> [I]in determining whether a reverse exchange outside the scope of Rev. Proc. 2000-37 meets the requirements of § 1031, the Service will not follow the principle in the court opinions that an exchange facilitator may be treated as the owner of property regardless of whether it possesses the benefits and burdens of ownership. … Taxpayers that use accommodating parties outside the scope of Rev. Proc. 2000-37 have not engaged in an exchange if the taxpayer, rather than the accommodating party, acquires the benefits and burdens of ownership of the replacement property before the taxpayer transfers the relinquished property. The Service will not follow the Tax Court's opinion in *Bartell* to the extent the opinion provides otherwise.

2. 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 transferor 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 IRS provides guidance on the application of the Affordable Care Act's market reforms to HRAs, EPPs, FSAs, and EAPs — it's the bee's knees! Notice 2013-54, 2013-40 I.R.B. 287 (9/13/13), *supplemented by* Notice 2015-87, 2015-52 I.R.B. 889 (12/16/15). The Patient Protection and Affordable Care Act amended the Public Health Service Act to implement certain market reforms for group health plans, including requirements that: (1) group health plans not establish any annual limit on the dollar amount of benefits for any individual, and (2) non-grandfathered group health plans provide certain preventive services without imposing any cost-sharing requirements for the services. The notice provides guidance, in Q&A format, on the application of these market reforms to: (1) health reimbursement arrangements (including HRAs integrated with group health plans), (2) group health plans under which employers reimburse employees for premium expenses incurred for an individual health insurance policy (referred to in the notice as "employer payment plans"), and (3) health flexible spending arrangements. The notice also provides guidance on employee assistance programs and on § 125(f)(3), which generally provides that a qualified health plan offered through a health insurance exchange established under the Affordable Care Act is not a qualified benefit that can be offered through a cafeteria plan. The notice applies for plan years beginning on and after 1/1/14, but taxpayers can apply the guidance provided in the notice for all prior periods. The Department of Labor has issued guidance in substantially identical form (Technical Release 2013-03) and the Department of Health and Human Services is issuing guidance indicating that it concurs.

a. The obvious solution has a great big catch in it. In a Q&A issued on 5/13/14, available on the IRS's web site (https://perma.cc/FK5A-FRF2), the IRS states:

> Q1. What are the consequences to the employer if the employer does not establish a health insurance plan for its own employees, but reimburses those employees for premiums they pay for health insurance (either through a qualified health plan in the Marketplace or outside the Marketplace)?
>
> [A1]. Under IRS Notice 2013-54, such arrangements are described as employer payment plans. An employer payment plan, as the term is used in this notice, generally does not include an arrangement under which an employee may have an after-tax amount applied toward health coverage or take that amount in cash compensation. As explained in Notice 2013-54, these employer payment plans are considered to be group health plans subject to the market reforms, including the prohibition on annual limits for essential health benefits and the requirement to provide certain preventive care without cost sharing. Notice 2013-54 clarifies that such arrangements cannot be integrated with individual policies to satisfy the market reforms. Consequently, such an arrangement fails to satisfy the market reforms and may be subject to a $100/day excise tax per applicable employee (which is $36,500 per year, per employee) under section 4980D of the Internal Revenue Code.

b. Good news (?) for some employers: the IRS reiterates prior guidance and clarifies issues related to employer payment plans and provides transition relief from the § 4980D excise tax. Notice 2015-17, 2015-14 I.R.B. 845 (2/18/15). This notice reiterates the conclusion in prior guidance, including Notice 2013-54, 2013-40 I.R.B. 287, that employer payment plans are group health plans that will fail to comply with the market reforms that apply to group health plans under the Affordable Care Act. The notice provides guidance, in Q&A format, on several issues, including the treatment of: (1) an S corporation's payment or reimbursement of premiums for individual health insurance coverage covering a 2-percent shareholder, (2) an employer's reimbursement of an employee's Medicare premiums or payment of medical expenses for employees covered by TRICARE, (3) an employer's increase of an employee's compensation to assist with payments for individual coverage, and (4) an employer's provision of premium assistance on an after-tax basis. The notice also provides a transition rule under which the IRS will not assert the excise tax imposed by § 4980D for any failure to satisfy the market reforms by employer payment plans that pay, or reimburse employees for individual health policy premiums or Medicare part B or Part D premiums: (1) for 2014 for employers that are not applicable large employers for 2014, and (2) for 1/1/15 through 6/30/15 for employers that are not applicable large employers for 2015. Generally, applicable large employers are those that employed an average of at least 50 full-time employees on business days during the preceding calendar year. Employers eligible for this transition rule are not required to file Form 8928 (Return of Certain Excise Taxes Under Chapter 43 of the Internal Revenue Code) solely as a result of having employer payment plans for the period for which the employer is eligible for the relief.

c. Final regulations provide guidance on many issues under the Affordable Care Act and incorporate prior guidance issued in forms other than regulations.

T.D. 9744, Final Rules for Grandfathered Plans, Preexisting Condition Exclusions, Lifetime and Annual Limits, Rescissions, Dependent Coverage, Appeals, and Patient Protections Under the Affordable Care Act, 80 F.R. 72192 (11/18/15). The Treasury Department and the IRS have issued final regulations regarding grandfathered health plans, preexisting condition exclusions, lifetime and annual dollar limits on benefits, rescissions, coverage of dependent children to age 26, internal claims and appeal and external review processes, and patient protections under the Affordable Care Act. Among many other changes, the final regulations provide guidance on integration of health reimbursement arrangements with other group health plan coverage and modify Notice 2015-17 by providing a special rule for employers with fewer than 20 employees who offer group health plan coverage to employees who are not eligible for Medicare but do not offer coverage to employees who are eligible for Medicare. If such an employer is not required by the applicable Medicare secondary payer rules to offer group health plan coverage to employees who are eligible for Medicare coverage, then the employer's reimbursement of Medicare part B or D premiums may be integrated with Medicare and deemed to satisfy the annual dollar limit prohibition and the preventive services requirements if the employees who are not offered other group health plan coverage would be eligible for that group health plan but for their eligibility for Medicare. The regulations are effective on 1/19/16 and apply to group health plans and health insurance issuers beginning on the first day of the first plan year (or, in the individual market, the first day of the first policy year) beginning on or after 1/1/17.

d. Just in time for Christmas! The IRS continues to prove that the Affordable Care Act, like the jelly-of-the-month club, is, as cousin Eddie put it, "the gift that keeps on giving [guidance] the whole year." Notice 2015-87, 2015-52 I.R.B. 889 (12/16/15). This notice, in Q&A format, provides guidance on the application of various provisions of the Affordable Care Act to employer-provided health coverage. The notice supplements the guidance in Notice 2013-54, 2013-40 I.R.B. 287 (9/13/13) and T.D. 9744, Final Rules for Grandfathered Plans, Preexisting Condition Exclusions, Lifetime and Annual Limits, Rescissions, Dependent Coverage, Appeals, and Patient Protections Under the Affordable Care Act, 80 F.R. 72192 (11/18/15). The notice (1) provides guidance on the application of the Affordable Care Act's market reforms for group health plans to various types of employer health care arrangements, including health reimbursement arrangements and group health plans under which an employer reimburses an employee for some or all of the premium expenses incurred for an individual health insurance policy; (2) clarifies certain aspects of the employer shared responsibility provisions of § 4980H; (3) clarifies certain aspects of the application to government entities of § 4980H, the information reporting provisions for applicable large employers under § 6056, and application of the rules for health savings accounts to persons eligible for benefits administered by the Department of Veterans Affairs; (4) clarifies the application of the COBRA continuation coverage rules to unused amounts in a health flexible spending arrangement carried over and available in later years, and conditions that may be put on the use of carryover amounts; and (5) addresses relief from penalties under §§ 6721 and 6722 that has been provided for employers that make a good faith effort to comply with the requirements under § 6056 to report information about offers made in calendar year 2015. The guidance provided in the notice generally applies for plan years beginning on and after 12/16/15, but taxpayers can apply the guidance provided in the notice for all prior periods.

e. Colleges and universities providing health insurance premium reductions to students who perform services might have employer payment plans that violate the Affordable Care Act's market reforms, and may need to look at alternatives. Notice 2016-17, 2016-9 I.R.B. 358 (2/5/16). Colleges and universities often provide students, especially graduate students, with health coverage at greatly reduced or no cost as part of a package that includes tuition assistance and a stipend for living expenses. Some of these students perform services for the school (such as teaching or research), which raises the issue whether these premium reduction arrangements might be viewed as employer-sponsored group health plans that are employer payment plans that violate the market reform provisions of the Affordable Care Act. The notice concludes that whether such arrangements constitute group health plans will depend on all of the facts and circumstances, and that they might or might not be viewed as employer payment plans. To give colleges and universities time to examine this issue and adopt suitable alternatives if necessary, the notice provides that Treasury (and the Department of Labor and the Department of Health and Human

Services) will not assert that a premium reduction arrangement fails to satisfy the Affordable Care Act's market reforms if the arrangement is offered in connection with other student health coverage (either insured or self-insured) for a plan year or policy year beginning before 1/1/17. Thus, colleges and universities have relief for plan years or policy years that are roughly coterminous with academic years beginning in the summer or fall of 2016 and ending in 2017. This notice applies for plan years beginning before 1/1/17.

f. Congress provides relief from the § 4980D excise tax for small employers offering health reimbursement arrangements, imposes new reporting requirements, limits the exclusion from gross income under § 106, and coordinates HRAs with the § 36B premium tax credit. The 21st Century Cures Act ("Cures Act"), Pub. L. No. 114-255, was signed by the President on 12/13/16. Among other changes, the Cures Act made several modifications to the rules related to health reimbursement arrangements.

Health Reimbursement Arrangements Offered by Small Employers—Section 18001(a)(1) of the Cures Act amends Code § 9831 by adding subsection (d), which provides that, for purposes of title 26 (other than the Cadillac Tax of § 4980I), a "qualified small employer health reimbursement arrangement" (QSEHRA) is not treated as a group health plan. The effect of this amendment is to allow employers to offer health reimbursement arrangements that meet the definition of a QSEHRA without becoming subject to the excise tax of § 4980D. An arrangement is a QSEHRA if it (1) is offered by an "eligible employer;" (2) subject to certain exceptions, is provided to all "eligible employees" on the same terms, (3) is funded solely by the employer and does not call for contributions through salary reduction; (4) provides for the payment or reimbursement of documented expenses for medical care (as defined in § 213(d)) incurred by the employee or the employee's family members; and (5) the amount of payments and reimbursements for the year do not exceed $4,950 ($10,000 in the case of an arrangement that also provides for payments or reimbursements for family members of the employee). These dollar limitations will be adjusted for inflation after 2016. An "eligible employer" is an employer that is not an applicable large employer as defined in § 4980H(c)(2) and does not offer a group health plan to any of its employees. An "eligible employee" generally is any employee of the employer, but the terms of the arrangement may exclude from consideration certain employees, such as those who have not completed 90 days of service, those who have not attained age 25, and part-time or seasonal employees. This relief from the § 4980D excise tax applies for years beginning after 12/31/16, which means that employers may begin offering QSEHRAs beginning in 2017.

New Reporting Obligations—The Cures Act imposes two new reporting requirements related to health reimbursement arrangements. **First**, Code § 9831(d)(4), as added by § 18001(a)(1) of the Cures Act, provides that an employer funding a QSEHRA for any year must provide to each eligible employee a written notice not later than 90 days before the beginning of the year (or, if later, the date on which the employee becomes an eligible employee). The notice must include the following information: (1) a statement of the amount of the employee's permitted benefit under the arrangement for the year; (2) statement that the employee should provide the amount of his or her permitted benefit to any health insurance exchange to which the employee applies for advance payment of the premium tax credit; and (3) a statement that, if the employee is not covered under minimum essential coverage for any month, the employee may be subject to tax under section § 5000A for that month and reimbursements under the arrangement may be includible in gross income. An employer that fails to provide the required notice is subject to a $50 penalty per employee for each incident of failure, subject to a $2,500 calendar year maximum for all failures. **Second**, new Code § 6501(a)(15), as added by § 18001(a)(6) of the Cures Act, requires an employer to report on Form W-2 the amount of each employee's permitted benefit under a QSEHRA. These rules regarding reporting apply to years beginning after 12/31/16. However, the legislation provides that a person shall not be treated as failing to provide the written notice required by § 9831(d)(4) if the notice is provided not later than 90 days after the date of the enactment of the Cures Act.

Extension of Relief Provided by Notice 2015-17—Notice 2015-17, 2015-14 I.R.B. 845 (2/18/15), provided a transition rule under which the IRS would not assert the excise tax imposed by § 4980D for any failure to satisfy the market reforms by employer payment plans that pay or reimburse employees for individual health policy premiums or Medicare part B or Part D premiums: (1) for 2014 for employers that are not applicable large employers for 2014, and (2) for 1/1/15 through 6/30/15 for employers that are not applicable large employers for 2015. Section

18001(a)(7)(B) of the Cures Act provides that the relief under Notice 2015-17 shall be treated as applying to any plan year beginning on or before 12/31/16. This means that employers that are not applicable large employers will not be subject to the § 4980D excise tax as a result of offering an employer payment plan for plan years beginning on or before 12/31/16.

Limitation on the Exclusion of Code § 106—New Code § 106(g), as added by § 18001(a)(2) of the Cures Act, provides that, for purposes of Code §§ 105 and 106, payments or reimbursements to an individual for medical care from a QSEHRA shall not be treated as paid or reimbursed under employer-provided coverage for medical expenses under an accident or health plan if, for the month in which the medical care is provided, the individual does not have minimum essential coverage within the meaning of § 5000A(f). The effect of this amendment is that payments or reimbursements under a QSEHRA are included in an individual's gross income if the individual does not have minimum essential coverage.

Coordination with the § 36B Premium Tax Credit—Code § 36B(c)(4), as added by § 18001(a)(3) of the Cures Act, makes an individual ineligible for the § 36B premium tax credit for any month if the individual is provided a QSEHRA for the month that constitutes affordable coverage. If the QSEHRA does not constitute affordable coverage, then the employee remains eligible for the premium tax credit for the month, but the amount of the credit is reduced by 1/12 of the employee's permitted benefit under the QSEHRA for the year. A QSEHRA constitutes affordable coverage for a month (and therefore makes an employee ineligible for the premium tax credit) if the *excess of* (1) the premium for the month for self-only coverage under the second lowest cost silver plan offered in the relevant individual health insurance market, *over* (2) 1/12 of the employee's permitted benefit under the QSEHRA, *exceeds* 1/12 of 9.69 percent (for 2017) of the employee's household income. (Note that this calculation requires using the cost of self-only coverage, even for employees with insured family members.) The statutory rules provide for adjusting the calculation in the case of employees employed for less than a full year. An employee must provide the amount of his or her permitted benefit to any health insurance exchange to which the employee applies for advance payment of the premium tax credit.

Application of the Cadillac Tax—Generally, § 4980I, which was enacted as part of the Affordable Care Act, imposes a 40 percent excise tax on the amount by which the cost of group health coverage provided by an employer (referred to as "applicable employer-sponsored coverage") exceeds a specified dollar limit. Subsequent to the enactment of the Affordable Care Act, Congress in 2015 delayed the effective date of the Cadillac Tax to taxable years beginning after 12/31/19. Section 18001(a)(4) of the Cures Act amends Code § 4980I(d)(2)(D) to provide that a QSEHRA is considered "applicable employer-sponsored coverage" for purposes of the Cadillac Tax. Accordingly, the cost of a QSEHRA to the employer must be taken into account in determining the applicability of the Cadillac Tax.

g. Employers offering Qualified Small Employer Health Reimbursement Arrangements in 2017 need not provide the initial written notice to employees until after the IRS provides guidance. Notice 2017-20, 2017-11 I.R.B. 1010 (2/27/17). The 21st Century Cures Act, signed by the President on 12/13/16, added Code § 9831(d)(4), which requires each employer that funds a QSEHRA to provide each eligible employee a written notice with specified information not later than 90 days before the beginning of the year (or, if later, the date on which the employee becomes an eligible employee). For 2017, the legislation provides that employers will be treated as complying with this requirement if they provide the notice not later than 90 days after the date of enactment of the Cures Act. The 90th day was 3/13/17. An employer that fails to provide the required notice is subject to a $50 penalty per employee for each incident of failure, subject to a $2,500 calendar year maximum for all failures. Because employers might have difficulty complying with the notice requirement in the absence of guidance, the IRS has announced that employers funding QSEHRAs in 2017 need not provide the initial written notice until after the IRS issues such guidance.

h. Guidance on issues related to Qualified Small Employer Health Reimbursement Arrangements, including required reporting by employers. Notice 2017-67, 2017-47 I.R.B. 517 (10/31/17). In this notice, the IRS has provided guidance to employers offering Qualified Small Employer Health Reimbursement Arrangements, which are described in Code

§ 9831(d). Among other guidance, the notice clarifies that a QSEHRA can be provided only to current employees, not to retirees. The notice provides that employers ofering a QSEHRA in 2017 or 2018 must provide the required written notice to employees by the later of (1) 90 days before the first day of the QSEHRA plan year, or (2) February 28, 2018. The notice contains sample language and provides requirements for the notice. An employer must report payments and reimbursements that an employee was entitled to receive (i.e., without regard to the amounts the employee actually received) in Box 12 of Form W-2 using code FF.

2. 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 minimus* 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).

3. There are no adverse tax consequences for employers or employees if employees forgo their vacation, sick, or personal leave in exchange for the employer's contributions to charitable organizations providing disaster relief for those affected by Hurricanes Harvey and Irma. Notice 2017-48, 2017-39 I.R.B. 254 (9/5/17) and Notice 2017-52, 2017-40 I.R.B. 262 (9/14/17). In these notices, the IRS has provided guidance on the tax treatment of cash payments that employers make pursuant to leave-based donation programs for the relief of victims of Hurricanes Harvey and Irma (as well as the Tropical Storm forms of these hurricanes). Under leave-based donation programs, employees can elect to forgo vacation, sick, or personal leave in exchange for cash payments that the employer makes to charitable organizations described in § 170(c). The notices provide that the IRS will not assert that: (1) cash payments an employer makes before January 1, 2019, to charitable organizations for the relief of victims of Hurricanes Harvey and Irma in exchange for vacation, sick, or personal leave that its employees elect to forgo constitute gross income or wages of the employees; (2) the opportunity to make such an election results in constructive receipt of gross income or wages for employees; or (3) an employer is permitted to deduct these cash payments exclusively under the rules of § 170 as a charitable contribution rather than the rules of § 162 as a business expense. Employees who make the election cannot claim a charitable contribution deduction under § 170 for the value of the forgone leave. The employer need not include cash payments made pursuant to the program in Box 1, 3 (if applicable), or 5 of the employee's Form W-2.

4. Ministers pray this "crabby" case gets reversed (again!) on appeal. Gaylor v. Mnuchin, 120 A.F.T.R.2d 2017-6128 (W.D. Wis. 10/6/17). In a case that previously was overturned on appeal to the Seventh Circuit, the U.S. District Court for the Western District of Wisconsin (Judge Crabb) held that § 107(2) is unconstitutional because it violates the First Amendment's establishment clause. Section 107(2) excludes from gross income a "rental allowance" paid to a minister as part of his or her compensation. Section 107(1) excludes the "rental value of a home" furnished to a minister as part of his or her compensation. For technical reasons, only § 107(2)'s "rental allowance" exclusion was at issue in this case. The named plaintiff, Gaylor, is co-president of the true plaintiff, Freedom from Religion Foundation, Inc. ("FFRF"). In a prior iteration of the case, *Freedom from Religion Foundation, Inc. v. Lew*, 773 F.2d 815 (7th Cir. 2014), the Seventh Circuit vacated Judge Crabb's prior ruling striking down § 107(2) by determining that FFRF lacked standing to sue; however, the Seventh Circuit essentially instructed FFRF on how it might obtain standing. FFRF dutifully followed the Seventh Circuit's directions and then refiled its claim with Judge Crabb that § 107(2) violates the First Amendment's establishment clause because it "demonstrates a preference for ministers over secular employees." Look for the IRS and Treasury to appeal this one yet again.

5. 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.

6. 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.

7. 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.

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.

2. If you use an ESOP to attempt to reduce tax liability, failing to pay yourself compensation for services can be costly. DNA Pro Ventures, Inc. Employee Stock Ownership Plan v. Commissioner, T.C. Memo. 2015-195 (10/5/15). The IRS determined that an ESOP was not qualified under § 401(a) and that its related trust therefore was not tax-exempt under § 501(a). In this declaratory judgment action, the Tax Court (Judge Dawson) held that the IRS did not abuse its discretion in making this determination. The sponsor of the ESOP, DNA Pro Ventures, Inc., was formed by an orthopedic surgeon (Dr. Prohaska) and his wife, who were the corporation's sole stockholders, directors, and employees. In 2008, the corporation issued 1,150 shares of class B common stock to the ESOP's trust with a par value of $10 per share. The trust then allocated those shares to Dr. Prohaska's ESOP account. The corporation paid no compensation to Dr. Prohaska or his wife in 2008. Under § 401(a)(16), a trust is not qualified if the plan provides for benefits or contributions that exceed the limitations of § 415, which for the 2008 plan year limited annual additions (the sum of employer contributions, employee contributions, and forfeitures) to the lesser of $40,000 or 100% of the participant's compensation. The court held that, because neither Dr. Prohaska nor his wife received any compensation from the corporation for 2008, their contribution limits were zero, and the corporation's transfer of the class B common stock in 2008 was an employer contribution that exceeded the contribution limit by $11,500. Accordingly, the court held, the ESOP failed the requirements of § 401(a)(16) and was not a qualified plan for 2008. Further, a § 415 failure is a continuing failure, and therefore the ESOP was not a § 401(a) qualified plan for all subsequent plan years. The ESOP also failed to be a § 401(a) qualified plan because it had failed to obtain annual appraisals in violation of the plan itself, which required valuation of the trust fund on each valuation date.

a. The Eighth Circuit sees it the same way. DNA Pro Ventures, Inc. v. Commissioner, 856 F.3d 557 (8th Cir. 5/9/17). In an opinion by Judge Loken, the U.S. Court of Appeals for the Eighth Circuit affirmed the Tax Court's decision. The court held that, because neither Dr. Prohaska nor his wife received any compensation from the corporation for 2008, their contribution limits were zero, and the corporation's transfer of the class B common stock of DNA Pro Ventures, Inc. to the ESOP's trust in 2008 was an employer contribution that exceeded the contribution limit of § 415. Under § 401(a)(16), a trust is not qualified if the plan provides for benefits or contributions that exceed the limitations of § 415. Accordingly, the ESOP was not qualified under § 401(a) and its related trust therefore was not tax-exempt under § 501(a) for 2008 and the subsequent tax years under audit.

3. IRA trustees and plan administrators can take the taxpayer's word for it that the taxpayer is eligible for a waiver of the 60-day rollover period. Rev. Proc. 2016-47, 2016-37 I.R.B. 346 (8/24/16). This revenue procedure provides for a self-certification procedure (subject to verification on audit) that a taxpayer can use to claim eligibility for a waiver with respect to a rollover into a qualified plan or IRA. Under §§ 402(c)(3) and 408(d)(3), any amount distributed from a qualified plan or IRA is excluded from gross income if it is transferred to an eligible retirement plan no later than the 60th day following the day of receipt. A similar rule applies to § 403(a) annuity plans, § 403(b) tax sheltered annuities, and § 457 eligible governmental plans. A taxpayer who fails to meet the 60-day requirement can seek a waiver, pursuant to §§ 402(c)(3)(B) and 408(d)(3)(I), on the grounds that "failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement." Taxpayers seek a waiver by submitting a request for a private letter ruling pursuant to Rev. Proc. 2003-16, 2003-1 C.B. 359. This revenue procedure does not eliminate a taxpayer's ability to seek a private letter ruling, but allows a taxpayer to make a written self-certification to a plan administrator or an IRA trustee provided that three conditions are met: (1) the IRS has not previously denied a waiver request with respect to the rollover, (2) the taxpayer failed to meet the 60-day requirement because of the taxpayer's inability to complete a rollover due to one or more of several specified reasons, including an error by the financial institution receiving the contribution or making the distribution, the taxpayer's misplacement and failure to cash the distribution check, severe damage to the taxpayer's principal residence, incarceration of the taxpayer, serious illness of the taxpayer or a member of the taxpayer's family, or the death of a member of the taxpayer's family, and (3) the taxpayer makes the contribution to the plan or IRA as soon as practicable after the circumstance justifying the waiver no longer prevents the taxpayer from making the contribution. (This third requirement is deemed to be satisfied if the contribution is made within 30 days after the circumstance justifying the waiver no longer prevents the taxpayer from making the contribution.) The revenue procedure provides a model letter that taxpayers can use for a self-certification. A plan administrator or IRA trustee can rely on a taxpayer's self-certification in determining whether the taxpayer has satisfied the conditions for a waiver of the 60-day rollover requirement unless the administrator or trustee has actual knowledge to the contrary. However, IRA trustees will be required to report on Form 5498 that a contribution was accepted after the 60-day deadline. The self-certification allows a taxpayer to report a contribution as a valid rollover, but the IRS can challenge on audit the taxpayer's eligibility for a waiver and can still seek to impose penalties such as the failure-to-pay penalty of § 6651. The revenue procedure modifies Rev. Proc. 2003-16 by providing that the IRS may grant a waiver during an examination of the taxpayer's income tax return. The revenue procedure is effective on 8/24/16.

a. The IRS examination division has authority to grant a hardship waiver of the 60-day rollover period, and the IRS's decision is subject to judicial review, says the Tax Court. Trimmer v. Commissioner, 148 T.C. No. 14 (4/20/17). Shortly after the taxpayer had retired from the New York City Police Department in 2011 and his post-retirement job as a security guard had fallen through, the taxpayer began experiencing symptoms of major depressive disorder. His depression lasted approximately one year. His wife testified that, during this period, he was "'like a lost soul,' and when she came home from work in the evening she would often find him where she had left him in the morning." During this period, the taxpayer received two checks in the total amount of approximately $100,000 from his retirement accounts with the New York City Employees' Retirement System and the New York City Police Pension Fund. The checks stayed on his dresser for about one month before he deposited them in the couple's joint bank account. The funds remained in the bank account for approximately nine months when, on the advice of the couple's tax return preparer, the taxpayer moved the funds into an IRA at the same bank. The IRS issued Notice CP-2000 asserting that the taxpayer had to include the $100,000 in gross income and was subject to the 10 percent penalty tax of § 72(t). The taxpayer responded to the notice with a letter in which he explained that he had experienced depression and that the funds had been moved into an IRA and stated:

> I went through a rough time upon separation from my job, causing me emotional hard times that caused this situation. Penalizing me and my family would not benefit anybody, only cause extreme duress and punish my children who played no part in this situation. I ask you to consider these facts and please come to a fair decision.

The IRS responded with a letter summarily denying relief that did not mention the availability of a hardship waiver under § 402(c)(3)(B) of the normal requirement that funds withdrawn from a qualified plan be rolled over within 60 days to an eligible retirement plan in order to be excluded from gross income. The taxpayer filed a petition in the Tax Court in response to the IRS's subsequent issuance of a notice of deficiency. The IRS asserted two main arguments: (1) the hardship waiver provision of § 402(c)(3)(B) was inapplicable because the taxpayer had failed to request a private letter ruling pursuant to Rev. Proc. 2003-16, 2003-1 C.B. 359 and therefore the IRS examination division had no authority to determine whether the taxpayer qualified for a waiver; and (2) even if the examination division did have authority to consider a hardship waiver, the IRS's determination concerning the waiver is not subject to judicial review. The Tax Court (Judge Thornton) rejected both of the IRS's arguments and concluded that the taxpayer was eligible for a hardship waiver of the 60-day rollover requirement. With respect to the authority of the IRS to consider a hardship waiver during an examination, the court reviewed Rev. Proc. 2003-16, 2003-1 C.B. 359, and its modification by Rev. Proc. 2016-47, 2016-37 I.R.B. 346 (8/24/16), and concluded that "the purpose and effect of the 2016 modification of Rev. Proc. 2003-16 [to permit the grant of a waiver during examination] … was not to create some new authority that had not previously existed for IRS examiners to consider hardship waivers during examinations, but rather to make clear the existence of that authority." According to the court, the IRS had, in fact, made a final determination to deny the taxpayer a hardship waiver. With respect to the issue whether the IRS's determination of eligibility for a hardship waiver is subject to judicial review, the court concluded that the jurisdiction conferred by the taxpayer's filing of a timely petition in response to the notice of deficiency "includes reviewing administrative determinations that are necessary to determine the merits of deficiency determinations." Further, there were no reasons, the court explained, for the court to refrain from reviewing the IRS's exercise of administrative discretion. The appropriate standard of review of the IRS's determination concerning a hardship waiver, according to the court, is abuse of discretion. The court concluded that the IRS—which had "failed to address or even acknowledge any of the facts and circumstances [the taxpayer] set forth in his letter"—had abused its discretion in denying the taxpayer a hardship waiver. Finally, the court concluded based on all of the evidence that the taxpayer qualified for a hardship waiver of the 60-day rollover period. Because the distributions were not included the taxpayer's gross income, the 10 percent penalty tax of § 72(t) also did not apply.

- The taxpayer was represented by students enrolled in the Low Income Taxpayer Clinic at Fordham University School of Law.

4. 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.

5. Some inflation-adjusted numbers for 2018. Notice 2017-64, 2017-45 I.R.B. 486 (10/19/17).

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

- The limit on contributions to an IRA will be unchanged at $5,500. The AGI phase out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to $63,000 to $73,000 (from $62,000-$72,000) for single filers and heads of household, increased to $101,000-$121,000 (from $99,000-$119,000) 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 $186,000-$196,000) 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 $189,000-$199,000 (from $186,000-$196,000) for married couples filing jointly, and increased to $120,000-$135,000 (from $118,000-$133,000) for singles and heads of household.

- The annual benefit from a defined benefit plan under § 415 is increased to $220,000 (from $215,000).

- The limit for defined contribution plans is increased to $55,000 (from $54,000).

- The amount of compensation that may be taken into account for various plans is increased to $275,000 (from $270,000), and is increased to $405,000 (from $4005,000) for government plans.

- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to $63,000 (from $62,000) for married couples filing jointly, increased to $47,250 (from $46,5005) for heads of household, and increased to $31,500 (from $31,000) for singles and married individuals filing separately.

C. <u>Nonqualified Deferred Compensation, Section 83, and Stock Options</u>

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.

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

D. Individual Retirement Accounts

1. A lesson on how not to handle a deceased spouse's IRA. Ozimkoski v. Commissioner, T.C. Memo. 2016-228 (12/19/16). The will of the taxpayer's deceased husband appointed the taxpayer as personal representative and, with minor exceptions, left all of his property to the taxpayer. The taxpayer and her deceased husband each had a traditional IRA with Wachovia (later acquired by Wells Fargo). The deceased husband's adult son, who was the taxpayer's stepson, petitioned the probate court to revoke the will. In settlement of the stepson's claims, the taxpayer and the stepson agreed that the taxpayer would transfer to the stepson a 1967 Harley Davidson motorcycle and $110,000. The agreement provided that "[a]ll payments shall be net payments free of any tax." Because of the stepson's claims, Wachovia froze the deceased husband's IRA. In 2008, following the settlement, Wachovia transferred approximately $235,000 from the deceased husband's IRA to the taxpayer's IRA. The taxpayer, who was age 53, then withdrew a total of approximately $175,000 from her IRA during 2008, $110,000 of which she paid to the stepson. Wachovia issued a Form 1099-R reporting the distributions as early distributions. The taxpayer filed her 2008 income tax return twenty-four days late and did not include the IRA distributions in her gross income. The IRS issued a notice of deficiency asserting an income tax deficiency of $62,185, a § 72(t) penalty tax for early withdrawal by a taxpayer not yet age 59-1/2 of $17,460, a late-filing penalty of $3,100, and an accuracy-related penalty of $12,437 for substantial understatement of income tax. The taxpayer, who appeared pro se, argued that $110,000 of the distributions should not be included in her gross income because the stepson was entitled to that amount through the probate litigation and resulting settlement. The Tax Court (Judge Paris) first concluded that Wachovia had incorrectly rolled the deceased husband's IRA into the taxpayer's IRA because she was not a named beneficiary of the deceased husband's IRA. In the court's view, Wachovia should have distributed the assets of the deceased husband's IRA to his estate. Nevertheless, the court reasoned that it could not unwind that transaction and had to decide the issues based on the transfers that had actually occurred. The court held that the taxpayer had to include in her gross income all of the 2008 distributions from her IRA, including the $110,000 that she paid to her stepson. The court also upheld the imposition of the § 72(t) penalty tax. Although an exception § 72(t)(2)(A)(ii) provides that the penalty tax does not apply to distributions "made to a beneficiary (or to the estate of the employee) on or after the death of the employee," the court relied on prior decisions, including *Gee v. Commissioner*, 127 T.C. 1 (2006), to conclude that the exception does not apply where, as here, a beneficiary rolls over the funds from a deceased spouse's IRA into his or her IRA and then withdraws funds from his or her IRA. The court also upheld the late-filing penalty because the taxpayer had failed to establish that the late filing was due to reasonable cause and not due to willful neglect. However, the court held that, taking into account all the circumstances, including the taxpayer's experience, knowledge, and education, the taxpayer had established a reasonable cause, good faith defense to the accuracy-related penalty with respect to the portion of the understatement attributable to the $110,000 the taxpayer paid to her stepson (but not with respect to the portion attributable to the remaining $65,000 in distributions).

- It appears to us that, with proper advice and planning, the taxpayer could have avoided both the 10 percent penalty of § 72(t) and the inclusion in her gross income of the $110,000 she paid to her stepson. Rather than transfer the $235,000 balance of her deceased husband's IRA into her own IRA, the taxpayer could have left the funds in her deceased husband's IRA. This should have permitted a direct payment of $110,000 from her deceased husband's IRA to the stepson without inclusion of those funds in her gross income. It also should have permitted her to avoid the 10 percent penalty by taking advantage of the exception in § 72(t)(2)(A)(ii).

2. The form of the transaction was a mystery, but Judge Gustafson peers through the fog to find that the substance was what the taxpayer said it was. McGaugh v. Commissioner, T.C. Memo. 2016-28 (2/24/16). The taxpayer had a self-directed IRA of which Merrill Lynch was the custodian. Among its other assets, the IRA held stock in First Personal Financial Corp. The taxpayer asked Merrill Lynch to purchase additional stock in First Personal Financial Corp. for the IRA. Although the investment in First Personal Financial Corp. was not a prohibited investment for the IRA, Merrill Lynch, for reasons not reflected in the record, refused to purchase the stock directly. At the taxpayer's request, Merrill Lynch issued a wire transfer directly to First Personal Financial Corp., and more than 60 days thereafter, First Personal Financial Corp. issued the stock in the name of the taxpayer's IRA. Merrill Lynch attempted to deliver the stock certificate to the taxpayer, but at trial, the possession of the stock certificate issued in the name of the IRA was unclear. The record indicated that if the stock certificate had been received by Merrill Lynch within the 60-day period, it would have been accepted. Merrill Lynch reported the transaction on Form 1099-R as a taxable distribution because it had determined that the wire transfer was a distribution to the taxpayer that was not followed by a rollover investment within the 60-day period permitted under § 408(d)(3). The IRS determined that the wire transfer issued by Merrill Lynch constituted a "distribution" from the IRA and was includible in gross income under §§ 408(d) and 72 and that, because the taxpayer had not yet reached age 59-1/2, it was an "early distribution" subject to the § 72(t) 10 percent additional tax. The Tax Court (Judge Gustafson) held that there had not been a distribution from the IRA to the taxpayer and did not uphold the deficiency. The opinion noted that there was no evidence that the taxpayer requested an IRA distribution to himself. "No cash, check, or wire transfer ever passed through [the taxpayer's] hands, and he was therefore not a literal "payee or distributee" of any amount." The taxpayer "was, at most, a conduit of the IRA funds." The court distinguished *Dabney v. Commissioner*, T.C. Memo. 2014-108, which involved a similar wire transfer of self-directed IRA funds to purchase an asset and in which the court found a taxable distribution, on the basis that the asset purchased in *Dabney* (land) was one that the IRA custodian would not permit the IRA to hold. In contrast, the asset purchased in this case, stock of First Personal Financial Corp., was a permissible investment that the IRA already held.

a. The Seventh Circuit agrees. McGaugh v. Commissioner, 860 F.3d 1014 (7th Cir. 6/26/17), *aff'g* T.C. Memo. 2016-28 (2/24/16). In an opinion by U.S. District Judge DeGuilio (sitting by designation), the U.S. Court of Appeals for the Seventh Circuit affirmed the Tax Court's decision. The government argued on appeal that the taxpayer had constructively received the IRA proceeds and therefore had to include them in gross income. The court rejected this argument:

> McGaugh didn't direct a distribution to a third party; he bought stock. That is a prototypical, permissible IRA transaction. … Further, there is no indication that McGaugh orchestrated this purchase for the benefit of [First Personal Financial Corp.] or for any reason other than because he wished to obtain stock to be held by his IRA. Thus, there is no evidence that he constructively received funds, either in ordering Merrill Lynch to wire funds to [First Personal Financial Corp.], or in any other respect.

3. 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.

		2018 Rates for Single Individuals **If taxable income is:**	**Then income tax equals:**
1	*Before TCJA*	Not over $9,525	10% of taxable income
	After TCJA	Not over $9,525	10% of taxable income
2	*Before TCJA*	Over $9,525 but not over $38,700	$952.50 plus 15% of the excess over $9,525
	After TCJA	Over $9,525 but not over $38,700	$952.50, plus 12% of the excess over $9,525
3	*Before TCJA*	Over $38,700 but not over $93,700	$5,328.75 plus 25% of the excess over $38,700
	After TCJA	Over $38,700 but not over $82,500	$4,453.50, plus 22% of the excess over $38,700
4	*Before TCJA*	Over $93,700 but not over $195,450	$19,078.75 plus 28% of the excess over $93,700
	After TCJA	Over $82,500 but not over $157,500	$14,089.50, plus 24% of the excess over $82,500
5	*Before TCJA*	Over $195,450 but not over $424,950	$47,568.75 plus 33% of the excess over $195,450
	After TCJA	Over $157,500 but not over $200,000	$32,089.50, plus 32% of the excess over $157,500
6	*Before TCJA*	Over $424,950 not over $426,700	$123,303.75 plus 35% of the excess over $424,950
	After TCJA	Over $200,000 but not over $500,000	$45,689.50, plus 35% of the excess over $200,000
7	*Before TCJA*	Over $426,700	$123,916.25 plus 39.6% of the excess over $426,700
	After TCJA	Over $500,000	$150,689.50, plus 37% of the excess over $500,000

	2018 Rates for Married Individuals Filing Joint Returns and Surviving Spouses	If taxable income is:	Then income tax equals:
1	*Before TCJA*	Not over $19,050	10% of taxable income
	After TCJA	Not over $19,050	10% of taxable income
2	*Before TCJA*	Over $19,050 but not over $77,400	$1,905 plus 15% of the excess over $19,050
	After TCJA	Over $19,050 but not over $77,400	$1,905, plus 12% of the excess over $19,050
3	*Before TCJA*	Over $77,400 but not over $156,150	$10,657.50 plus 25% of the excess over $77,400
	After TCJA	Over $77,400 but not over $165,000	$8,907, plus 22% of the excess over $77,400
4	*Before TCJA*	Over $156,150 but not over $237,950	$30,345 plus 28% of the excess over $156,150
	After TCJA	Over $165,000 but not over $315,000	$28,179, plus 24% of the excess over $165,000
5	*Before TCJA*	Over $237,950 but not over $424,950	$53,249 plus 33% of the excess over $237,950
	After TCJA	Over $315,000 but not over $400,000	$64,179, plus 32% of the excess over $315,000
6	*Before TCJA*	Over $424,950 but not over $480,050	$114,959 plus 35% of the excess over $424,950
	After TCJA	Over $400,000 but not over $600,000	$91,379, plus 35% of the excess over $400,000
7	*Before TCJA*	Over $480,050	$134,244 plus 39.6% of the excess over $480,050
	After TCJA	Over $600,000	$161,379, plus 37% of the excess over $600,000

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.

2018 Rates of Tax on Adjusted Net Capital Gain

Tax Rate	Single	Head of Household	Married Filing Jointly	Married Filing Separately	Estates and Trusts
0% if taxable income does not exceed	$38,600	$51,700	$77,200	$38,600	$2,600
15% if taxable	$425,800	$452,400	$479,000	$239,500	$12,700

income does not exceed					
20% if taxable income exceeds	$425,800	$452,400	$479,000	$239,500	$12,700

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 interest in a defined benefit pension plan is not an asset for purposes of determining whether a taxpayer is insolvent and therefore eligible to exclude COD income. Schieber v. Commissioner, T.C. Memo. 2017-32 (2/9/17). The taxpayer, a retired police officer, received monthly payments from the California Public Employees' Retirement System (CalPERS) defined benefit pension plan. During 2009, a creditor of the taxpayer cancelled $418,596 of debt. On the joint return for 2009 that the taxpayer and his wife filed, they excluded a portion of the cancelled debt from gross income on the basis that they were insolvent. The IRS issued a notice of deficiency in which the IRS determined that the taxpayers had to include in gross income the entire amount of the cancelled debt. Section 108(d)(3) defines "insolvent" as the amount by which a taxpayer's liabilities exceed the fair market value of the taxpayer's assets immediately before the debt is cancelled. The IRS argued that, in determining whether the taxpayers were insolvent, the taxpayers' interest in the CalPERS pension plan must be considered an asset. Taking into account this asset, the IRS argued, the taxpayers were not insolvent. The Tax Court (Judge Morrison) held that the taxpayers' interest in the plan was not an asset for purposes of the insolvency exclusion. The taxpayers' interest in the plan, the court noted, entitled them only to monthly payments, could not be converted to a lump-sum cash amount, and could not be sold or assigned. The taxpayers could neither borrow against the interest nor borrow from the plan. The relevant inquiry established in prior cases such as *Carlson v. Commissioner*, 116 T.C. 87 (2001) for determining whether an item is an asset for this purpose is whether the item gives the taxpayer the ability to pay an immediate tax on income from the cancelled debt, not whether it gives the taxpayer the ability to pay the tax gradually over time. Because the taxpayers' interest in the plan was not considered an asset, they were insolvent by $293,308 and entitled to exclude this portion of the $418,596 cancelled debt.

2. Provisions of the 2017 Tax Cuts and Jobs Act that affect ABLE accounts.

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

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

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 2017 and before 2026.

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

D. Deductions and Credits for Personal Expenses

1. A dependency exemption, but not the child tax credit, is available for a permanently and totally disabled child who has attained age seventeen. Polsky v. United States, 844 F.3d 170 (3d Cir. 12/15/16). The taxpayers, a married couple appearing pro se, had a daughter who was permanently disabled and who was over age seventeen. For the years 2010 and 2011, the taxpayers claimed a child tax credit with respect to their daughter under § 24. The IRS disallowed the credit on the ground that their daughter had attained age seventeen. Section 24(c)(1) allows the credit only for a "qualifying child," defined in § 24(c)(1) as "a qualifying child of the taxpayer (as defined in section 152(c)) who has not attained age 17." The taxpayers argued that the credit nevertheless was available because the cross-reference in § 24(c)(1) to § 152(c) incorporates § 152(c)(3)(B), which states that a child is a qualifying child without regard to the child's age if the child is permanently and totally disabled. In a per curiam opinion, the U.S. Court of Appeals for the Third Circuit affirmed the District Court and held that the child tax credit is available only when the qualifying child both "meets the non-age-related requirements of § 152(c) and 'has not attained age 17.'" Accordingly, the taxpayers were not entitled to the credit. The court quoted from the District Court's opinion:

> Section 24 imports the basic qualifications from § 152(c), and adds an age limitation of seventeen years. ... The age restriction in § 24(c)(1) is intended to end the tax *credit* when the child reaches seventeen years of age. In contrast, the special rule applicable to permanently and totally disabled dependents in § 152(c)(3)(B) is calculated to extend the tax *deduction* as long as the child is disabled. Therefore, the taxpayer can take a dependent deduction regardless of the child's age as long as the child is permanently and totally disabled, but cannot receive a tax credit for a disabled child who, by the close of the taxable year, was seventeen years of age.

2. Proposed regulations address several issues related to the definition of a dependent. REG-137604-07, Definition of Dependent, 82 F.R. 6370 (1/19/17). The Treasury Department and the IRS have issued proposed regulations that address several issues related to the definition of a dependent. Section 151 authorizes the deduction of an exemption amount for each dependent as defined in § 152. The term "dependent" also is relevant for purposes of other Code provisions. Generally, the term "dependent" is defined in § 152(a) as a qualifying child or a qualifying relative. The following summary discusses some of the highlights of the proposed regulations.

Relationship Test (Qualifying Child and Qualifying Relative)—Under § 152(d)(1), an individual can be a qualifying relative of a taxpayer only if, among other requirements, the individual is not a qualifying child of the taxpayer or any other taxpayer. This rule could prevent a taxpayer from claiming a dependency exemption deduction for an unrelated child that the taxpayer supports, e.g., if the unrelated child and the child's parent both live with the taxpayer. The proposed regulations adopt the rule in Notice 2008-5, 2008-2 I.R.B. 256 (12/18/2007), and provide that an individual is not a qualifying child of a person if that person (1) is not required to file an income tax return under § 6012, and (2) either does not file an income tax return or files an income tax return solely to claim a refund of estimated or withheld taxes.

Residency Test (Principal Place of Abode)—For a person to be a qualifying child of a taxpayer under § 152(c)(1), the person must, among other requirements, have the same principal place of abode as the taxpayer for more than one-half of the taxable year. Similarly, under § 152(d), a person other than the taxpayer's spouse can be a qualifying relative of the taxpayer if, among other requirements, the person has the same principal place of abode as the taxpayer and is a member of the taxpayer's household. In Prop. Reg. § 1.152-4(c), "principal place of abode" is defined as "the primary or main home or dwelling where the taxpayer resides." The proposed regulations provide that (1) temporary lodging such as a homeless shelter or relief housing resulting from displacement by a natural disaster may qualify as a person's principal place of abode; (2) a person has the same principal place of abode as the taxpayer despite a temporary absence, defined as occurring "if the taxpayer would have resided at the abode but for the absence and, under the facts and circumstances, it is reasonable to assume that the person will return to reside at the place of abode;" and (3) a person is treated as having the same principal place of abode as the taxpayer for more than one-half of the taxable year if the individual resides with the taxpayer for at least 183 nights during the taxable year (or at least 184 nights during leap years). The proposed regulations provide rules for determining nights of residence.

Age Test—For a person to be a qualifying child of a taxpayer under § 152(c)(1), the person must, among other requirements, be younger than the taxpayer and, as of the close of the calendar year, not have attained the age of 19 or be a student who has not attained the age of 24. In Prop. Reg. § 1.152-1(b)(2), the term "student" is defined as an individual who, during some part of each of five calendar months during the calendar year is a full-time student at an educational organization described in § 170(b)(1)(A)(ii)—generally a school that normally maintains a regular faculty and curriculum and has a regular body of students in attendance—or is pursuing a full-time course of institutional on-farm training under the supervision of specified authorities.

Support Test—For a person to be a qualifying child of a taxpayer under § 152(c)(1), the person must, among other requirements, not provide more than one-half of the person's own support. Similarly, under § 152(d), a person can be a qualifying relative of the taxpayer if, among other requirements, the taxpayer provides more than one-half of the person's support. According to Prop. Reg. § 1.152-4(a), "the amount of support provided by the individual, or the taxpayer, is compared to the total amount of the individual's support from all sources." The amount of an individual's support from all sources generally includes support the individual provides and income that is excludable from gross income. The term "support" includes food, shelter, clothing, medical and dental care, education, and similar items for the benefit of the supported individual. Generally, governmental payments and subsidies are treated as support provided by a third party. These include Temporary Assistance for Needy Families (TANF), low-income housing assistance, benefits under the Supplemental Nutrition Assistance Program, Supplemental Security Income payments, foster care maintenance payments, and adoption assistance payments. In contrast, old age benefits under the Social Security Act, which are based on earnings, are treated as support provided by the recipient to the extent the recipient uses the benefits for support. Similarly, SSDI payments to the child of a deceased or disabled parent are treated as support provided by the child to the extent those payments are used for the child's support. The proposed regulations provide that governmental payments used by the intended beneficiary or recipient to support another individual constitute support provided by the intended beneficiary or recipient of the payments. For example, a mother who uses TANF payments to support her children is treated as providing that support. The preamble to the proposed regulations states that the IRS will no longer assert the position it took in *Lutter v. Commissioner*, 61 T.C. 685 (1974), *aff'd per curiam*, 514 F.2d 1095 (7th Cir. 1975), in which the government successfully argued that governmental payments received by a parent and used for the support of children constituted support provided by the government.

Tiebreaker Rules and Determination of AGI of Joint Filers—Under the tiebreaker rules of § 152(c)(4), if a person meets the definition of a qualifying child for two or more taxpayers, the taxpayer who is a parent of the person may claim the person as a qualifying child. If more than one parent claims the person as a qualifying child, and if the parents do not file a joint return with each other, then the person is treated as the qualifying child of the parent with whom the person resides for the longest period during the year. If the person resides an equal amount of time with each parent, then the person is treated as the qualifying child of the parent with the highest adjusted gross income. If no eligible parent claims the person as a qualifying child, then the person may be claimed as a qualifying child by another taxpayer only if the taxpayer's adjusted gross income exceeds the adjusted gross income of each eligible parent and (under Prop. Reg. § 1.152-2(g)(1)(ii)) of any other taxpayer who is eligible to claim the person as a qualifying child. For purposes of these rules, Prop. Reg. § 1.152-2(g)(2) provides that the adjusted gross income of each person who files a joint return is the total adjusted gross income shown on the joint return. For example, if daughter, daughter's husband and their three-year-old child live with daughter's mother (grandmother), and if daughter and husband file a joint return showing total adjusted gross income of $45,000, grandmother can claim the child as a qualifying child only if daughter and husband do not do so and grandmother's adjusted gross income exceeds $45,000. This is a change from Publication 501, *Exemptions, Standard Deduction, and Filing Information*, and will be reflected in revisions to Publication 501. Since 2009, Publication 501 has stated that, if a child's parents file a joint return with each other, then the adjusted gross income of each parent is determined by dividing the parents' combined adjusted gross income equally between them.

Noncustodial Spouse Claiming Dependency Exemption—Section 152(e)(2)(A) provides that a noncustodial parent can claim the dependency exemption only if "the custodial parent signs a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such custodial parent will not claim such child as a dependent for any taxable year beginning in such calendar year." The IRS generally requires the custodial spouse's written declaration to be on Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents.* Under Prop. Reg. § 1.152-5(e)(2)(i), the noncustodial spouse can submit the written declaration with an original return, an amended return, or during an examination of a return. However, a written declaration submitted with an amended return or during an examination will not satisfy the requirement of § 152(e) if (1) the custodial parent signed the written declaration after the custodial parent filed a return claiming a dependency exemption for the child for the year at issue, and (2) the custodial parent has not filed an amended return to remove the custodial parent's claim of a dependency exemption.

Childless Earned Income Credit—The IRS's position since 1995, reflected in Publication 596, *Earned Income Credit*, has been that, if a person meets the definition of a qualifying child for more than one taxpayer but is not treated as the qualifying child of a taxpayer under the tiebreaker rules, then the taxpayer for whom the person is not a qualifying child is precluded from claiming the childless earned income credit (the earned income credit that is available to taxpayers without a qualifying child). The proposed regulations reflect a change in the IRS's position. According to Prop.

Reg. § 1.32-2(c)(3)(ii), if a person is not a qualifying child of a taxpayer under the tiebreaker rules, then the person also is not treated as a qualifying child of the taxpayer for purposes of § 32(c)(1)(A), and therefore the taxpayer may claim the earned income credit for a taxpayer without a qualifying child if all other requirements for the earned income credit are satisfied.

Effective Date—The regulations are proposed to apply to taxable years beginning after the date final regulations are published in the Federal Register. Pending the issuance of final regulations, taxpayers can choose to apply the proposed regulations in any open tax years.

3. A grandmother was precluded from claiming her grandchildren as dependents because her good-for-nothing son had done so, and the son's submission of an amended return to the IRS Chief Counsel attorney before trial did not change the result. Smyth v. Commissioner, T.C. Memo. 2017-26 (2/7/17). The taxpayer, who worked as a certified nursing assistant, provided the financial support for her two young grandchildren and the parents of the grandchildren (the taxpayer's son and daughter-in-law). Her son, daughter-in-law, and grandchildren all lived in the taxpayer's home. Neither the son—referred to as being involved in dealing drugs—nor the daughter-in-law was employed. For the 2012 tax year, the taxpayer claimed her two grandchildren as dependents, head-of-household filing status, the earned income credit, and the child tax credit. Although the taxpayer's son represented to her that he and his wife had not claimed the children as dependents for 2012, this was not true. The IRS issued a notice of deficiency disallowing both the taxpayer's deduction for the two dependents and her earned income credit and child tax credit, and changing her filing status to single. Two weeks before trial, the son delivered to the IRS Chief Counsel attorney an amended return for 2012 on which he did not claim the children as dependents. The Tax Court (Judge Holmes) upheld the government's disallowance of the taxpayer's deduction and credits and its change of the taxpayer's filing status. The court observed that each grandchild was a "qualifying child" within the meaning of § 152(c) of both the taxpayer and the taxpayer's son. Under the tiebreaker rules of § 152(c)(4), if the parents of a qualifying child do not claim the child as a dependent, another individual with respect to whom the child is a qualifying child may do so if the individual's adjusted gross income is higher than that of both parents. Although the taxpayer's adjusted gross income was higher than that of her son and daughter-in-law, the court explained, the fact that her son had filed a return claiming the children as dependents precluded the taxpayer from doing so. The son's amended 2012 return on which the son did not claim the children as dependents did not change the result. Under the relevant regulations, an amended return is filed if it is mailed to the correct IRS Service Center or hand-delivered to a person assigned the responsibility to receive returns in the local IRS office. Submitting the amended return to the IRS Chief Counsel attorney handling the trial, the court reasoned, did not meet either requirement and therefore did not constitute "filing" the return. The court noted that the parent's filing of an amended return in some cases might allow another individual to claim the child as a dependent:

> A few cases imply that an amended return could under the right circumstances be used to give up a previously claimed dependency exemption deduction. In *Brooks*, we suggested that if the taxpayer's daughter had prepared an amended return releasing her claim before the IRS started auditing her mother and had filed it with the IRS before trial, then the court might have reached a different result. And in *McBride v. Commissioner*, T.C. Memo. 2015-6, we suggested that a grandfather might be entitled to a dependency exemption deduction for his grandchild if the child's mother had correctly filed an amended return giving up her claim before the IRS was barred from determining a deficiency against her. *Id*. at *4. We note that the Commissioner points out in his brief that allowing a taxpayer to amend his return—and essentially give his dependency exemption deduction to another—after he has already received a refund because of that deduction effectively puts the IRS in an unmanageable situation. We don't have to decide this question now, but will have to think about it carefully when someone in a case like this one actually files an amended return to give up a qualifying-child claim.

4. He might not have been wearing an orange jumpsuit, but he still earned his income while he was an inmate at a penal institution, and therefore the income was excluded in

determining eligibility for the EITC. Skaggs v. Commissioner, 148 T.C. No. 15 (4/26/17). Section 32(c)(2)(B)(iv) provides that, in determining eligibility for the earned income tax credit, "no amount received for services provided by an individual while the individual is an inmate at a penal institution shall be taken into account." The taxpayer was convicted of several felony offenses, sentenced to 310 months' imprisonment, and taken into custody by the Kansas Department of Corrections. During 2015, the taxpayer resided in the Larned State Hospital, described by the court as "the home of the State security hospital, which was established to treat mentally ill inmates and those committed by the State and to hold them in custody." The taxpayer performed custodial duties at the hospital and filed a return for 2015 on which he reported $2,921 of income and claimed an EITC of $214. The IRS denied the EITC on the ground that the taxpayer had earned the income for services performed while he was an inmate at a penal institution. The Tax Court (Judge Buch) upheld the IRS's denial of the credit. The court noted that neither the statute nor the regulations define the terms "inmate" or "penal institution." Nevertheless, the court concluded that the taxpayer was an inmate at a penal institution. The court reasoned that, although he might not have been subject to some of the restrictions that normally apply to inmates in Kansas correctional facilities (e.g., the taxpayer asserted that he was able to wear his own clothes and had greater discretion with the income he earned), he was still an inmate. The court also concluded, based on the statutes that govern the hospital, that it was a penal institution.

5. Final regulations provide guidance on eligibility for the § 36B premium tax credit of married taxpayers who are victims of domestic abuse or spousal abandonment and do not file a joint return, allocation rules for reconciliation of advance credit payments and the credit, and guidance on the deduction for health insurance costs of self-employed individuals. T.D. 9822, Health Insurance Premium Tax Credit, 82 F.R. 34601 (7/26/17). The Treasury Department and the IRS have finalized, with only a minor change, proposed and temporary regulations (T.D. 9683, Rules Regarding the Health Insurance Premium Tax Credit, 79 F.R. 43622 (7/28/14)) regarding the premium tax credit authorized by § 36B for individuals who meet certain eligibility requirements and purchase coverage under a qualified health plan through an Affordable Insurance Exchange. The regulations generally apply to taxable years beginning after December 31, 2013.

Eligibility for the Premium Tax Credit of Married Taxpayers Who Are Victims of Domestic Abuse or Spousal Abandonment—To be eligible for the premium tax credit, an individual who is married within the meaning of § 7703 must, among other requirements, file a joint return. See I.R.C. § 36B(c)(1)(C). Married individuals who live apart can be treated as not married if they meet the requirements of § 7703(b), but victims of domestic abuse or spousal abandonment might not meet those requirements. Accordingly, absent relief, victims of domestic abuse or spousal abandonment who are married and do not file a joint return (e.g., because of the risk of injury arising from contacting the other spouse, a restraining order that prohibits contact with the other spouse, or inability to locate the other spouse) would be precluded from claiming the premium tax credit. The final regulations provide that a married taxpayer will satisfy the joint filing requirement of § 36B(c)(1)(C) if he or she uses a filing status of married filing separately and meets three requirements: (1) at the time the individual files the return, the individual lives apart from his or her spouse, (2) the individual is unable to file a joint return because he or she is a victim of domestic abuse or spousal abandonment, and (3) the individual certifies on the return in accordance with instructions that he or she meets the first two requirements. Reg. § 1.36B-2(b)(2)(iii). A taxpayer ceases to be eligible for this relief from the joint filing requirement if he or she qualified for the relief for each of the three preceding taxable years. Reg. § 1.36B-2(b)(2)(v). The final regulations generally define domestic abuse as including "physical, psychological, sexual, or emotional abuse, including efforts to control, isolate, humiliate, and intimidate, or to undermine the victim's ability to reason independently." Reg. § 1.36B-2(b)(2)(iii). A taxpayer is considered a victim of spousal abandonment "if, taking into account all facts and circumstances, the taxpayer is unable to locate his or her spouse after reasonable diligence." Reg. § 1.36B-2(b)(2)(iv).

Allocation Rules for Reconciliation of Advance Credit Payments and Premium Tax Credit—An individual who enrolls in coverage through a health insurance exchange can seek advance payment of the premium tax credit authorized by § 36B. The exchange makes an advance determination of eligibility for the credit and, if approved, the credit is paid monthly to the health insurance issuer. An individual who receives advance credit payments is required by § 36B(f)(1) to reconcile the amount of the advance payments with the premium tax credit calculated on the individual's income tax return for the year. If the taxpayer's advance credit payments exceed the actual premium tax credit allowed, then the taxpayer owes the excess as a tax liability. A taxpayer must reconcile the advance credit payments for coverage of all members of the taxpayer's family (defined as the taxpayer, spouse, and dependents) with the premium tax credit the taxpayer is allowed for the taxable year. To compute the premium tax credit and perform the required reconciliation, a taxpayer must know the advance credit payments, the actual premiums paid, and the premiums for the second lowest cost silver plan (the benchmark plan) for all family members. The final regulations provide rules for allocating advance credit payments, premiums, and benchmark plan premiums among family members. This allocation is necessary when: (1) married individuals file separate returns, (2) married individuals become divorced or legally separated during the year, or (3) an individual such as a child is enrolled in a qualified health plan by one taxpayer but another taxpayer claims a personal exemption deduction for the individual. In the latter two situations, the taxpayers can agree on an allocation percentage and, if the taxpayers do not agree, a default allocation percentage is provided.

Deduction for Health Insurance Costs of Self-Employed Individuals—A self-employed individual who is enrolled in a qualified health plan and eligible for the premium tax credit may also be allowed a deduction under § 162(*l*) for premiums paid for health insurance covering the taxpayer, the taxpayer's spouse, the taxpayer's dependents, and any child of the taxpayer who has not attained age 27. The final regulations provide rules for taxpayers who claim a § 162(*l*) deduction and also may be eligible for a § 36B credit for the same qualified health plan or plans. Under the final regulations, a taxpayer is allowed a § 162(*l*) deduction for "specified premiums" not to exceed an amount equal to the lesser of (1) the specified premiums less the premium tax credit attributable to the specified premiums, and (2) the sum of the specified premiums not paid through advance credit payments and the additional tax imposed under § 36B(f)(2)(A) and Reg. § 1.36B-4(a)(1) with respect to the specified premiums after the application of the limitation on additional tax in § 36B(f)(2)(B) and Reg. § 1.36B-4(a)(3). See Reg. § 1.162(*l*)-1T(a)(1). The term "specified premiums" generally is defined as premiums for which the taxpayer can otherwise claim a deduction under § 162(*l*) for a qualified health plan covering the taxpayer or another member of the taxpayer's family for a month that a premium tax credit is allowed for the family member's coverage.

6. Excess advance premium tax credits are treated as an increase in tax, and we do not have equitable power to change that result, says the Tax Court. McGuire v. Commissioner, 149 T.C. No. 9 (8/28/17). The taxpayers, a married couple, purchased health insurance for 2014 through Covered California, a health insurance exchange created under the Affordable Care Act. At the time they applied for coverage in 2013, their only income was that of Mr. McGuire. Based on this income, they qualified for an advance payment of the premium tax credit authorized by § 36B. Later in 2013, Mrs. McGuire became employed and the couple's income increased. They informed the exchange of the increase in income and of their change of address. The exchange did not update their address. The exchange sent them a letter informing them that they no longer qualified for the premium tax credit, but they never received the letter. Similarly, they never received from the exchange Form 1095-A, which taxpayers use to calculate their premium tax credit for the year. During 2014, the exchange made monthly payments to the health insurance issuer of $591, for an annual total of $7,092. The taxpayers worked with a CPA to prepare their 2014 return. Because they had received advance credit payments, they were required by § 36B(f)(1) to reconcile the amount of the advance payments with the premium tax credit calculated on their return. The taxpayers did not report their advance credit payments on their return. The IRS ultimately issued a notice of deficiency disallowing the entire credit. Because they did not qualify for any premium tax credit and had received $7,092 in advance credit payments, they owed the entire $7,092 as a tax liability. The taxpayers argued that the exchange had a responsibility to ensure that only those eligible for advance credit payments receive them, and that they never would have enrolled in the health insurance coverage they had chosen without the assistance of the credit for which the exchange had told them they qualified. They asked the court to rule "fairly and justly." The Tax Court (Judge Buch) held that it had no ability grant relief to the taxpayers. The court reiterated that it is not a court of equity and "cannot ignore the law to achieve an equitable end."

> Although we are sympathetic to the McGuires' situation, the statute is clear; excess advance premium tax credits are treated as an increase in the tax imposed. Sec. 36B(f)(2)(A). The McGuires received an advance of a credit to which they ultimately were not entitled. They are liable for the $7,092 deficiency.

The court declined to impose accuracy-related penalties on the basis of negligence because the IRS had presented no evidence of negligence. The court also declined to impose such penalties on the basis of substantial understatement of income because the taxpayers had established a reasonable cause, good faith defense based on their reliance on a third party (the exchange) to fulfill their obligations, their failure to receive Form 1095-A, and their reliance on a CPA to prepare their return.

7. 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.

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.

8. 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.

9. 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.

10. 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.

11. 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).

12. 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.

13. 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 purposed of both the regular tax and the alternative minimum tax.

14. 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.

15. ♪♫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.

16. 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.

E. Divorce Tax Issues

1. A blue moon arrives in the Tax Court—a taxpayer successfully establishes through credible testimony that he was entitled to the dependency exemption, earned income tax credit, and child tax credit. Tsehay v. Commissioner, T.C. Memo. 2016-200 (11/3/16). The taxpayer, whose first language was not English and who worked as a custodian at a community college, filed a return on Form 1040A for 2013 through a paid preparer. On the return, the taxpayer claimed head of household filing status, a dependency exemption and the child tax credit for four children, and an earned income tax credit for three children. (It was unclear from the record why the paid preparer had listed different numbers of children for the exemptions and credits.) The IRS issued a notice of deficiency disallowing all of the claimed exemptions and credits. The notice also changed the taxpayer's filing status to single and imposed an accuracy-related penalty under § 6662(a). The IRS took the position that the taxpayer, who had previously been separated from his wife and ordered to pay child support, was a noncustodial parent and therefore subject to § 152(e)(2), which provides that a noncustodial parent can claim the dependency exemption for a child only if the custodial parent signs a written declaration that the custodial parent will not claim the child as a dependent and the noncustodial parent attaches the written declaration to his or her tax return. The taxpayer had failed to submit Form 8332, the form designated for such written declarations, with his income tax return. The Tax Court (Judge Kerrigan) found credible the taxpayer's testimony at trial. The taxpayer testified that, during 2013, he and his wife were married and lived together with their five children in a public housing apartment. Based on this testimony, the court held that the taxpayer was entitled to the dependency exemptions, the child tax credit, and the earned income tax credit. The court rejected the IRS's reliance on a child support order to establish that the taxpayer was a noncustodial parent because the order was entered in August 2015, after the tax year in issue. Regarding his filing status, the taxpayer testified that he and his wife had separated by the time he filed his 2013 return and that he had asked the preparer to list his filing status as married filing separately. The preparer erroneously listed his filing status as head of household. The court held that his filing status could not be changed to single, as the IRS contended, but instead should be married filing separately. Although the erroneous filing status might have supported the accuracy-related penalty, the court held that the taxpayer—who had a language barrier, sought and relied on professional advice, and was separated from his wife when he filed his return—had established a reasonable cause, good faith defense.

- There appears to be some inconsistency in the court's conclusions. A taxpayer whose filing status is married filing separately cannot claim the earned income tax credit.

a. Oops, the Tax Court must have missed that, says the IRS. A.O.D. 2017-05, 2017-27 I.R.B. 1 (7/3/17). The IRS has nonacquiesced in the Tax Court's decision in *Tsehay*. Specifically, "the Service will not follow the court's opinion in *Tsehay* in allowing an EITC to a married taxpayer filing separately."

2. ♪♫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.

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.

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:

AMT Exemption Amounts for 2018		
Filing Status	**Before TCJA**	**After TCJA**
Married Filing Separately	$43,100	$54,700
Single and HOH	$55,400	$70,300
Married Filing Jointly and Surviving Spouses	$86,200	$109,400
Estates and Trusts	$24,600	$24,600

AMTI Phase-Out Thresholds for 2018		
Filing Status	**Before TCJA**	**After TCJA**
Married Filing Separately	$82,050	$500,000
Single and HOH	$123,100	$500,000
Married Filing Jointly and Surviving Spouses	$164,100	$1 million
Estates and Trusts	$82,050	$82,050

VI. CORPORATIONS

A. Entity and Formation

1. The "Bell" did not save this taxpayer in a faulty attempt to convert ordinary income to capital gain. Bell v. Commissioner, 120 A.F.T.R.2d 2017-5152 (9th Cir. 7/12/17), *aff'g* T.C. Memo. 2015-111 (6/15/15). In this relatively easy case for the Ninth Circuit to affirm, the taxpayers, a married couple, attempted to sell contracts into which Mr. Bell had entered to their newly-formed S corporation. The contracts were between Mr. Bell and various lenders and entities and provided that Mr. Bell, a licensed real estate broker who operated as a sole proprietor, would assist them with real estate owned properties (properties acquired by the lenders through foreclosure). Mr. Bell sold these real estate owned contracts in exchange for the S corporation's contractual obligation to pay $10,000 per month plus 10 percent interest. Weeks after the purchase agreement, the S corporation's board of directors resolved to issue 250 shares to each of the taxpayers in exchange for $500. The S corporation had no equity capital and no operating history. Therefore, the IRS argued, and the Tax Court (Judge Haines) and the Ninth Circuit agreed, that the purported sale was in substance a contribution of the real estate owned contracts to the S corporation in a § 351 nonrecognition transaction. The taxpayer's right to payments of $10,000 per month plus 10 percent interest, the courts held, should be recharacterized as additional stock, not indebtedness, issued in the incorporation transaction.

- **Note:** You might be wondering, *"Why on earth would Bell have wanted the transfer of the real estate owned contracts to his S corporation to be taxable instead of being nontaxable under § 351?" Here's why:* Taxpayers occasionally structure sales of assets (land before subdividing into lots; apartments before converting to condominiums) to their newly-formed S corporations with the goal of converting what otherwise would be ordinary income into capital gain. Often, the newly-formed S corporation issues a promissory note to a shareholder-taxpayer for the fair market value of the taxpayer's capital asset or § 1231 asset. The taxpayer reports the capital gain or quasi-capital gain realized from the sale over time on the installment method. Meanwhile, the S corporation obtains a cost basis in the asset. The asset then will be subdivided (land into lots) or converted (apartments to condominiums) to ordinary income property to be sold by the S corporation. The sales of the ordinary income property by the S corporation are used to repay the note issued to the shareholder-taxpayer who reports capital or § 1231 gain on the repayments. Any residual ordinary income generated by the S corporation's sales is reported by the taxpayer as flow-through income from the S corporation. Hence, future ordinary income has been converted to capital gain. A variation of this strategy was employed successfully by the taxpayer in Gyro Engineering Corp. v. United States, 417 F.2d 437 (9th Cir. 1969). If, however, the newly-formed S corporation is thinly capitalized, the IRS challenges these transactions by asserting that the purported sale of the asset to the newly-formed S corporation is in substance a § 351 nonrecognition transaction. The promissory note issued to the shareholder-taxpayer is recharacterized as stock issued in the § 351 transaction. This is what happened in Bell. Had the taxpayer in Bell adequately capitalized his S corporation with other assets, his strategy might have had a better chance of success.

B. Distributions and Redemptions

C. Liquidations

D. S Corporations

1. A § 267 "looptrap" snares an accrual-method subchapter S corporation with an ESOP shareholder. Petersen v. Commissioner, 148 T.C. No. 22 (6/13/17). The taxpayers, a married couple, owned stock in an accrual-method S corporation with many employees. As permitted by § 1361(c)(7), an ESOP benefitting the employees also owned stock in the S corporation. The S corporation had accrued and deducted the following amounts with respect to its ESOP participants as of the end of its 2009 and 2010 tax years: for 2009, unpaid wages of $1,059,767 (paid by January 31, 2010) and vacation pay of $473,744 (paid by December 31, 2010); for 2010, unpaid wages of $825,185 (paid by January 31, 2011) and vacation pay of $503,896 (paid by December 31, 2011). Notwithstanding the fact that the S corporation was an accrual-method taxpayer, the IRS asserted under § 267(a)(2) (forced-matching) that the corporation was not entitled to deduct the foregoing accrued amounts until the year of actual payment and inclusion in gross income by the ESOP's employee-participants. In a case of first impression, the Tax Court (Judge Lauber) agreed with the IRS based upon a plain reading of §§ 67(a)(2), (b), and (e), as well as a determination that the S corporation's ESOP is a "trust" within the meaning of § 267(c). Specifically, § 267(a)(2) generally requires so-called "forced matching" of an accrual-method taxpayer's deductions with the gross income of a cash-method taxpayer to whom a payment is to be made if the taxpayer and the person to whom the payment is to be made are related persons as defined by § 267(b). For an S corporation, pursuant to § 267(e), all shareholders are considered related persons under § 267(b) regardless of how much or how little stock such shareholders actually *or constructively* own. Furthermore, under § 267(c) beneficiaries of a trust are deemed to own any stock held by the trust. Because the assets held by an ESOP are owned by a trust (as required by ERISA, *see* 29 U.S.C. § 1103(a)), the participating employees of the ESOP are treated as shareholders of the S corporation. Hence, the forced-matching rule of § 267(a)(2) applies to accrued but unpaid wages and vacation pay owed to the S corporation's ESOP participants at the end of the year. Judge Lauber noted that this odd situation probably was a "drafting oversight"—in our words, a *looptrap*—because § 318, which defines related parties for certain purposes under subchapter C, excepts tax-exempt employee trusts from its constructive ownership rules. Nevertheless, Judge Lauber wrote, the Tax Court is "not at liberty to revise section 267(c) to craft an exemption that Congress did not see fit to create." Mercifully, however, the Tax Court declined to impose § 6662 negligence or substantial understatement penalties on the taxpayers because the case was one where "the issue was one not previously considered by the Court and the statutory language was not clear" (even though the court obviously relied upon the plain language of § 267 to reach its decision).

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

3. 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.

4. 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 cap.

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

1. Guidance on north-south transactions in corporate divisions. Rev. Rul. 2017-9, 2017-21 I.R.B. 1244 (5/3/17). This ruling considers whether transfers of money or property by a parent or subsidiary followed by a subsidiary's distribution of a controlled corporation's stock should be respected as separate transactions or instead integrated in two situations.

Situation 1. In the first situation, a parent corporation (P) transfers assets that constitute an active trade or business (conducted by P for at least five years) with a value of $25,000 to a wholly-owned subsidiary, D, which previously was not engaged in the active conduct of a trade or business, in exchange for additional shares of D's stock. Subsequently, D distributes to P as a dividend (and for a valid business purpose) all of the stock, worth $100,000, of D's wholly-owned subsidiary, C, which has been engaged in the active conduct of a trade or business for at least five years. Following these transfers, D continues to operate the business it received from P. If these transfers are integrated, then P's transfer of business assets to D would be treated as made in exchange for 25 percent of the stock of C, which would result in recognition of gain or loss for both P and D. Further, because D would then be treated as distributing only the remaining 75 percent of the stock of C to P, D's distribution of the remaining C stock would not qualify for nonrecognition under § 355 and D therefore would recognize gain under § 311(b). P would be treated as receiving a distribution from D subject to the rules of § 301(c) (a dividend to the extent of D's earnings and profits, followed by recovery of basis, followed by gain). In contrast, if the transfers are respected as separate transactions, then P's transfer of business assets to D in exchange for additional stock of D would qualify for nonrecognition under § 351, and D's distribution of the stock of C to P would qualify for nonrecognition under § 355 (assuming all requirements of §§ 351 and 355 are otherwise satisfied). The ruling concludes that the transfers will be respected as separate transactions and therefore qualify for nonrecognition. The ruling emphasizes that there is nothing to indicate that P's transfer should be properly treated other than in accordance with its form, that each step provides for continued ownership in modified corporate form, that the steps do not resemble a sale, and that none of the interests are liquidated or otherwise redeemed.

Situation 2. In the second situation, D and C each have been engaged in the active conduct of a trade or business for at least five years. C declares a dividend and, pursuant to this declaration, transfers to D $15,000 in money and property having a fair market value of $10,000, which D retains. Subsequently, D transfers to C property having a fair market value of $100,000 and a basis of $20,000, and distributes to P all of the C stock owned by D in a transaction qualifying as a reorganization under §§ 368(a)(1)(D) and 355. The ruling states that the initial dividend declaration by C is part of the plan of reorganization. If C's distribution of money and property to D is treated as separate from D's distribution of the C stock to P, then C's distribution to D would be governed by the rules of § 301(c) and D would not recognize gain from its transfer of property to C. If instead C's dividend declaration is considered part of the plan of reorganization, then the distribution by C would constitute boot to D (because D did not distribute it to shareholders in pursuance of the plan of reorganization), and D therefore would recognize gain on the transfer of property to C to the extent of the money and fair market value of property received from C. The ruling concludes that, because C's distribution is made in pursuance of the plan of reorganization, D will be treated as receiving boot subject to recognition of gain. In reaching this conclusion, the ruling relies on *Estate of Bell v. Commissioner*, T.C. Memo. 1971-285, for the proposition that the rules regarding boot are "the exclusive measure of dividend income provided by Congress where cash is distributed to shareholders as an incident of a reorganization."

Change in Policy on Issuing Private Letter Rulings. Section 5.02 of Rev. Proc. 2017-3, 2017-1 I.R.B. 130 (12/29/16), provided that the Service would not rule on whether transfers of money, stock, or other property in north-south transactions would be respected as separate transactions. This ruling removes § 5.02 from Rev. Proc. 2017-3, which means that the Service will now issue private letter rulings on this question. The ruling cautions, however, that the Service may decline to issue a letter ruling addressing the integration of steps when appropriate in the interest of sound tax administration or on other grounds when warranted by the facts or circumstances of a particular case.

G. Affiliated Corporations and Consolidated Returns

1. The Tax Court invokes a "common law" doctrine to disallow a double deduction for the same economic loss. Duquesne Light Holdings, Inc. v. Commissioner, T.C. Memo. 2013-216 (9/11/13). Duquesne Light Holdings, Inc. was the common parent of a consolidated group of corporations. Duquesne held 1.2 million shares of AquaSource, Inc., which until 2001 was a wholly-owned member of the group. In 2001, Duquesne sold 50,000 shares of AquaSource to Lehman Brothers—remember them—and claimed a capital loss of approximately $199 million ("2001 stock loss"). Duquesne filed an application for tentative refund, in which it carried back to 2000 a portion of the 2001 stock loss, and the IRS paid a tentative refund of $35 million. In 2002 and 2003, AquaSource, while still a member of the group, sold all of its assets (stock in its wholly-owned subsidiaries) and recognized aggregate capital losses of $252 million ("2002 and 2003 assets losses"), which were claimed on Duquesne's consolidated return, carried back to 2000, and resulted in the IRS paying a tentative refund of $52 million. The IRS determined that the 2001 stock loss on the disposition of 50,000 shares of AquaSource stock (approximately 4% of the stock) recognized by the common parent was a loss attributable to the fact that there was built-in loss in the underlying assets of AquaSource, and that the group was not permitted to take the duplicative portion ($199 million) of the 2002 and 2003 asset losses upon the subsequent sale of AquaSource's assets under the doctrine of *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934). The Tax Court (Judge Chiechi) upheld the IRS's determination, relying in part on its prior opinion in *Thrifty Oil v. Commissioner*, 139 T.C. 198 (2012). In doing so, the court rejected the taxpayer's argument that *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), which held invalid the loss disallowance rule of former Reg. § 1.1502-20, supported allowing deduction of the 2002 and 2003 assets losses, and that the disallowance of double deductions could be effected only through the promulgation of valid regulations. Although the court acknowledged that former Temp. Reg. § 1.1502-35T, which was in effect for the years in question, did not disallow the losses, the court concluded that nothing prohibited it from disallowing duplicate deductions for the same economic loss under *Charles Ilfeld Co.* Finally, the court held that even though the limitations period on assessment had expired for 2000–the year to which losses had been carried back–the period was still open pursuant to § 6501(h) and § 6501(k), thereby allowing the IRS to assess a deficiency attributable to the disallowance of the loss carryback.

a. The *Ilfeld* doctrine is alive and well in the Third Circuit, which concluded that the failure of the consolidated return regulations to disallow a loss is not clear authorization for the taxpayer to take a double deduction for the same economic loss. Duquesne Light Holdings, Inc. v. Commissioner, 861 F.3d 396 (3d Cir. 6/29/17), *aff'g* T.C. Memo. 2013-216 (9/11/13). In an opinion (2-1) by Judge Ambro, the Third Circuit affirmed the Tax Court's decision. The majority opinion construed *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934), as standing for the proposition that there is a presumption that statutes and regulations do not allow a double deduction for the same economic loss, and "[t]his presumption must be overcome by a clear declaration in statutory text or a properly authorized regulation." The majority acknowledged that there is some uncertainty whether the *Ilfeld* doctrine applies to taxpayers not filing consolidated returns, but concluded that it "remains good law in the consolidated-return context." The court held that neither the text of § 165, nor the combination of the statutory text with the applicable regulations, authorized the taxpayer to deduct the same economic loss twice. According to the court, the language of § 165(a), which authorizes a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise," is broad and does not meet the *Ilfeld* doctrine's "requirement of explicit approval for duplicating the underlying economic loss." The regulations in effect during the years in question did not preclude Duquesne from deducting the 2002 and 2003 asset losses. One regulation, Reg. § 1.1502-35T, precluded deduction of a loss recognized on the disposition of subsidiary stock to the extent of the duplicated loss if, immediately after the disposition, the subsidiary remained a member of the consolidated group. This regulation did not apply to the 2002 and 2003 asset losses because the subsidiaries that AquaSource sold were not members of the consolidated group after their disposition. Duquesne relied on Reg. § 1.337(d)-2T as authority for its deduction of the 2002 and 2003 asset losses. Paragraph (a)(1) of Reg. § 1.337(d)-2T provided a general rule that "[n]o deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary loss." Paragraph (c)(2) provided that a loss on the disposition of subsidiary stock "is not disallowed" by the general rule "to the extent the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain … on the disposition of an asset (including stock and securities)." Although Reg. § 1.337(d)-2T did not disallow Duquesne's 2002 and 2003 asset losses, the court held that the regulation was insufficient to overcome the presumption of *Ilfeld* because "there is no mention in the regulation of approval for a loss deduction that duplicates another already taken for the same underlying economic loss." The court emphasized that Reg. § 1.337(d)-2T "has nothing to do with loss duplication" because it was accompanied by Notice 2002-18, 2002-1 C.B. 644, which stated that "the IRS and Treasury believe that a consolidated group should not be able to benefit more than once from one economic loss" and would issue another regulation addressing that issue. That other regulation, issued in 2003 retroactive to 2002, was Reg. § 1.1502-35T which, as previously discussed, did not preclude the 2002 and 2003 asset losses. The majority also affirmed the Tax Court's ruling that the IRS's assessment of a deficiency attributable to the disallowance of the loss carryback was not barred by the limitations period on assessment.

- In a dissenting opinion, Judge Hardiman disagreed with several aspects of the majority's reasoning. He took issue with the majority's conclusion that *Ilfeld* requires an explicit authorization of a double deduction:

> That means even if the Code separately allows Deduction A and Deduction B, the taxpayer could not take both deductions unless a provision authorized them both to be taken simultaneously. This triple-authorization requirement, I believe, goes above and beyond any rule envisioned by the Supreme Court.

Judge Hardiman emphasized that *Ilfeld* requires only that a provision of the statute or regulations can "fairly be read to authorize" the double deduction. He concluded that Reg. § 1.337(d)-2T can fairly be read to authorize Duquesne's deduction. "When the IRS writes that a deduction is 'not disallowed,' we should accept that it is not. And without that ambiguity, it is not our place to investigate the structure and purpose of the scheme in order to restyle the language of the regulation." Regarding the interplay of the regulations and the *Ilfeld* doctrine, Judge Hardiman stated:

> [I]t seems unnatural for the IRS to write a regulation that literally authorizes a specific action, only to expect taxpayers to appreciate that the regulation is undermined by common-law doctrines lurking in the shadows.

- Heads Up: The Treasury Department's 2017-2018 Priority Guidance Plan (10/20/17) lists Reg. § 1.1502-36 (unified loss rule) and related provisions regarding losses on subsidiary stock as an area of focus for the coming year.

2. A U.S. District Court concludes that the members of a consolidated group who bore the economic burden of a tax have a property right in the refund of that tax, and the group's tax allocation agreement did not change that result. Federal Deposit Insurance Corp. v. FBOP Corp., 252 F. Supp. 3d 664 (N.D. Ill. 5/12/17). The common parent of a consolidated group, FBOP Corporation, received two tax refunds in the amounts of $10.3 million and $265.3 million. The $10.3 million refund was produced by estimated tax payments funded by banks that were subsidiary members of the consolidated group for 2009, during which the group experienced a consolidated net operating loss (CNOL) and therefore did not have any liability for federal income tax. The $265.3 million refund was produced by FBOP's filing of amended consolidated returns for 2004 through 2008 to carry back the 2009 CNOL pursuant to 2009 legislation that extended the carryback period. According to the FDIC, all of the 2009 CNOL was attributable to the operating losses of the bank subsidiaries. During 2009, each bank subsidiary was placed into receivership with the FDIC as its receiver. The group's common parent, FBOP, subsequently entered into settlement agreements with its creditors in which FBOP pledged all of its assets as security for previously unsecured debt and ultimately assigned all of its assets to a trustee for the benefit of creditors, including any property interest of FBOP in the tax refunds. The issue in the case is whether the bank subsidiaries have a property interest in the tax refunds, in which case the refunds must be turned over to the FDIC, or instead a contractual right to the refunds, in which case the refunds must be turned over to the trustee for the benefit of FBOP's creditors. In ruling on motions for partial judgment on the pleadings, the court (Judge Durkin) applied Ilinois law rather than federal common law but noted that the court might reconsider the choice of law issue in the future. The court held that, under Illinois law, "the party who paid the taxes, or, more accurately, bore the economic burden of the taxes, is the owner of any refunds resulting from those taxes." Further, the court held that the consolidated group's tax allocation agreement did not override this "default rule" of state law. Because the bank subsidiaries bore the economic burden of the taxes that were refunded, the court denied FBOP's motion for judgment on the pleadings and held that the banks (and therefore the FDIC) had property rights in the tax refunds. However, because the court was unable to determine whether the bank subsidiaries had paid the entire amount of the original taxes that led to the $265.3 million refund (and whether the tax allocation agreement required FBOP to distribute all of it to the banks), the court withheld ruling on the FDIC's cross-motion for partial judgment on the pleadings pending further proceedings.

3. Better be careful in drafting those tax allocation agreements! A subsidiary member of a consolidated group was entitled to a refund produced by the subsidiary's loss because the group's tax allocation agreement was ambiguous and provided that any ambiguity must be resolved in favor of the subsidiary. In re United Western Bancorp, Inc., 574 B.R. 876 (D. Colo. 7/10/17). United Western Bancorp, Inc. ("Holding Company") was the common parent of a consolidated group. One member of the consolidated group was a wholly-owned subsidiary, United Western Bank ("Bank"). The Holding Company received a refund of $4.8 million that was produced by carrying back a 2010 consolidated net operating loss (produced by the Bank's loss) to 2008, a year in which the consolidated group had paid tax on income of the Bank. According to the court, "[t]here is no dispute that, to whatever extent a refund was due, it was entirely the result of revenue generated by the Bank in 2008 and losses incurred by the Bank in 2010 …." In the same year the 2010 consolidated return was filed, the Bank was placed into receivership with the FDIC as its receiver. Subsequently, the Holding Company became a debtor in a chapter 7 bankruptcy proceeding. The bankruptcy trustee asserted that the refund was an asset of the bankruptcy estate, and the FDIC asserted that the refund was an asset of the Bank. In a thorough and thoughtful opinion, the District Court (Judge Martinez) held that the Bank was entitled to the refund. The court noted that, in *Barnes* *v. Harris*, 783 F.3d 1185 (10th Cir. 2015), the Tenth Circuit, relying on *In re Bob Richards Chrysler-Plymouth Corp., Inc.*, 473 F.2d 262 (9th Cir. 1973), had held that, in the absence of a contrary agreement, "a tax refund due from a joint return generally belongs to the company responsible for the losses that form the basis of the refund." In this case, however, the consolidated group members had entered into a tax allocation agreement. The District Court ultimately framed the issue as whether, under the tax allocation agreement, the Holding Company was acting as the agent of the Bank or instead had a standard commercial relationship with the Bank. If the former, then the Holding Company was acting as a fiduciary of the Bank and the refund would belong to the Bank; if the latter, then the Bank was a creditor of the Holding Company and the refund would be an asset of the Holding Company's bankruptcy estate. The court concluded that the tax allocation agreement was ambiguous on this point, which triggered a provision in the agreement that required any ambiguity in the agreement to be resolved in favor of the Bank. Accordingly, the court concluded, the Bank had equitable title to the refund. The Holding Company had only legal title to the refund and the refund was not part of the Holding Company's bankruptcy estate.

H. Miscellaneous Corporate Issues

1. 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 (Judge Kerrigan) upheld the IRS's recharacterization. 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 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.

2. Due date of corporate income tax returns: temporary and proposed regulations address the filing date chaos created by Congress. T.D. 9821, Return Due Date and Extended Due Date Changes, 82 F.R. 33441 (7/20/17). Treasury and the IRS have issued proposed, temporary, and final regulations regarding the due date and extended due date of corporate income tax returns. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(a), amended Code § 6072(b) to require C corporations to file their income tax returns by the 15th day of the fourth month after the close of their taxable year (by subjecting them to § 6702(a)), thus deferring the due date by one month. On the other hand, under amended § 6072(b), S corporations continue to be required to file their tax returns by the 15th day of the third month (March 15 for calendar year S corporations). Pursuant to this statutory directive, Temp. Reg. § 1.6072-2T(a)(1) provides that the income tax return of a C corporation is due on the 15th day of the fourth month following the close of its taxable year and that the income tax return of an S corporation is due on or before the 15th day of the third month following the close of its taxable year. However, pursuant to Temp. Reg. § 1.6072-2T(a)(2), the income tax return of a C corporation that has a taxable year that ends on June 30 is due on the 15th day of the *third* month following the close of its taxable year for taxable years beginning before January 1, 2026. (Yes, that's correct, a ten-year deferred effective date only for C corporations with a fiscal year ending on June 30.) For this purpose, a return for a short period ending on any day in June is treated as a return for a taxable year that ends on June 30. This special rule for C corporations using a June 30 taxable year implements the effective date rule enacted by § 2006(a)(3) of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015.

- The extended due dates for C corporation returns were changed by § 2006(c) of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 through amendments to Code § 6081(b). The temporary regulations reflect these changes. Pursuant to Temp. Reg. § 1.6081-3T, a C corporation is allowed an automatic six-month extension of the due date. However, for periods beginning before January 1, 2026, the automatic extension is 7 months for a C corporation with a taxable year that ends on June 30. Code § 6081(b), as amended by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, provides that the automatic extension is only 5 months for a calendar-year C corporation for periods ending before January 1, 2026. Nevertheless, the temporary regulations provide an automatic 6-month extension for calendar-year C corporations pursuant to § 6081(a), which authorizes the Secretary of the Treasury to grant reasonable extensions of not more than 6 months.

- The temporary regulations apply to corporate returns and extension requests filed on or after July 20, 2017, but the statutory amendments made by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 apply to returns for corporate taxable years that begin after December 31, 2015. Accordingly, the preamble to the temporary regulations provides that taxpayers can elect to apply the regulations to returns filed for periods beginning after December 31, 2015.

3. 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 whom 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.

4. 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 Holmes) 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.

5. 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.

6. 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.

7. 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.

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 <u>NOTHING</u> 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*, 147 T.C. No. 8 (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, the Tax Court (Judge Laro) 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.

What about partnership interests held by S corporations? Under § 1061(c)(4)(A), an interest in a partnership is not subject to the carried interest rule if it is held "directly or indirectly … by a corporation." Absent any limitation in the statute, the term "corporation" should include a subchapter S corporation. Has Congress left a glaring loophole?

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 "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.

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 that 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).

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.

- **Dissent:** 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

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 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 no need to carve out an exception to prevent U.S. real property interests from being swept into the indivisible capital asset treatment that section 741 otherwise prescribes.

The court noted that this conclusion is consistent with the court's prior decision in *Pollack v. Commissioner*, 69 T.C. 142 (1977).

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

- In reaching its conclusion that the taxpayer's gain was not effectively connected with the conduct of a U.S. trade or business, the court rejected the 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 or business (and therefore taxable by the U.S. unless provided otherwise by treaty) to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The amount of gain or loss treated as effectively connected under this rule is reduced by the amount of such gain or loss that is already taxable under § 897 (relating to U.S. real property interests). TCJA § 13501 makes corresponding changes to the withholding rules for effectively connected income under § 1446. These changes to § 864(c) and § 1446 statutorily reverse the Tax Court's recent decision in *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner*, 149 T.C. No. 3 (7/13/17) and effectively adopt the 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 of more than $250,000 immediately after the transfer. Generally, the consequence of § 743(d) is an automatic election under § 754 resulting in a downward adjustment to a partnership's basis in its built-in loss assets. Essentially, then, § 743(d) is designed to hinder sales of partnership interests when a substantial built-in loss exists by preventing the transferee from benefitting from the absence of a § 754 election upon the partnership's subsequent sale of assets. This TCJA change is permanent. The Conference Report illustrates the application of expanded § 743(d) as follows:

> 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 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).

Pre-2018 Election Into the New Regime. The reissued proposed regulations do not affect the ability of partnerships to elect into the new regime for tax years beginning before January 1, 2018, but after November 2, 2015. See T.D. 9780, Election into the Partnership Audit Regime Under the Bipartisan Budget Act of 2015, 81 F.R. 51795 (8/5/16).

c. 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 elction 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 TEFRA partnership's failure to challenge penalties does not preclude a partner from raising a reasonable cause, good faith defense to penalties in a partner-level proceeding. McNeill v. United States, 836 F.3d 1282 (10th Cir. 9/6/16). The taxpayer invested in and was the tax matters partner of TEFRA partnerships used as vehicles for distressed asset/debt (DAD) tax shelters. In a partnership-level proceeding, the IRS issued a notice of final partnership administrative adjustment that imposed several million dollars in penalties and interest. As the tax matters partner, the taxpayer brought an action in federal district court, but that action was dismissed without prejudice and the taxpayer never sought to reinstate it. The IRS determined that the taxpayer's share of the partnership's liability was approximately $7.5 million, which he paid. The taxpayer filed a refund action in a federal district court and argued that he had a reasonable cause, good faith defense, pursuant to § 6664(c) (based on reliance on professional advice), to approximately $4.6 million in penalties and related interest. The District Court held that the taxpayer was precluded from asserting defenses by § 6230(c)(4), which provides:

> For purposes of any claim or suit under this subsection, the treatment of partnership items on the partnership return, under the settlement, under the final partnership administrative adjustment, or under the decision of the court (whichever is appropriate) shall be conclusive. *In addition, the determination under the final partnership administrative adjustment or under the decision of the court (whichever is appropriate) concerning the applicability of any penalty ... which relates to an adjustment to a partnership item shall also be conclusive.* Notwithstanding the preceding sentence, the partner shall be allowed to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment.

(Emphasis added). In an opinion by Judge Gorsuch, the Tenth Circuit reversed. According to the Tenth Circuit, the third sentence of the relevant provision states that a partner "shall be allowed to assert any partner level defenses," and this overrides the language in the preceding sentence stating that determinations concerning penalties at the partnership level are conclusive. The court noted that the government's position on the availability of defenses in partner-level proceedings seems to have changed over time and is not well defined. For example, the court noted, in *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009), the government argued that the reasonable cause, good faith defense is a partner-level defense that can be asserted only in partner-level proceedings. Accordingly, the court reversed and remanded to the District Court.

- Judge Phillips dissented. He reasoned that the third sentence in § 6230(c)(4) does not override the conclusive determination of penalties at the partnership level. According to Judge Phillips, the third sentence should be read "as ensuring that partners can always bring partner-level defenses subject to any conclusive determinations being applied in those partner-level proceedings."

a. On remand, the taxpayers successfully established a partner-level defense to the accuracy-related penalty. McNeill v. United States, 119 A.F.T.R.2d 2017-943 (D. Wyo. 2/24/17). In the course of investing in the DAD tax shelter and deducting the losses that it produced, the taxpayers had received an opinion from a law firm and advice from Ernst & Young. On remand from the Tenth Circuit, the U.S. District Court (Judge Freudenthal) concluded, based on the taxpayers' efforts to determine their tax liability and their reliance on professional advice, that the taxpayers had established a reasonable cause, good faith defense to the accuracy-related penalty.

3. The "Buch" stops here in this hypertechnical TEFRA case and offers a lesson in taking your lumps instead of testing the IRS's patience. Malone v. Commissioner, 148 T.C. No. 16 (5/1/17). The taxpayer failed to report his distributive share of partnership items in 2005 consisting of $3.2 million of ordinary income and $3.5 million of long-term capital gain. Under § 6222(a), partners in a partnership subject to the TEFRA audit rules must report partnership items consistent with the partnership's return unless the partner timely files a Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request. Accordingly, the IRS subsequently issued a notice of deficiency to the taxpayer for these partnership items as well as certain other non-partnership adjustments, including *in an amended answer* (Uh-oh!) the § 6662(a) negligence penalty. In an order dated June 5, 2012, the Tax Court granted the IRS's motion to strike the partnership items from any deficiency proceedings for lack of jurisdiction (meaning that the assessment against the taxpayer for these items was upheld), but reserved judgment on whether the § 6662(a) negligence penalty remained subject to the court's jurisdiction. The taxpayer then filed a motion with the Tax Court to dismiss the § 6662(a) negligence penalty with respect to the partnership items, but the IRS objected pointing out in an "amendment to [the] amended answer" that the § 6662(a) penalties were being asserted only with respect to the taxpayer's failure to report the partnership items. The crux of the taxpayer's argument was that § 6230(a)(2)(A)(i) excludes from deficiency procedures penalties relating to adjustments to partnership items. In an opinion by Judge Buch, however, the Tax Court held that this case did not involve an adjustment to partnership items. The partnership items of $3.2 million of ordinary income and $3.5 million of long-term capital gain were not adjusted. Instead, the IRS's assertion of the § 6662(a) negligence penalty for the taxpayer's failure to report partnership items remains to be determined by the Tax Court. *To be continued…?*

4. 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)-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-thu 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.

G. Miscellaneous

1. The IRS finally gets tired of issuing private letter rulings: guidance for master limited partnerships on activities with respect to minerals or natural resources that produce qualifying income. T.D. 9817, Qualifying Income From Activities of Publicly Traded Partnerships With Respect to Minerals or Natural Resources, 82 F.R. 8318 (1/24/17). The Treasury Department and the IRS have finalized, with some changes, proposed regulations under § 7704(d)(1)(E) regarding the types of activities with respect to minerals or natural resources that generate qualifying income for publicly traded partnerships (REG-132634-14, Qualifying Income From Activities of Publicly Traded Partnerships With Respect to Minerals or Natural Resources, 80 F.R. 25970 (5/6/15)). Section 7704(a) provides that a publicly traded partnership is treated for federal tax purposes as a corporation, but § 7701(c) provides an exception for certain publicly traded partnerships if 90 percent or more of the partnership's gross income consists of qualifying income. Partnerships that qualify for this exception are not automatically classified as corporations and are eligible for the pass-through regime of subchapter K. Under § 7704(d)(1)(E), qualifying income includes income "derived from the exploration, development, mining or production, processing, refining, transportation …, or the marketing of any mineral or natural resource …." Under the final regulations, only "qualifying activities" produce qualifying income. Qualifying activities include both the activities enumerated in the statute, which the regulations refer to as "section 7704(d)(1)(E) activities," and support activities that are intrinsic to section 7704(d)(1)(E) activities, which the regulations refer to as ''intrinsic activities.'' The final regulations provide detailed guidance on which activities qualify as section 7704(d)(1)(E) activities and intrinsic activities. Generally, an activity is an intrinsic activity if the activity is: (1) specialized to support the section 7704(d)(1)(E) activity, (2) essential to the completion of the section 7704(d)(1)(E) activity, and (3) requires the provision of significant services to support the section 7704(d)(1)(E) activity. According to the preamble to the final regulations, Treasury and the IRS issued these regulations because of a significant increase in the number of requests for private letter rulings seeking guidance on whether income from certain activities is qualifying income under § 7704(d)(1)(E). The final regulations define qualifying activities in a manner that may be, at least in some respects, narrower than in private letter rulings the IRS previously issued.

- Based on the many comments submitted on the proposed regulations, the final regulations make several favorable changes to the proposed regulations. Two of the more significant changes relate to the definition of "section 7704(d)(1)(E) activities." First, the proposed regulations provided an exclusive list of operations that qualified as section 7704(d)(1)(E) activities. In contrast, the final regulations provide a general definition of each of the eight listed active terms in § 7704(d)(1)(E) (exploration, development, mining or production, processing, refining, transportation, and marketing) followed by a non-exclusive list of examples of each one. Nevertheless, the preamble to the final regulations cautions that "the Treasury Department and the IRS do not intend that these final regulations be interpreted or applied in an expansive manner … [but] should be interpreted and applied in a manner that is consistent with their plain meaning and the overall intent of Congress to restrict the [§ 7701(c)] exception …." Second, the final regulations create a new category, referred to as "additional activities," the income derived from which is considered derived from a section 7704(d)(1)(E) activity. Income from additional activities includes income received to reimburse a partnership for its costs in performing a section 7704(d)(1)(E) activity, income from certain passive interests or non-operating interests, and income from providing blending or additization services with respect to certain products. The final regulations generally retain the definition of an "intrinsic activity" found in the proposed regulations, but make certain favorable changes to the "specialized" and "significant services" prongs of the intrinsic activities test, such as clarifying that these prongs can be met through employees of affiliates or subcontractors as long as they are being compensated by the partnership.

- The final regulations generally apply to income earned by a partnership in a taxable year beginning on or after 1/19/17, but provide a ten-year transition period. Under the transitional rule, a partnership can treat income from an activity as qualifying income during the period that ends on the last day of the partnership's taxable year that includes 1/19/27 if one of the following conditions is met : (1) the partnership received a private letter ruling holding that income from the activity is qualifying income; (2) prior to 5/6/15, the partnership was publicly traded, engaged in the activity, treated the activity as giving rise to qualifying income under § 7704(d)(1)(E), and that income was qualifying income under the statute as reasonably interpreted prior to the issuance of the proposed regulations; (3) prior to 5/6/15, the partnership was publicly traded and had entered into a binding agreement for construction of assets to be used in the activity that would give rise to income that was qualifying income under the statute as reasonably interpreted prior to 5/6/15; or (4) the partnership is publicly traded and engages in the activity after 5/6/15 but before 1/19/17, and the income from that activity is qualifying income under the proposed regulations. According to the preamble to the proposed regulations, both the legislative history and the IRS's interpretations prior to the issuance of the proposed regulations are taken into account in determining whether an interpretation is reasonable. The final regulations clarify that a technical termination of a partnership under § 708(b)(1)(B) does not end the transition period.

2. Due date for partnership income tax returns: temporary and proposed regulations reflect Congress's belief that some partners might not need filing extensions any more. T.D. 9821, Return Due Date and Extended Due Date Changes, 82 F.R. 33441 (7/20/17). Treasury and the IRS have issued proposed, temporary, and final regulations regarding the due date and extended due date of partnership income tax returns (Form 1065). The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(a), amended Code § 6072(b) to require partnerships to file their income tax returns by the 15th day of the third month following the close of the taxable year (March 15 for calendar year partnerships), thus accelerating the due date by one month. Act § 2006(b) directs the Treasury to modify the regulations to provide that the maximum extension for a partnership return will be a 6-month period ending on September 15 for calendar year partnerships. Pursuant to this statutory directive, Temp. Reg. § 1.6031(a)-1T(e)(2) provides that "the return of a partnership must be filed on or before the date prescribed by § 6072(b)." (The temporary regulations do not explicitly address the due date of Form 8804—Annual Return for Partnership Withholding Tax—but the 2016 instructions for Form 8804 indicate that the due date is the 15th day of the third month following the close of the taxable year.) Pursuant to Temp. Reg. § 1.6081(a)-2T(a)(1), a partnership is allowed an automatic 6-month extension to file both Form 1065 and Form 8804 by filing a timely application. No extension beyond the automatic extension is permitted.

- The temporary regulations apply to returns and extension requests filed on or after July 20, 2017, but the statutory amendments made by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 apply to returns for partnership taxable years that begin after December 31, 2015. Accordingly, the preamble to the temporary regulations provides that taxpayers can elect to apply the regulations to returns filed for periods beginning after December 31, 2015.

a. What, you weren't paying attention to the new accelerated due date for partnership returns? We've got your back, says the IRS. Late-filing penalties are waived, but don't let this happen again! Notice 2017-47, 2017-38 I.R.B. 232 (9/1/17). In this notice, the IRS has waived penalties for a partnership's failure to file or furnish to partners certain returns by the accelerated due date enacted as part of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015. The penalty relief applies if one of the following two conditions is satisfied:

> (1) the partnership filed Form 1065, 1065-B, 8804, 8805, 5471, or other return required to be filed with the IRS and furnished copies (or Schedules K-1) to the partners (as appropriate) by the date that would have been timely under section 6072 before amendment by the Surface Transportation Act (April 18, 2017 for calendar-year taxpayers …), or
>
> (2) the partnership filed Form 7004 to request an extension of time to file by the date that would have been timely under section 6072 before amendment by the Surface

Transportation Act and files the return with the IRS and furnishes copies (or Schedules K-1) to the partners (as appropriate) by the fifteenth day of the ninth month after the close of the partnership's taxable year (September 15, 2017, for calendar-year taxpayers). If the partnership files Form 1065-B and was required to furnish Schedules K-1 to the partners by March 15, 2017, it must have done so to qualify for relief.

This relief is available only for the partnership's first taxable year that begins after 2015. The IRS will grant this relief automatically. Taxpayers that have already had penalties assessed should receive a letter indicating that the penalty has been abated and are instructed to contact the IRS for abatement if they do not receive such a letter.

b. Further penalty relief for partnerships and certain other entities that missed the new accelerated due date. Notice 2017-71, 2017-51 I.R.B. 561 (11/30/17). The IRS has expanded the penalty relief provided by Notice 2017-47, 2017-38 I.R.B. 232 (9/1/17), in two ways: (1) penalty relief is available not only with respect to filing or furnishing of returns, but also to taking other actions, such as making elections, contributing to an employee pension plan, or paying tax, by the due date of a partnership return, and (2) penalty relief is available not only to entities classified as partnerships for federal tax purposes, but also to real estate mortgage investment conduits (REMICs) and certain other entities that are required to file partnership returns. This notice provides that the IRS will treat acts of a partnership, REMIC, or any entity that may properly file a Form 1065 (such as a bank with respect to the return of a common trust fund or a religious or apostolic association or corporation) as timely if the entity took the act by the date that would have been timely under section § 6072 before amendment by the Surface Transportation Act (April 18, 2017, for calendar-year taxpayers). This relief is available only for the first taxable year that began after December 31, 2015, and ended before January 1, 2017. Despite the penalty relief, the notice cautions that the entity will be liable for any interest due under § 6601 from the date prescribed for payment until the date of payment. Taxpayers that have already had penalties assessed should receive a letter indicating that the penalty has been abated and are instructed to contact the IRS for abatement if they do not receive such a letter. This notice amplifies, clarifies, and supersedes Notice 2017-47.

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. Another U.S. bank that was dazzled by the STARS litigates its claimed tax benefits. Wells Fargo & Co. v. United States, 143 F. Supp. 3d 827 (D. Minn. 11/10/15). The STARS tax shelter in the form marketed to banks involved two basic components: a loan from Barclays Bank to the U.S. taxpayer, which generated interest deductions, and the U.S. taxpayer placing assets in a trust, which required payment of U.K. taxes and generated foreign tax credits. The transaction also featured a payment from Barclays to the U.S. taxpayer equal to approximately one-half of the U.K. taxes that the U.S. taxpayer paid. In a lengthy opinion, the court (Judge Schiltz) ruled on several motions by the taxpayer and denied most of them. The court granted the taxpayer's motion for partial summary judgment that § 269 does not apply to the transaction. Section 269 generally authorizes the IRS to disallow a deduction, credit or other tax benefit if a person acquires control of a corporation or a corporation acquires transferred-basis property from another non-controlled corporation, and the principal purpose of the acquisition was evasion or avoidance of federal income tax by securing a tax benefit that the person or corporation would not otherwise enjoy. The court agreed with the taxpayer that, even if all other requirements of § 269 were satisfied, the acquisition did not produce tax benefits (foreign tax credits) that the taxpayer would not otherwise have enjoyed because the taxpayer could have claimed the foreign tax credits even without the use of the corporate entities involved in the transaction. The court denied the taxpayer's motion for partial summary judgment that the payments received from Barclays should be considered pretax income rather than a tax benefit. The court reserved this issue for trial and noted that it is inclined to agree with the Second Circuit (*Bank of New York Mellon Corp. v. Commissioner*, 801 F.3d. 104 (2d Cir. 9/9/15)) that the Barclays payment is a tax benefit, rather than with the contrary conclusion of the Federal Circuit (*Salem Financial, Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 5/14/15)).The court also denied the taxpayer's motion for partial summary judgment that the loan from Barclays created a reasonable expectation of pretax profit from the STARS transaction, but indicated it is inclined to agree with the Second and Federal Circuits that analysis of the loan should be bifurcated from analysis of the foreign tax credits.

a. Who needs a business purpose? As long as the transaction had economic substance, it was not a sham transaction. Wells Fargo & Co. v. United States, 119 A.F.T.R.2d 2017-1976 (D. Minn. 5/24/17). Following the trial of this case, the jury found that the STARS tax shelter in which the taxpayer participated consisted of two separate transactions: a loan from Barclays Bank to the taxpayer, which generated interest deductions, and the taxpayer placing assets in a trust, which required payment of U.K. taxes and generated foreign tax credits. The issue for the court following trial was whether each transaction was a sham. In *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001), the Eighth Circuit, drawing on its prior decisions, stated that "a transaction will be characterized as a sham if 'it is not motivated by any economic purpose outside of tax considerations' (the business purpose test), and if it 'is without economic substance because no real potential for profit exists' (the economic substance test)." One reading of this test is that, to avoid characterization as a sham transaction, a transaction must meet both the business purpose and the economic substance portions of the test. The jury found that the trust structure that generated foreign tax credits had neither a non-tax business purpose nor a reasonable possibility of pre-tax profit, and therefore the court concluded that the trust transaction was a sham and disallowed the foreign tax credits. With respect to the loan transaction, however, the jury found that, although Wells Fargo entered into the loan solely for tax-related reasons, the loan had a reasonable possibility of pre-tax profit. The court therefore had to address whether a transaction that fails the business purpose portion of the Eighth Circuit's sham transaction test but meets the economic substance portion of the test should be treated as a sham. The court (Judge Schiltz) held that the loan transaction was not a sham and upheld the taxpayer's interest deductions. In reaching this conclusion, the court reasoned that "a doctrine that is intended to counter the creative and ever-evolving abuse of the tax code must necessarily be flexible" and that "[r]educing the sham-transaction doctrine to two mechanical, all-or-nothing tests would deprive the doctrine of the flexibility needed to accomplish its purpose." A flexible approach, the court stated, is consistent with the U.S. Supreme Court's formulation of the sham-transaction doctrine in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), which "reads more like a list of factors to weigh than a series of boxes to check."

- The court's decision stands for the proposition that a transaction for which a taxpayer does not have a business purpose can avoid characterization as a sham transaction if it has economic substance. Will the Eighth Circuit agree?

- Two U.S. Courts of Appeals previously have upheld the interest deductions produced by the loan portion of the STARS transaction. *Bank of New York Mellon Corp. v. Commissioner*, 801 F.3d. 104 (2d Cir. 9/9/15); *Salem Financial, Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 5/14/15). In a third case, the government did not contest the District Court's grant of summary judgment to the taxpayer with respect to the interest deductions. *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15 (1st Cir. 12/16/16).

- The court also upheld a 20 percent negligence penalty against the taxpayer for the underpayments associated with the disallowance of its foreign tax credits. The taxpayer argued that it was not subject to the penalty pursuant to Reg. § 1.6662-3(b)(1), which provides that a "return position that has a reasonable basis as defined in paragraph (b)(3) of this section is not attributable to negligence." Paragraph (b)(3) of the regulation provides that a return position generally has a reasonable basis if it is "reasonably based on one or more of the authorities set forth in § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments) ...." However, Wells Fargo stipulated that it would not make any contention that relied on its efforts to determine its proper tax liability arising out of the STARS transaction. Thus, the question was whether it was "enough for Wells Fargo to show that its return position had a reasonable basis under the authorities referenced in § 1.6662-3(b)(3)," or whether it had to "prove that it actually consulted those authorities in preparing its tax return." The court viewed the regulation as ambiguous on this issue and therefore treated the Treasury Department's interpretation of its own regulation as controlling. The court held that the taxpayer had to prove that it actually consulted the authorities that, in the taxpayer's view, provided a reasonable basis for its return position. The court expressed the view that "[i]t is difficult to know how a taxpayer could 'base' a return position on a set of authorities without actually consulting those authorities, just as it is difficult to know how someone could 'base' an opinion about the best restaurant in town on Zagat ratings without actually consulting any Zagat ratings."

2. You better hope that your HP computer works better than HP's tax planning strategies. Hewlett-Packard Co. v. Commissioner, 875 F.3d 494 (9th Cir. 11/9/17) *aff'g* T.C. Memo. 2012-135 (5/14/12). In an opinion by Judge Kozinski, the U.S. Court of Appeals for the Ninth Circuit affirmed the Tax Court's decision (Judge Goeke) denying millions in foreign tax credits claimed by Hewlett-Packard Co. (HP) from 1997 through 2003. The Ninth Circuit also affirmed the Tax Court's disallowance of a capital loss on the sale of the preferred stock by virtue of which HP had claimed the foreign tax credits. The transaction expressly was designed by AIG-Financial Products to generate foreign tax credits. HP purchased preferred stock in a Dutch company called Foppingadreef Investments (FOP) that purchased contingent interest notes. The transaction was structured to take advantage of asymmetric treatment of contingent interest in the U.S. and the Netherlands. The Netherlands taxes contingent interest prior to actual payment thereof while the U.S. taxes such interest only upon payment. In some cases, the contingent interest might never be paid. Thus, the transaction generated foreign tax credits without any actual U.S. tax on the contingent interest, which allowed HP to use the foreign tax credits against U.S. taxes on other foreign income. HP treated FOP as a controlled foreign corporation through its ownership of the preferred stock and warrants to acquire additional stock and claimed foreign tax credits for Dutch taxes on contingent interest. The transaction was pre-arranged to terminate in 2003 through the exercise of put options held by HP that allowed HP to transfer the preferred stock back to the common stockholder of FOP (a Dutch bank) for a price that resulted in a $16 million loss to HP. Judge Kozinski noted that the Courts of Appeals differ in their standard of review on the question whether an investment is debt or equity. Some Courts of Appeals view the question as one of fact, other view it as a question of law, and still others as a mixed question of law and fact. In the Ninth Circuit, the debt-equity distinction is a question of fact and therefore a trial court's conclusion on this issue cannot be overturned on appeal unless clearly erroneous. The Ninth Circuit concluded that the Tax Court committed no clear error in finding that the preferred stock was in reality debt not equity, thereby disqualifying HP from claiming foreign tax credits. Moreover, the Ninth Circuit agreed with the Tax Court that HP's claimed $16 million § 165 loss on the sale of the preferred stock back to the common stockholder of FOP was in effect a nondeductible fee paid to AIG in order to participate in a tax shelter. The Tax Court previously had held, and the Ninth Circuit previously had agreed, that fees spent for the generation of artificial tax losses are not deductible. *See Enrici v. Commissioner*, 813 F.2d 293, 296 (9th Cir. 1987); *see also New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. 161, 186 (2009), *aff'd*, 408 Fed. Appx. 908 (6th Cir. 2010) (holding payments made in a transaction that lacked economic substance nondeductible).

B. Identified "tax avoidance transactions"

1. Micro-captive insurance transactions are "transactions of interest" that might be on their way to being listed. Notice 2016-66, 2016-47 I.R.B. 745 (11/1/16). This notice identifies certain captive insurance arrangements, referred to as "micro-captive transactions," as transactions of interest for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 of the Code. Generally, these arrangements involve a person who owns an insured business and that same person or a related person also owns an interest in the insurance company providing coverage. The insured business deducts the premiums paid to the insurance company, and the insurance company, by making the election under § 831(b) to be taxed only on taxable investment income, excludes the premiums from gross income. An insurance company making the § 831(b) election can receive up to $2.2 million in premiums annually (adjusted for inflation after 2015). The notice describes the coverage under these arrangements as having one or more of the following characteristics:

> (1) the coverage involves an implausible risk; (2) the coverage does not match a business need or risk of Insured; (3) the description of the scope of the coverage in the Contract is vague, ambiguous, or illusory; or (4) the coverage duplicates coverage provided to Insured by an unrelated, commercial insurance company, and the policy with the commercial insurer often has a far smaller premium.

The Treasury Department and the IRS believe these transactions have a potential for tax avoidance or evasion but lack enough information to determine whether the transactions should be identified specifically as a tax avoidance transaction. Transactions that are the same as, or substantially similar to, the transaction described in § 2.01 of the notice are identified as "transactions of interest" for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 effective November 1, 2016. Persons entering into these transactions after November 1, 2006, must disclose the transaction as described in Reg. § 1.6011-4.

a. Participants in micro-captive insurance transactions have until May 1, 2017, to disclose their participation in years for which returns were filed before November 1, 2016. Notice 2017-8, 2017-3 I.R.B. 423 (12/29/16). This notice extends the due date for participants to disclose their participation in the micro-captive insurance transactions described in Notice 2016-66, 2016-47 I.R.B. 745 (11/1/16). Generally, under Reg. § 1.6011-4(e)(2)(i), if a transaction becomes a transaction of interest or a listed transaction after a taxpayer has filed a return reflecting the taxpayer's participation in the transaction, then the taxpayer must disclose the transaction for any year for which the limitations period on assessment was open on the date the transaction was identified as a listed transaction or transaction of interest within 90 calendar days after the date on which the transaction was identified. This meant that, for open years for which returns already had been filed on November 1, 2016 (the date on which Notice 2016-66 was issued), disclosures were due on January 30, 2017. In this notice, the IRS has extended the due date from January 30 to May 1, 2017.

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.

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Form 1023-EZ regulations finalized. T.D. 9819, Guidelines for the Streamlined Process of Applying for Recognition of Section 501(c)(3) Status, 82 F.R. 29730 (6/30/17). Originally issued as proposed and temporary regulations in 2014 (T.D. 9674, Guidelines for the Streamlined Process of Applying for Recognition of Section 501(c)(3) Status, 79 F.R. 37630 (7/2/14)), these final regulations authorize without substantive change a streamlined process that certain small organizations may use to apply for recognition of tax-exempt status under § 501(c)(3). Essentially, the final regulations allow the IRS to promulgate Form 1023-EZ for "eligible organizations" to meet the notice requirements of § 508 for purposes of obtaining recognition of tax-exempt status under § 501(c)(3). Detailed annual or other guidance issued by the IRS defines "eligible organizations" allowed to file Form 1023-EZ. For 2017, Rev. Proc. 2017-5, § 6.05, 2017-1 I.R.B. 230, generally provides that an "eligible organization" is one that (1) has projected annual gross receipts of $50,000 or less in the current year and the next two years, (2) $50,000 or less of actual receipts for each of the past three years for which it was in existence, and (3) has total assets the fair market value of which does not exceed $250,000. For purposes of this last eligibility requirement, a good faith estimate of the fair market value of the organization's assets is sufficient. Notwithstanding the foregoing, Rev. Proc. 2017-5 contains a lengthy list of organizations that cannot submit Form 1023-EZ, including churches, schools, colleges, and hospitals. Form 1023-EZ must be submitted electronically and the user fee for doing so is $275, as opposed to the $850 user fee charged to organizations submitting a regular Form 1023. Organizations that submit Form 1023-EZ ordinarily will file an annual Form 990-N (e-postcard) instead of the regular Form 990 required of larger § 501(c)(3) organizations. The final regulations amend Reg. §§ 1.501(a)-1, 1.501(c)(3), and 1.508-1, and they are effective July 1, 2017.

2. Is this good for procrastinators? Temporary regulations implement the six-month automatic extension of time to file returns of exempt organizations, including those in the Form 990 series. T.D. 9821, Return Due Date and Extended Due Date Changes, 82 F.R. 33441 (7/20/17). Treasury and the IRS have issued proposed, temporary, and final regulations that provide an automatic six-month extension of time for the filing of certain returns, including those in the Form 990 series filed by tax-exempt organizations. Previously, Reg. § 1.6081-9(a) provided an automatic three-month extension for most returns in the 990 series. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(b)(4)-(8), directs the Treasury to modify relevant regulations to provide that the maximum extension of time for filing several types of returns, including those in the Form 990 series, is six months (ending on November 15 for calendar-year filers). Pursuant to this statutory directive, Temp. Reg. § 1.6081-9T(a) provides that entities required to file several types of returns, including those in the Form 990 series, are allowed an automatic six-month extension by filing a timely application (normally submitted on Form 8868 or Form 7004).

- The Form 990 returns eligible for this automatic extension are Form 990, Return of Organization Exempt from Income Tax; Form 990-EZ, Short Form Return of Organization Exempt from Income Tax; Form 990-PF, Return of Private Foundation; Form 990-T, Exempt Organization Business Income Tax Return; and Form 990-BL, Information and Initial Excise Tax Return for Black Lung Benefit Trusts and Certain Related Persons.

- The other returns eligible for this automatic extension are Form 1041-A, U.S. Information Return-Trust Accumulation of Charitable Amounts; Form 1120-POL, U.S. Income Tax Return for Certain Political Organizations; Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code; Form 5227, Split-Interest Trust Information Return; Form 6069, Return of Excise Tax on Excess Contributions to Black Lung Benefit Trust Under Section 4953 and Computation of Section 192 Deduction; and Form 8870, Information Return for Transfers Associated With Certain Personal Benefit Contracts.

- The temporary regulations apply to extension requests filed on or after July 20, 2017, but the statutory amendments made by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 apply to returns for taxable years that begin after December 31, 2015. Accordingly, the preamble to the temporary regulations provides that taxpayers can elect to apply the regulations to returns filed for periods beginning after December 31, 2015.

3. 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 . . . .

4. 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.

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).

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.

5. 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.

6. 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.

B. <u>Charitable Giving</u>

1. We really shouldn't have charitable organizations collect taxpayer identification numbers of donors, says the IRS. The proposed regulations are withdrawn. IRS-2015-0049-37970, Substantiation Requirement for Certain Contributions; Withdrawal, 81 F.R. 882 (1/8/16). The Treasury Department and the IRS have withdrawn proposed regulations (REG-138344-13, Substantiation Requirement for Certain Contributions, 80 F.R. 55802 (9/17/16)) under § 170(f)(8) governing the substantiation of charitable contributions of $250 or more. Section 170(f)(8)(A) requires a taxpayer who claims a charitable contribution deduction for any contribution of $250 or more to obtain substantiation in the form of a contemporaneous written acknowledgment (CWA) from the donee organization. An exception in § 170(f)(8)(D) provides that a CWA is not required if the donee organization files a return (on such form and in accordance with such regulations as are prescribed) that includes the information required in a CWA. When final regulations on the CWA requirements were issued in 1997, Treasury and the IRS declined to issue regulations under § 170(f)(8)(D) to effectuate donee reporting and have since taken the position that the § 170(f)(8)(D) exception is not available without final regulations prescribing the method by which donee reporting may be accomplished. Nevertheless, some taxpayers under examination for their claimed charitable contribution deductions have argued that a failure to comply with the CWA requirements can be cured if the donee organization files an amended Form 990 that includes the required information for the contribution at issue. The proposed regulations established a framework under which a donee organization could, pursuant to § 170(f)(8)(D), file an information return and furnish a copy to the donor no later than February 28 of the year following the calendar year in which the contribution was made. The information return required by the proposed regulations had to include the donor's name, address, and taxpayer identification number. In response to comments on the proposed regulations and their own misgivings about potential identity theft arising from donee organizations collecting and maintaining taxpayer identification numbers, Treasury and the IRS have withdrawn the proposed regulations. The withdrawal indicates that Treasury and the IRS have "decided against implementing the statutory exception to the CWA requirement" and continue to take the position that the § 170(f)(8)(D) "exception remains unavailable unless and until final regulations are issued prescribing the method for donee reporting."

a. You say mandatory, I say discretionary. Let's call the whole deduction off. 15 West 17th Street LLC v. Commissioner, 147 T.C. No. 19 (12/22/16). The partnership claimed a $64,490,000 charitable contribution deduction for the contribution of a conservation easement. The opinion is silent regarding whether the taxpayer failed to secure from the donee organization and maintain in its files a "contemporaneous written acknowledgment" as required by § 170(f)(8)(A), which as specified in § 170(f)(8)(B), among other things must state whether the donee provided the donor with any goods or services in exchange for the gift. But there is an inference from the context of the arguments that it did not do so. On audit, the IRS disallowed the charitable contribution deduction. After the case was docketed in the Tax Court, the donee organization submitted an amended Form 990 that included the information specified in § 170(f)(8)(B). The partnership moved for partial summary judgment, contending that filing by the donee eliminated the need for the taxpayer to have received a "contemporaneous written acknowledgment" as required by § 170(f)(8)(A) to substantiate the gift. This argument was grounded on § 170(f)(8)(D), which waives the contemporaneous written receipt requirement "if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe," that includes the information specified in § 170(f)(8)(B). The IRS and Treasury have not issued any regulations under § 170(f)(8)(B), but the partnership argued the regulations under which the donee organizations' Form 990 was filed satisfied the statutory requirement. In a reviewed opinion (8-3-6) by Judge Lauber, the Tax Court held that § 170(f)(8)(D) provides a discretionary, rather than mandatory, delegation of rule-making authority, and that § 170(f)(8)(D) is not self-executing in the absence of the regulations to which the statute refers. In the absence of such regulations, the requirements of § 170(f)(8)(A) applied and the motion for summary judgment was dismissed. The majority opinion stated that the partnership had not "cited, and our own research has discovered, no case in which a court has held to be self-executing a Code provision containing a discretionary delegation that refers to regulations that the Secretary 'may prescribe.' Conversely, every judicial decision that has held a Code provision to be self-executing in the absence of regulations has involved a mandatory delegation that included the word 'shall.'"

- Judge Gustafson, in a dissent in which Judges Colvin, Foley, Vasquez, Paris and Morrison joined, would have found the statutory requirement of § 170(f)(8)(D) to have been met by virtue of the information required by § 170(f)(8)(B) being included on the donee organization's return under § 6033, the informational requirements for which are provided in Reg. § 1.6033-2.

- Judge Foley's dissent, in which Judges Colvin, Vasquez, Gustafson, Paris and Morrison joined, would have held that § 170(f)(8)(D) abrogates the requirement that the donor comply with § 170(f)(8)(A) as long as the donee files a return that contains the information described in § 170(f)(8)(B), which was done in this case.

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. The 2017 Tax Cuts and Jobs Act, § 13705, permanently repealed § 170(f)(8)(D) effective for taxable years beginning after December 31, 2016.

2. Certain syndicated conservation easement transactions entered into after 2009 are listed transactions and taxpayers who have invested in them must disclose them for each tax year in which they participated. Notice 2017-10, 2017-4 I.R.B. 544 (12/23/16). This notice identifies certain syndicated conservation easement transactions entered into after 2009 as listed transactions. In these transactions, a promoter typically markets interests in a pass-through entity that owns real property. The pass-through entity grants a conservation easement on the real property based on an appraisal that, in the IRS's view, greatly inflates the value of the conservation easement based on unreasonable conclusions about the development potential of the real property. The charitable contribution deduction resulting from the grant of the conservation easement flows through to the investors in the pass-through entity. The effect of these transactions is that an investor in the pass-through entity receives a charitable contribution deduction that significantly exceeds the amount invested. The IRS plans to challenge these transactions based on the overvaluation of the conservation easement and also may challenge them based on the partnership anti-abuse rule, economic substance, or other rules or doctrines. Transactions that are the same as, or substantially similar to, the transactions described in § 2 of the notice are identified as "listed transactions" for purposes of Reg. § 1.6011-4(b)(2) and §§ 6111 and 6112 effective 12/23/16. A person entering into these transactions on or after 1/1/10 must disclose the transactions as described in Reg. § 1.6011-4 for each taxable year in which the person participated in the transactions, provided that the period of limitations for assessment of tax has not expired on or before 12/23/16.

a. Participants in listed syndicated conservation easement transactions have until October 2, 2017, to disclose their participation in years for which returns were filed before December 23, 2016. Notice 2017-29, 2017-20 I.R.B. 1243 (4/27/17). This notice extends the due date for participants to disclose their participation in the syndicated conservation easement transactions described in Notice 2017-10, 2017-4 I.R.B. 544 (12/23/16). Generally, under Reg. § 1.6011-4(e)(2)(i), if a transaction becomes a transaction of interest or a listed transaction after a taxpayer has filed a return reflecting the taxpayer's participation in the transaction, then the taxpayer must disclose the transaction for any year for which the limitations period on assessment was open on the date the transaction was identified as a listed transaction or transaction of interest within 90 calendar days after the date on which the transaction was identified. Notice 2017-10 extended this period to 180 days for listed syndicated conservation easement transactions, which meant that disclosures were due (for years for which returns already had been filed) on 6/21/17. In this notice, the IRS has extended the due date from 6/21 to 10/2/17. The notice cautions that the due date for disclosure with respect to returns filed after the date Notice 2017-10 was issued (12/23/17) and for disclosure by material advisors is unchanged and remains 5/1/17. The notice also provides that donees in these syndicated conservation easement transactions are not considered material advisors under § 6111.

b. Those affected by Hurricanes Harvey, Irma, or Maria have until October 31, 2017, to disclose their participation in syndicated conservation easement transactions for years for which returns were filed before December 23, 2016. Notice 2017-58, 2017-42 I.R.B. 326 (9/27/17). For participants in syndicated conservation easement transactions that are "affected participants," this notice extends the due date for disclosing their participation in the syndicated conservation easement transactions described in Notice 2017-10, 2017-4 I.R.B. 544 (12/23/16). Disclosure was due on October 2, 2017, for years of participation for which a return had already been filed by December 23, 2016 (the date Notice 2017-10 was issued). Affected particpants now have until October 31, 2017 to file disclosures. An affected participant is "any participant whose principal residence or principal place of business was located in a Hurricane Harvey, Hurricane Irma, or Hurricane Maria covered disaster area, as defined in [Reg.] § 301.7508A-1(d)(2), or whose records necessary to meet the disclosure obligation were maintained in such a covered disaster area."

3. If you are donating a used motor vehicle, boat, or airplane, you better not neglect to obtain and attach to your return Form 1098-C, says the Tax Court. Izen v. Commissioner, 148 T.C. No. 5 (3/1/17). On 4/14/16, during a pending Tax Court proceeding, the taxpayer filed an amended federal income tax return for 2010 and claimed a charitable contribution deduction of $338,080 for his donation of a 50 percent interest in a 1969 model Hawker-Siddley DH125-400A private jet to the Houston Aeronautical Heritage Society (Society), an organization exempt from tax under § 501(c)(3), which operates a museum at the William P. Hobby Airport. The taxpayer included with his amended return: (1) an acknowledgment letter dated 12/30/10 and signed by the president of the Society; (2) a Form 8283, *Noncash Charitable Contributions*, dated 4/13/16 and executed by the managing director of the Society; (3) a copy of an "Aircraft Donation Agreement" allegedly executed on 12/31/10 by the president of the Society (but not by the taxpayer); and (4) an appraisal dated 4/7/11, stating that the fair market value of the taxpayer's 50 percent interest in the aircraft, as of 12/30/10, was $338,080. The IRS moved for summary judgment and asserted that the taxpayer was not entitled to the charitable contribution deduction because he had failed to satisfy the substantiation requirements of § 170(f)(12), which applies to contributions of used motor vehicles, boats, and airplanes. Section 170(f)(8) requires a contemporaneous written acknowledgement from the donee organization as a condition for deducting charitable contributions of $250 or more, but § 170(f)(12) imposes more stringent substantiation requirements. Section 170(f)(12) requires a more detailed contemporaneous written acknowledgment and, unlike § 170(f)(8), requires the taxpayer to include the acknowledgment with the return that includes the deduction. The statute directs the donee organization to provide to the government the information contained in the acknowledgment, and the IRS has designated for this purpose Form 1098-C, *Contributions of Motor Vehicles, Boats, and Airplanes*, a copy of which is to be provided to the donor. The taxpayer did not submit Form 1098-C with his amended return. The Tax Court (Judge Lauber) concluded that the documentation the taxpayer did submit with his amended return did not comply with the requirements of § 170(f)(12). Accordingly, the court disallowed the taxpayer's deduction.

4. The Eighth Circuit takes the "gimme" in yet another golf course conservation easement case, and a taxpayer learns the hard way that a retroactive effective date doesn't work. RP Golf, LLC v. Commissioner, 860 F.3d 1096 (8th Cir. 6/26/17), *aff'g* T.C. Memo 2016-80 (4/28/16). In this case, the Eighth Circuit quickly and easily dispensed with a taxpayer's $16.4 million deduction for a golf course conservation easement. The taxpayer had donated a conservation easement to a land trust on December 29, 2003 (which was recorded in county deed records on December 30, 2003); however, at the time of the donation two mortgages remained on the property. The mortgages were not subordinated to the conservation easement as required by Reg. § 1.170A-14(g)(2). Uh oh! To remedy this mistake, the taxpayer and the mortgage holders entered into a subordination agreement that purported to be effective as of December 31, 2003, although the subordination agreement was not executed until April 14, 2004. Huh, why April 14, 2004? The Tax Court (Judge Paris) disallowed the $16.4 million deduction on the same ground as the Ninth and Tenth Circuits (*Minnick v. Commissioner*, 796 F.3d 1156 (9th Cir. 2015) and *Mitchell v. Commissioner*, 775 F.3d 1243 (10th Cir. 2015)), both of which have held that mortgages must be subordinated to conservation easements at the time of the donation, not thereafter, to meet the "protected in perpetuity" requirement of the regulations. The taxpayer, though, argued that *Minnick* and *Mitchell* were distinguishable. In *Minnick* the gap between the donation and subordination was five years while in *Mitchell* the gap was two years. Thus, the taxpayer argued that a subordination agreement retroactively effective to the year of the donation and executed so soon after the conveyance complies with the "protected in perpetuity" requirement of the regulations. Moreover, the taxpayer argued that the mortgage holders had orally agreed to the subordination at the time of the donation. The Eighth Circuit, though, affirmed the Tax Court's holding that (i) a retroactive subordination agreement does not meet the "protected in perpetuity" requirement of the regulations, and (ii) there was insufficient evidence to support the existence of an oral subordination agreement at the time of the donation.

- **Notably, RP Golf, LLC won an earlier "match play" round with the IRS in this case:** In 2012, Judge Paris sided with RP Golf against the IRS over whether the conservation easement deed as accepted and signed by the donee land trust met the "contemporaneous written acknowledgement" requirement of § 170(f)(8). *See RP Golf, LLC v. Commissioner*, T.C. Memo. 2012-282. For charitable contributions of $250 or more, § 170(f)(8) generally requires the donee charity to provide the donor with a contemporaneous written acknowledgement regarding the property contributed, whether goods or services were provided in exchange therefor, and a good faith estimate of the value of the property contributed. Typically, charities provide short letters to donors acknowledging their contributions—so-called "goods and services" letters—by the end of the year in which any donation is made. In a number of cases involving contributions of conservation easements, however, the typical "goods and services" letter was not sent by the charity to the donor of the conservation easement. The IRS often latches on this technical deficiency as an argument (with mixed success) to disallow conservation easement deductions even when the donee charity signs the deed acknowledging receipt of the conservation easement. *See, e.g., 15 West 17th Street LLC v. Commissioner,* 147 T.C. No. 19 (12/22/16) (taxpayer unfavorable); *Averyt v. Commissioner*, T.C. Memo. 2012-198 (taxpayer favorable); *Simmons v. Commissioner*, T.C. Memo. 2009-208, *aff'd* 646 F.3d 6 (Fed. Cir. 2011) (taxpayer favorable); *Schrimsher v. Commissioner*, T.C. Memo. 2011-71 (taxpayer unfavorable). More recently, though, the Tax Court has ruled that a conservation easement deed acknowledged and signed by the donee-charity meets the "contemporaneous written acknowledgment" requirement of § 170(f)(8). *See Big River Development, L.P. v. Commissioner,* T.C. Memo. 2017-166 (8/28/17); *310 Retail, LLC v. Commissioner*, T.C. Memo. 2017-164 (8/24/17).

5. It took some time, but finally we "gotcha," says the IRS, in this infamous charitable contribution case involving billionaire and Miami Dolphins' owner Stephen Ross and the University of Michigan. RERI Holdings I, LLC v. Commissioner, 149 T.C. 1 (7/3/17). In a TEFRA case that has gone on for some time and has produced at least one other noteworthy holding (see below), the IRS prevailed in denying a $33 million charitable contribution deduction to a partnership in which Stephen Ross, owner of the Miami Dolphins, was a partner. The property was donated to the University of Michigan, Mr. Ross's alma mater. The partnership had paid only $2.95 million for the property a little over a year prior to its donation. In fact, at some point after the donation the University of Michigan sold the property for only $1.94 million. These facts, of course, displeased the IRS greatly, and the IRS convinced the Tax Court to deny the partnership's charitable contribution deduction on technical grounds (as discussed below). Moreover, contrary to decisions of the Fifth and Ninth Circuits, the Tax Court (Judge Halpern) determined that the partners of the partnership potentially are liable for aggregate gross valuation misstatement penalties of about $11.8 million.

The facts of the case are complicated, but essentially reveal that for tax year 2003 the partnership claimed a $33 million charitable contribution deduction under § 170(a)(1) for a donation to the University of Michigan. The donated property consisted of a remainder interest in a disregarded single-member LLC that the partnership owned and that held underlying real property. On its Form 8283, Noncash Charitable Contributions, the partnership failed to report its "cost or adjusted basis" for the donated property as required by Reg. § 1.170A-13(c)(4)(ii)(E), instead leaving the line on the form completely blank. Judge Halpern ruled that this failure to comply either strictly or substantially with the regulations is fatal to a claimed charitable contribution deduction, thereby denying the deduction in full. Lastly, for purposes of determining potential penalties, the Tax Court held that the correct value of the property at the time of the donation was approximately $3.5 million.

Regarding the IRS's assertion of the 40 percent penalty under § 6662(h) for "gross valuation misstatements" (valuation of 400 percent or more of correct value), the partnership argued that § 6662 should not apply because the $33 million charitable contribution deduction was completely disallowed and hence was not "attributable to" a valuation misstatement. *See, e.g., Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990), *rev'g* T.C. Memo. 1988-408; *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990), *aff'g* T.C. Memo. 1988-416. Judge Halpern's opinion, however, relies upon the Tax Court's more recent decision in *AHG Investments, LLC v. Commissioner*, 140 T.C. 73 (2013), in which the court declined to follow *Heasley* and *Gainer*. Judge Halpern noted that both the Fifth and Ninth Circuits have expressed reservations about *Heasley* and *Gainer*, and because any appeal by the partnership (due to its dissolution in 2004) would be to the U.S. Court of Appeals for the Federal Circuit, the Tax Court was free to follow its decision in *AHG Investments*. Judge Halpern then determined that the correct fair market value of the donated property should have been roughly $3.5 million, i.e., $29.5 million less than the value claimed by the partnership. Therefore, subject to partner-level § 6662(e)(2) calculations ($5,000 underpayment threshold per partner), the partners of the partnership potentially are liable for penalties aggregating as much as $11.8 million (40 percent of the $29.5 million valuation overstatement).

- The IRS probably thought it should have won this case previously on a similar technicality. In *RERI Holdings I, LLC v. Commissioner*, 143 T.C. 41 (2014), the IRS had cleverly argued on a summary judgment motion that the partnership's "qualified appraisal" (*see*

§ 170(f)(11)) of the property was fatally flawed. Specifically, the IRS had argued that although the partnership obtained an otherwise qualified appraisal, the partnership's appraisal valued a remainder interest in the underlying real property, not the remainder interest in the disregarded single-member LLC that held the real property. The remainder interest in the disregarded single-member LLC was the property the partnership donated to the University of Michigan, not the real property itself. Thus, argued the IRS, the partnership's otherwise qualified appraisal was for *the wrong property* (even though under § 7701 the single-member LLC was completely disregarded for all other tax purposes)! But, in 2014 Judge Halpern did not let the IRS win so easily. Judge Halpern accepted the IRS's argument that a charitable contribution of an interest in a disregarded single-member LLC should be viewed differently (and perhaps valued differently) than a charitable contribution of the underlying asset(s). Judge Halpern so held even while acknowledging that a single-member LLC otherwise is ignored for federal tax purposes. Judge Halpern's opinion relied heavily on the Tax Court's earlier decision in a gift tax case involving a disregarded single-member LLC. *See Pierre v. Commissioner*, 133 T.C. 24 (2009), *supplemented by* T.C. Memo. 2010-106. Nevertheless, perhaps to avoid so-easily granting summary judgment against the taxpayer and in favor of the IRS in 2014, Judge Halpern reasoned that there was an unresolved issue of material fact whether a valuation of the real property held by the partnership's disregarded single-member LLC could "stand proxy" for the otherwise required "qualified appraisal." Surprisingly, though, Judge Halpern's decision in the earlier *RERI* ruling raises the prospect of a disregarded single-member LLC interest being regarded and valued separately for purposes of determining charitable contributions under § 170.

6. 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.

7. 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.

8. Tax Court Not Giving in to First Circuit? Palmolive Building Investors, LLC v. Commissioner, 149 T.C. No. 18 (10/10/17). In this TEFRA partnership audit case, the Tax Court refused to follow the First Circuit's opinion in *Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012), regarding the § 170(h)(5)(A) "protected in perpetuity" requirement for deducting conservation easements. In particular, the taxpayer, a limited liability company classified for federal tax purposes as a partnership, contributed a $33.41 million facade conservation easement to a § 501(c)(3) qualified organization in 2004 by executing a deed in favor of the donee organization. The building subject to the façade easement was encumbered by two mortgages; however, before executing the façade easement deed, the taxpayer obtained mortgage subordination agreements from the two mortgagee banks. Unfortunately, though, the subordination agreements provided that if the façade easement was extinguished through a condemnation proceeding, the claims of the mortgagee banks to the condemnation proceeds would take priority over the claims of the qualified donee organization. On the other hand, the subordination agreements contained a "savings clause" providing that the mortgagee's rights "shall be deemed amended to the extent necessary" to comply with applicable regulations governing conservation easements. The IRS argued that due to the failure of the subordination agreements to elevate the rights of the qualified donee organization over the mortgagee's rights upon condemnation of the building, the façade easement was not "protected in perpetuity" and did not grant the donee an adequate "property right," as required by § 170(h)(5)(A) and Reg. § 1.170A-14(g)(2) and (g)(6). To rebut the IRS's contentions, the taxpayer relied upon the First Circuit's decision in *Kaufman*, which allowed a charitable contribution deduction for a façade easement subject to similar mortgage subordination rights. Furthermore, the taxpayer argued that the "savings clause" cured any problem with the subordination agreements. Noting that the case presumably was appealable to the Seventh Circuit, the Tax Court, in a unanimous reviewed opinion by Judge Gustafson, was not persuaded and not only refused to follow the First Circuit's decision in *Kaufman*, but also held that the "savings clause" did not cure the problem with the subordination agreements. (Judge Lauber did not participate in consideration of the opinion.) In the view of the Tax Court, the requirements of § 170(h)(5)(A) and Reg. § 1.170A-14(g)(2) and (g)(6) must be met at the time of the contribution of the easement to the qualified donee and retroactive reformation of a deed contingent upon a condition subsequent (such as with a "savings clause") will not be respected. The court cited several cases for this proposition, including *Belk v. Commissioner*, 774 F.3d 221 (4th Cir. 2014).

9. Provisions of the 2017 Tax Cuts and Jobs Act that affect charitable contributions.

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.

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. In this case a not-for-profit corporation is treated the same as a for-profit corporation. Maimonides Medical Center v. United States, 809 F.3d 85 (2d Cir. 12/18/15). In an opinion by Judge Lynch, the Second Circuit held that the lower interest rate that under § 6621(a)(1) applies to a refund for an overpayment of taxes due to a corporation applies to not-for-profit corporations as well as to for-profit corporations.

a. The Sixth Circuit agrees. United States v. Detroit Medical Center, 833 F.3d 671 (6th Cir. 8/12/16). The IRS refunded FICA taxes paid by the plaintiff, a not-for-profit corporation, for periods prior to 4/1/05 following the IRS's ruling that medical residents were eligible for the student exemption from FICA taxes. The IRS paid interest on the employer portion of the FICA taxes at the statutory rate provided by § 6621(a)(1) for corporations (the federal short-term rate plus 2 percentage points, reduced to 0.5 percentage points to the extent the overpayments exceed $10,000). The plaintiff asserted that, because it is a nonprofit corporation, it should not be treated as a corporation for this purpose. Instead, it asserted, it was entitled to interest at the higher statutory rate provided for non-corporate taxpayers (the federal short-term rate plus 3 percentage points). According to the plaintiff, it was entitled to additional interest of approximately $9.1 million. In an opinion by Judge Sutton, the Sixth Circuit held that nonprofit corporations are "corporations" for purposes of determining the rate of interest on overpayments. Accordingly, the court affirmed the District Court's grant of the government's motion for summary judgment.

b. The Seventh Circuit jumps on the bandwagon. Medical College of Wisconsin Affiliate Hospitals, Inc. v. United States, 854 F.3d 930 (7th Cir. 4/25/17). In a case raising the same issue, the United States Court of Appeals for the Seventh Circuit, in an opinion by Judge Easterbrook, concluded that a nonprofit corporation is entitled to interest on a tax overpayment at the statutory rate provided by § 6621(a)(1) for corporations.

2. 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, sine 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."

3. 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, and the American Opportunity Tax Credit. T.D. 9799, Tax Return Preparer Due Diligence Penalty Under Section 6695(g), 81 F.R. 87444 (12/5/16). The Treasury Department and the IRS have issued proposed and temporary regulations that amend Reg. § 1.6695-2 to implement changes made by the Protecting Americans from Tax Hikes Act of 2015. These changes extend the § 6695(g) preparer due diligence requirements 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). As a result of these changes, one return or claim for refund may contain claims for more than one credit 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 temporary regulations illustrate how multiple penalties could apply when one return or claim for refund is filed. Revisions to Form 8867 have been made for 2016 so that it is a single checklist to be used for all applicable credits. The temporary regulations are effective on 12/5/16.

a. 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.

4. A de minimis safe harbor permits payors to avoid penalties for incomplete or incorrect information returns and payee statements without correcting them unless the payee elects for the safe harbor not to apply. Notice 2017-9, 2017-4 I.R.B. 542 (1/4/17). Section 6721 imposes penalties for failure to timely file information returns or failure to include complete or correct information on such returns. Section 6722 imposes penalties for similar failures with respect to furnishing payee statements. The penalties are reduced if the failures are corrected within 30 days of the date prescribed for filing the return or furnishing the statement. Both provisions contain an exception for de minimis failures under which the penalties do not apply if a failure to provide complete or correct information is corrected on or before August 1 of the calendar year in which the return or statement is due and the number of information returns or payee statements otherwise subject to penalties does not exceed the greater of 10 or one-half of 1 percent of the total number of information returns or payee statements the person is required to file during the calendar year. Section 202 of the Protecting Americans from Tax Hikes Act of 2015 amended §§ 6721 and 6722 to provide a safe harbor with respect to the de minimis exception. Under the safe harbor, an error on an information return or payee statement does not need to be corrected to avoid a penalty if the error relates to an incorrect dollar amount and differs from the correct amount by no more than $100 ($25 with respect to an amount of tax withheld). Sections 6721(c)(3)(B) and 6722(c)(3)(B) provide that the safe harbor does not apply if a payee makes an election that the safe harbor not apply. Thus, if a payee makes this election, the error must be corrected to avoid penalties. The notice (1) provides the requirements for making the election, (2) clarifies that the de minimis error safe harbor does not apply in the case of an intentional error or if a payor fails to file an information return or furnish a payee statement, and (3) requires payors to retain certain records. The notice also solicits comments regarding the rules contained in the notice and regarding any potential abuse of the de minimis error safe harbor. Generally, the payee must make the election using any reasonable method prescribed by the payor (or, if there is no prescribed method, in writing), include information specified in the notice such as the payee's name, address and taxpayer identification number, and make the election with respect to payee statements required to be furnished in the calendar year in which the payee makes the election (or alternatively, with respect to payee statements required to be furnished in the calendar year of the election and succeeding calendar years). The notice applies with respect to information returns required to be filed, and payee statements required to be furnished, after 12/31/16. The notice provides that regulations incorporating the rules set forth in the notice will be issued to implement the de minimis error safe harbor and the payee election. To the extent the regulations incorporate the rules set forth in the notice, the regulations will be effective retroactively to the effective date of the notice. Although the notice does not impose a requirement for payors to notify payees regarding the de minimis error safe harbor and the available election, the regulations are expected to impose this requirement.

5. 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.

6. Fraudulent is in the eye of the beholder. Even though the check had a restrictive endorsement on the back, the sender did not willfully file a fraudulent Form 1099 when the recipient did not communicate his rejection of the check. Shiner v. Turnoy, 850 F.3d 923 (7th Cir. 3/16/17). The appellant in this case was an insurance broker who had sold insurance policies to the in-laws of an attorney whose practice focuses on tax and estate planning. The attorney demanded that the broker share with him one-half of the commissions that the broker had earned on certain policies. In response, the broker sent the attorney a check on 12/17/12 in the amount of $149,000 with a notation on the back indicating that, by cashing the check, the attorney accepted the payment in full satisfaction of any claims. The attorney did not cash the check and instead brought an action against the broker in state court the following day for breach of contract, but did not serve process on the broker until 1/30/13. By that time, on the advice of his CPA, the broker had submitted to the IRS a Form 1099 reporting the $149,000 payment to the attorney. The breach of contract action ultimately was resolved in the broker's favor. The attorney also brought this action in federal district court asserting that the broker had filed a fraudulent information return and therefore was liable to the attorney under § 7434, which authorizes a civil action for damages against a person who willfully files a fraudulent information return. The U.S. District Court held in favor of the attorney and ordered the broker to pay damages of approximately $16,000. The relevant regulation, Treas. Reg. § 1.6041-1(h), provides that a check is income for tax purposes only if "credited or set apart to a person without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made." The District Court apparently viewed the broker's restrictive endorsement on the check as a substantial limitation or restriction and concluded that the broker should not have filed the Form 1099. In an opinion by Judge Posner, the U.S. Court of Appeals for the Seventh Circuit reversed. The broker had not willfully filed a fraudulent information return, the court reasoned, because the broker had filed the Form 1099 more than a month after sending the check to the attorney, who during that period "had neither asked [the broker] for a new check—a check without a restrictive endorsement—nor otherwise communicated to [the broker] a rejection of the check. [The attorney's] inaction gave [the broker] a solid basis for believing that [the attorney] had accepted the check … despite the restrictive endorsement, so [the broker's] filing of the Form 1099 could not have been 'willfully ... fraudulent,' as required by 26 U.S.C. § 7434."

7. "As" and "as if" do not mean the same thing, says the Tax Court. A deficiency is not reduced by prior assessments of restitution ordered in a criminal prosecution. Muncy v. Commissioner, T.C. Memo. 2017-83 (5/17/17). The taxpayer, who at one point claimed that his wages were not taxable because he was a "'a sovereign, living soul' who was not a citizen of the United States … and not a party to the United States Constitution," pleaded guilty to one count of willful attempt to evade and defeat tax for 2004. The plea agreement stated that it did not bar any civil or administrative claim, including tax matters, that it was binding only on the U.S. Attorney's Office for the Eastern District of Arkansas and the taxpayer, and that it did not bind any other federal or state administrative or regulatory authority. In connection with the criminal proceeding, the U.S. District Court ordered the taxpayer to pay criminal restitution for the years 2003 through 2005. The IRS subsequently assessed the restitution pursuant to § 6201(a)(4). The IRS also issued a notice of deficiency for several tax years, including 2003 through 2005. For those years, the notice of deficiency reduced the taxpayer's corrected tax liability by the amounts of criminal restitution. In the Tax Court, however, the IRS took the position that the criminal restitution did not reduce the deficiency for the years in question. The Tax Court (Judge Nega) agreed with the government. The court reasoned that the term "deficiency" generally is defined in § 6211(a) as the excess of (1) the correct tax for the year over (2) the amount of tax shown due on the return plus "the amounts previously assessed (or collected without assessment) as a deficiency." Criminal restitution, the court concluded, is not an "amount[] previously assessed … as a deficiency." The court based its conclusion on § 6201(a)(4), which provides—for criminal restitution paid after August 16, 2010—that the IRS shall assess criminal restitution "in the same manner as if such amount were such tax." The court also relied on § 6213(b)(5), which provides that a notice of assessment of criminal restitution is not considered a notice of deficiency and is not subject to normal deficiency procedures.

According to the court, "[a]lthough neither section 6201(a)(4) nor section 6213(b)(5) explicitly provides that assessed restitution amounts may not be considered in the definition of a deficiency under section 6211, we believe common sense dictates that they not be included as "amounts previously assessed … as a deficiency" for purposes of that section. This result is consistent with *Weber v. Commissioner*, T.C. Memo. 1995-125, a decision issued before the enactment of § 6201(a)(4).

- The result in this case does not mean that the taxpayer will pay twice for the same tax liability. The court noted that "[a]ny amount paid to the IRS as restitution for taxes owed must be deducted from any civil judgment the IRS obtains to collect the same tax deficiency." Thus, criminal restitution paid with respect to a specific year does not reduce the amount of the deficiency for that year, but the IRS must subtract the restitution paid from the amount it collects for the year.

8. What is the meaning of "same taxpayer" under § 6621(d) when corporations merge (Part Deux)? Or, see what happens when different interest rates apply to overpayments and underpayments (which has never made any sense since 1986 anyway)! Ford Motor Co. v. United States, 119 A.F.T.R.2d 2017-1998 (Fed. Cl. 5/30/17). Enacted in 1998, § 6621(d) states simply: "To the extent that, for any period, interest is payable under subchapter A [underpayments] and allowable under subchapter B [overpayments] on equivalent underpayments and overpayments by the same taxpayer of tax imposed by this title, the net rate of interest under this section on such amounts shall be zero for such period." In theory, § 6621(d) accounts for and corrects the disparity between the higher interest rate imposed on underpayments and the lower interest rate applied to overpayments as long as the "same taxpayer" has made the payments. (Note: The IRS always has allowed interest netting for the same taxpayer for the same tax year.) Nevertheless, this straightforward concept and the simple language of § 6621(d) belie the difficult questions that arise regarding determinations of the "same taxpayer" in the merger and acquisition context. It seems to us that the controversy and confusion in this area are the result of two extreme views: The IRS interprets § 6621(d) very narrowly so that the term "same taxpayer" requires the same taxpayer identification number. Corporate taxpayers, however, interpret the term more broadly so that virtually any consolidation of corporate entities where one corporation has an overpayment and another has an underpayment meets the "same taxpayer" requirement. A reasoned approach would allow "same taxpayer" treatment if the corporate entities combine via a § 368(a)(1)(A) merger (regardless of the surviving corporation's taxpayer identification number), but not for other types of consolidations where corporate entities remain separately responsible for pre- and post-acquisition liabilities. *Read on only if you wish to risk incurring brain damage*.

Ford and its FSC. Ford Motor Company ("Ford") made an overpayment for 1992 while its former Netherlands foreign sales corporation, Ford Export Services B.V. ("Export"), made underpayments for 1992 through 1998 (excepting 1994). As a foreign sales corporation ("FSC") and a tax "Dodge" (pun intended) sanctioned under prior law, Export did not engage in substantial business activities. Export did perform enough activity to qualify under the FSC rules, but no physical transfers of money between Export and Ford occurred. Instead, transactions between Ford and Export were "reflected as entries on [Ford's and Export's] books of account or accounting and tax records." Between 1999 and 2005, Ford paid the IRS any underpayments owed by Export, plus interest accruing at the standard underpayment interest rate, while in 2008 the government credited the 1992 overpayment due to Ford, plus interest accruing at the standard overpayment interest rate.

Ford's 2008 claim for refund. Meanwhile, in 2003 after the favorable rules for FSCs were repealed, Export elected to be treated as a disregarded entity owned entirely by Ford. This election of disregarded entity status had the tax effect of liquidating all of Export's assets and liabilities into Ford pursuant to Reg. § 301.7701-3(g)(1)(iii). Then, in August 2008 after the IRS had credited Ford's 1992 overpayment plus interest at the overpayment rate, Ford filed a claim for refund to recover $11,740,528 from the IRS. Ford's position was that the "net interest rate of zero under [Subsection] 6621(d) [should] be applied to the underpayments and overpayments" of Export and Ford as the "same taxpayer." The IRS disallowed Ford's 2008 refund claim noting that Export and Ford filed separate returns under different taxpayer identification numbers; therefore, the "same taxpayer" requirement was not met.

Ford's 2010 claim for refund. Undaunted, after a series of transactions in 2010 that resulted in the assets and liabilities of Export becoming part of Ford, in November 2010 Ford filed a second claim for refund but this time for $20,410,788. Ford argued that Export's eventual consolidation into Ford satisfied the "same taxpayer" requirement of § 6621(d). The IRS, though, again disallowed Ford's claim on the basis that Export and Ford still were not the "same taxpayer" because the 2010 transactions "did not result in [Ford] being both liable ... for the tax that [Export] underpaid and entitled to a credit or refund of the tax that [Export] overpaid." Thus, according to the IRS, there had not been a "merger" of Export and Ford. Now exasperated, Ford filed a refund suit in the U.S. Court of Federal Claims on May 28, 2014, seeking to recover $20,410,788 under § 6621(d). The dispute came before Judge Lettow on cross-motions for summary judgment.

The landscape of interest netting. This is not an entirely new issue. According to Judge Lettow's opinion, two cases, *Energy E. Corp. v. United States*, 645 F.3d 1358 (Fed. Cir. 2011) and *Wells Fargo & Co v. United States*, 827 F.3d 1026 (Fed. Cir. 2016), *rev'g in part and aff'g in part*, 119 Fed. Cl. 27 (2014), establish how the interest netting rules of § 6621(d) should work.

1. If the surviving corporation in a merger or mergers has overpayments and underpayments across open tax years, interest netting is permitted. Wells Fargo supports this rule, and the IRS agrees because the overpayments and underpayments are made by a taxpayer with the same taxpayer identification number across the open years. (OK. This makes perfect sense to us. These were the facts of "Situation Two" in Wells Fargo.)
2. Oddly, though, if across open years one corporation has made an overpayment and another has made an underpayment, interest netting under § 6621(d) does not apply (according to the Federal Circuit) even if the two corporations subsequently merge under § 368(a)(1)(A). Wells Fargo supports this rule as well (contrary to the opinion of the lower court), and the IRS agrees because the taxpayer identification numbers of the overpaying and underpaying corporations are different at the time of the payments. (Our take: This makes no sense if the assets and liabilities of the two merging corporations become one. These are, though, the facts of "Situation One" in Wells Fargo where the IRS won.)
3. If a surviving corporation with an underpayment acquires the stock of another corporation with an overpayment (even if it subsequently files a consolidated return with the acquired subsidiary), interest netting is not permitted because the two corporations were not the "same taxpayer" at the time of the separate payments. In other words, a corporation apparently cannot "acquire" another corporation's overpayment via a stock purchase for purposes of § 6621(d) even if consolidated returns are subsequently filed. Energy E. Corp. supports this rule. (Our take: Although Judge Lettow's opinion does not elaborate, this rule makes sense too because after a stock purchase, even if the parent files a consolidated return with the acquired subsidiary, the parent is liable only for the subsidiary's post-acquisition taxes. See Reg. § 1.1502-6. The IRS presumably agrees with this approach because the taxpayer identification numbers of the underpaying and overpaying corporations remain different in this type of consolidation.)
4. On the other hand, if a corporation has an overpayment for an open tax year and merges into a surviving corporation that subsequently makes an underpayment, § 6621(d) interest netting is allowed. Wells Fargo "Situation Three" supports this rule. (Our take: This rule makes perfect sense because, in a merger, the assets and liabilities of the acquired corporation become the assets and liabilities of the acquiring corporation. Nonetheless, it seems completely inconsistent with the court's holding for "Situation One" in Wells Fargo, and it seems the IRS would disagree as well because the corporation's taxpayer identification number at the time of the overpayment is different from the corporation's taxpayer identification number at the time of the underpayment.)

The Claims Court's ruling. As if matters could get any more confusing, in Ford's § 6621(d) refund claim, Ford was the surviving entity throughout a series of consolidations and had an overpayment while Ford's FSC subsidiary had an underpayment. Naturally, Ford (having made the overpayment and being owed interest by the IRS) contended that it was the "same taxpayer" as Export (having made the underpayment and therefore owing a greater amount of interest to the IRS). Strategically, though, Ford did not dispute the courts' holdings in either *Energy E. Corp.* or *Wells Fargo*. Instead, Ford made the novel argument that because Export was not really an active corporation since it was just a FSC set up to avoid taxes (legitimately, of course), Export's separate corporate existence should be ignored, and Export should be considered the "same taxpayer" as Ford for purposes of § 6621(d). After hearing cross motions for summary judgment, Judge Lettow decided (not surprisingly) that under basic principles of tax law—specifically, *Moline Properties*—Ford and Export are separate and therefore not the "same taxpayer" for purposes of § 6621(d). Ford's $20,410,788 refund claim thus was denied.

What does all this mean for corporate taxpayers with overpayments and underpayments? The rules applicable to corporate taxpayers under § 6621(d) are a mess under current caselaw (i.e., *Ford*, *Wells Fargo*, and *Energy E. Corp.*). In our view, "same taxpayer" treatment under § 6621(d) should apply across open years if the overpaying and underpaying corporations combine pursuant to a § 368(a)(1)(A) straight merger but probably not otherwise. Guidance from Congress or Treasury would be helpful, but don't hold your breath there.

9. Pouring salt on an already mortal wound, the IRS revoked this taxpayer's exempt status and charged ten year's worth of interest on retroactively determined, unpaid taxes of the formerly-exempt taxpayer. Creditguard of America, Inc. v. Commissioner, 149 T.C. No. 17 (10/10/17). The IRS initiated an examination of the taxpayer in 2003 to determine if it qualified for tax-exempt status under § 501(c)(3). The examination concluded on February 1, 2012, when the IRS issued an adverse determination letter revoking the taxpayer's exempt status retroactively from 2002. As a non-exempt corporation, the taxpayer would have been obligated to file a 2002 IRS Form 1120, U.S. Corporate Income Tax Return, by March 17, 2003. Consequently, after the adverse determination was final, the IRS subsequently issued a notice of deficiency to the taxpayer asserting unpaid corporate taxes for 2002. The taxpayer filed a petition in the Tax Court contesting the deficiency for 2002. The Tax Court entered a stipulated decision that determined a deficiency for 2002 of $216,547. In connection with the Tax Court's determination of the deficiency, the taxpayer and the IRS entered into a stipulated decision that underpayment interest on the deficiency would be assessed later "as provided by law." That later day came on March 13, 2013, when the IRS assessed the $216,547 in unpaid taxes as well as $142,185 in underpayment interest against the taxpayer dating back to 2002. The taxpayer did not timely pay either the $216,547 in taxes or the $142,185 in interest. The taxpayer's nonpayment ultimately led the IRS to issue a Notice of Federal Tax Lien Filing and Your Rights to a [Collection Due Process] Hearing to the taxpayer in 2013. The taxpayer timely requested a collection due process hearing in response to the notice. Subsequently, after settlement and collection discussions collapsed, the IRS issued the taxpayer a final notice of determination in December 2015 sustaining the collection action for $216,547 in unpaid taxes and $142,185 in interest relating to 2002. In response to the notice of determination, the taxpayer timely petitioned the Tax Court; however, the taxpayer contested only the $142,185 of interest assessed by the IRS. The taxpayer argued that the interest should be calculated from February 1, 2012, the date of the IRS's adverse determination letter revoking the taxpayer's exempt status, not March 17, 2003, the date the taxpayer's corporate tax return would have been due as a non-exempt corporation. In a case of first impression responding to cross-motions for summary judgment, the Tax Court (Judge Lauber) upheld the IRS's determination that underpayment interest against the taxpayer should be calculated from March 17, 2003, not February 1, 2012, when the IRS revoked the taxpayer's tax-exempt status. The taxpayer had argued that although the general rule of § 6601(b) requires interest to be calculated "from the last date prescribed for payment" (which for 2002 was March 17, 2003), in the unusual circumstances of this case § 6601(b)(5) should apply. Section 6601(b)(5) provides that "[i]n the case of taxes payable by stamp and in all other cases in which the last date for payment is not otherwise prescribed, the last date for payment shall be deemed to be the date the liability for the tax arises." The taxpayer's position was that the unpaid taxes for 2002 did not "arise" until the IRS's issuance of the adverse determination letter revoking the taxpayer's exempt status. The Tax Court rejected the taxpayer's argument on the grounds that this was not a case where "the last date for payment is not otherwise prescribed" because the taxpayer, being treated (albeit retroactively) as a taxable corporation for 2002 and subsequent years, was required to file a Form 1120 and pay its tax liability as of March 17, 2003. Furthermore, the Tax Court held that the taxpayer's liability for unpaid taxes did not "arise" on February 1, 2012, when the IRS revoked the taxpayer's exempt status, but instead arose as of March 17, 2003, when the taxpayer should have filed a corporate tax return. The taxpayer's filing of an IRS Form 990 in 2003 on the assumption that it was tax-exempt for 2002 did not prevent the IRS from assessing back taxes and interest for 2002 when the taxpayer later was found not to have qualified for exemption. Finally, the Tax Court held that the purpose of interest is to put the IRS in the same position that it would have occupied had the taxpayer properly and timely paid its tax liability; therefore, the court concluded that it was proper to assess interest against the taxpayer from March 17, 2003, when the corporate income tax should have been paid.

10. 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.

B. Discovery: Summonses 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 Olsen, 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.

2. 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. Under § 280E, otherwise allowable business deductions and credits are denied to taxpayers trafficking in a "controlled substance" under federal law. 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 at least 28 states. 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 two grounds. First, 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 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). Second, the taxpayer in this case made a somewhat strained argument 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 authority. Moreover, 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 quickly dispensed of these claims by the taxpayer and upheld the District Court's dismissal the taxpayer's suit to enjoin the IRS's audit.

C. Litigation Costs

D. Statutory Notice of Deficiency

1. Rumors of the death of tax exceptionalism are greatly exaggerated. A notice of deficiency need not comply with the APA's requirement that an agency provide reasoned explanation for its action. QinetiQ US Holdings, Inc. v. Commissioner, 845 F.3d 555 (4th Cir. 1/6/17), *aff'g* T.C. Memo. 2015-123 (7/2/15). In 2002, an S corporation issued stock to two individuals. The stock was subject to the terms of a shareholders agreement that restricted transfers of the shares and gave the corporation the option to purchase the shares upon the executive's death, disability or termination of employment. The purchase price varied based on the individuals' length of employment and the event that triggered the option to purchase. The corporation terminated its S election effective in 2007 and, in 2008, was acquired by merger into QinetiQ US Holdings, Inc., the taxpayer in this case. Immediately prior to the merger, the acquired corporation waived its rights with respect to stock transfer restrictions or partially vested stock. In its taxable year ending 3/31/09, the taxpayer (the acquiring corporation) deducted $117.7 million—the value of the stock that had been transferred to one of the individuals in 2002—as wages pursuant to § 83(h). The taxpayer's position was that the transfer of stock had been nontransferable and subject to a substantial risk of forfeiture until 2008. The IRS issued a notice of deficiency stating "that the IRS had determined that QinetiQ 'ha[d] not established that [it was] entitled' to a deduction 'under the provisions of [26 U.S.C.] § 83,' and that QinetiQ's taxable income for the year thereby was increased by '$117,777,501.'" The notice of deficiency provided no further explanation. The Tax Court (Judge Goeke) held that the taxpayer was not entitled to the deduction because the stock had not been transferred in connection with the performance of services as required by § 83 and that, even if it had been, the stock was not subject to a substantial risk of forfeiture. In an opinion by Judge Keenan, the Fourth Circuit affirmed. The Fourth Circuit first addressed the taxpayer's argument that the notice of deficiency was invalid because it was a final agency action that failed to provide a reasoned explanation for the agency's decision, as required by the U.S. Supreme Court's interpretation of the Administrative Procedure Act in *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502 (2009). The Fourth Circuit rejected this argument because it failed to take into account "the unique system of judicial review provided by the Internal Revenue Code for adjudication of the merits of a Notice of Deficiency." Some agency-specific statutes, the court reasoned, "provide materially different procedures for judicial review that predate the APA's enactment." The Internal Revenue Code's authorization of de novo review of a notice of deficiency in the Tax Court is one example of this kind of statute. In light of this, the court concluded:

> the APA's general procedures for judicial review, including the requirement of a reasoned explanation in a final agency decision, were not intended by Congress to be superimposed on the Internal Revenue Code's specific procedures for de novo judicial review of the merits of a Notice of Deficiency.

The Court also rejected the taxpayer's argument that the notice of deficiency was insufficient to satisfy the requirement of § 7522(a) that the notice "describe the basis for, and identify the amounts (if any) of, the tax due, interest, additional amounts, additions to the tax, and assessable penalties included in such notice." After reviewing situations in which courts had and had not viewed flaws in notices of deficiency as rendering them invalid, the court held that the notice of deficiency issued to the taxpayer had satisfied the basic requirements of the statute. Finally, the court affirmed the Tax Court's holding that the stock issued by the taxpayer had not been subject to a substantial risk of forfeiture, but declined to address whether it had been transferred in connection with the performance of services.

2. This case might raise more questions than it answers. A notice of deficiency that erroneously set forth a deficiency of zero was a valid notice of deficiency. Dees v. Commissioner, 148 T.C. No. 1 (2/2/17). The taxpayer claimed on his 2014 federal income tax return a refundable premium tax credit pursuant to § 36B, which the IRS disallowed. The IRS issued a notice of deficiency that stated: "We determined that there is a deficiency in your income tax which is listed above." Above that language, the notice listed the deficiency as zero. The attached computation pages decreased refundable credits but erroneously computed a bottom-line deficiency of zero. In one place, the notice of deficiency stated "A decrease to refundable credit results in a tax increase." The taxpayer filed a petition in the Tax Court in response to the notice of deficiency to challenge the disallowance of the credit. The court ordered the IRS to explain whether the deficiency was zero and subsequently issued an order to show cause why the case should not be dismissed for lack of jurisdiction on the ground that the IRS had failed to determine a deficiency. The IRS explained the zero amount as a clerical error. The Tax Court, in a reviewed opinion (7-3-7) by Judge Buch, held that the notice of deficiency was valid and that the court therefore had jurisdiction over the case. The court reviewed its prior decisions regarding the validity of notices of deficiency and framed the analysis as follows:

> In the holdings of these cases we see a two-pronged approach to the question of the validity of the notice of deficiency. First, we look to see whether the notice objectively put a reasonable taxpayer on notice that the commissioner determined a deficiency in tax for a particular year and amount. If the notice, viewed objectively, sets forth this information, then it is a valid notice. ... Accordingly, if the notice is sufficient to inform a reasonable taxpayer that the Commissioner has determined a deficiency, our inquiry ends there; the notice is valid. But what if, as here, the notice is ambiguous? Then our caselaw requires the party seeking to establish jurisdiction to establish that the Commissioner made a determination and that the taxpayer was not misled by the ambiguous notice.

Elsewhere in its opinion, the court characterized the analysis of an ambiguous notice as looking "beyond the notice to determine whether the Commissioner made a determination and whether the taxpayer knew or should have known that the Commissioner determined a deficiency." In this case, the court concluded, although the notice of deficiency was ambiguous, the IRS had established that it had determined a deficiency and that the taxpayer was not misled by the notice. As evidence that the taxpayer was not misled, the court highlighted the fact that the taxpayer had filed a Tax Court petition, which made clear that the taxpayer understood that the IRS had disallowed his refundable credit.

- In a concurring opinion, Judge Marvel, joined by Judge Paris, expressed concern with the analysis in the court's opinion. Judge Marvel disagreed with the proposition that the court's prior decisions "support[] a test that looks, in part, to whether the taxpayer knew or should have known that the Commissioner determined a deficiency or was misled." References in prior decisions to a taxpayer's knowledge or being misled, she stated, were dicta that should not be elevated to a test. "The opinion of the Court has concluded, on the basis of the record as a whole, that, although the notice of deficiency was ambiguous, respondent determined an income tax deficiency with respect to petitioner and the notice is valid. No other analysis is needed or should be required."

- In a lengthy concurring opinion, Judge Ashford argued that the relevant statutory provisions, §§ 6212, 6213 and 6214, do not support the analysis in the court's opinion and instead dictate that the court's jurisdiction depends on the issuance of a notice of deficiency, but does not depend on the notice's contents. Judge Ashford distinguished between the IRS's determination of a deficiency and its issuance of the notice of deficiency: "the notice of deficiency is a predicate for our jurisdiction, but our jurisdiction does not derive from or attach to the notice of deficiency; our jurisdiction is instead over the Commissioner's determination that there is a deficiency." Finally, Judge Ashford expressed the view that the appropriate remedy for a notice of deficiency with inadequate information is not to decline jurisdiction over the case, but to shift to the IRS the burden of proof on any matter not reflected in the notice or stated incorrectly in the notice. "In short, I believe we can exercise jurisdiction over this case within the statutory confines Congress established … ."

- Judge Foley wrote a dissenting opinion joined by six other judges (Judges Colvin, Vasquez, Gale, Goeke, Gustafson, and Morrison). The dissenting opinion takes the position that the notice of deficiency did not fairly advise the taxpayer that the IRS had determined a deficiency of a specific amount, and therefore was invalid.

- Judge Gustafson wrote a separate dissenting opinion joined by five other judges (Judges Colvin, Foley, Vasquez, Goeke, and Morrison) to express his disagreement with the statement in the court's opinion that the notice in this case was not a $0 deficiency notice because the attachments to the notice informed the taxpayer that he had a decrease to refundable credits, which results in a tax increase. After discussing the statutory definition of a deficiency, Judge Gustafson concluded: "If the difference between the tax imposed and the 'excess' defined in section 6211(a) and (b) is zero, then by definition there is no deficiency. A notice that reports such a zero is not a notice of deficiency; it is a notice of no deficiency." Because the IRS had not mailed a notice of deficiency, he reasoned, the case should be dismissed for lack of jurisdiction.

E. <u>Statute of Limitations</u>

1. The one-year statute of limitations with respect to the penalty for failing to report a listed transaction does not begin to run until Form 8886 is filed. May v. United States, 119 A.F.T.R. 2d 2017-1785 (9th Cir. 5/16/17). On audit, the IRS determined that the taxpayer had failed to report a "listed transaction" by filing a Form 8886, Reportable Transaction Disclosure Statement, with the IRS and, as required by Reg. § 1.6011-4(e), a copy with the Office of Tax Shelter Analysis ("OTSA"). A "listed transaction" is one that is the same as, or substantially similar to, a tax avoidance transaction under § 6011. The IRS assessed a penalty against the taxpayer under § 6707A, but the penalty was assessed more than one year after the IRS had sufficient information from which to determine that the taxpayer had engaged in a listed transaction. Section 6501(c)(10)(A) provides in relevant part that the IRS must assess a § 6707A penalty against a taxpayer who fails to disclose a listed transaction within one year of the date that "the Secretary is furnished the information so required" by § 6011. The taxpayer argued and the United States District Court for the District of Arizona (Judge Wake) agreed that the IRS's assessment was time-barred. On the government's appeal to the U.S. Court of Appeals for the Ninth Circuit, however, in a memorandum opinion, the majority of a three-judge panel reversed, holding that "the information so required" should be interpreted to refer to the Form 8886. According to the majority, the one-year limitations period under § 6501(c)(10)(A) for assessing a penalty under § 6707A does not begin to run until the taxpayer files Form 8886 with the IRS and a copy with the OTSA. Because the taxpayer had not filed Form 8886, the limitations period never began to run and the IRS's assessment of the penalty was timely.

- Judge Clifton dissented. He argued that the majority's position "exalts form over substance" and means that "it doesn't actually matter when the relevant information was provided to the appropriate IRS agents because the provision of information doesn't count unless it is presented to the IRS on Form 8886."

2. Those seeking to toll the limitations period on seeking tax refunds based on financial disability must strictly comply with Rev. Proc. 99-21, says this U.S. District Court. Estate of Kirsch v. United States, 265 F.Supp.3d 315 (W.D.N.Y. 7/13/17). The taxpayer filed her 2008 federal income tax return on June 5, 2014. Her return indicated that she had paid approximately $51,000 in tax and owed roughly $10,000 and therefore asserted a claim for refund of $41,000. All of the tax had been paid or was deemed to have been paid on April 15, 2009. Section 6511(a) provides that a claim for refund must be filed within the later of two years from the time tax was paid or three years from the time the return was filed. Her claim for refund was filed within three years of the time the return was filed (and therefore was timely under § 6511(a)) because she had submitted it simultaneously with her return. However, § 6511(b)(2)(A) provides that, when a claim for refund is timely under the three-years-from-filing period of § 6511(a), the taxpayer can recover only the portion of the tax paid within the three-year period ending on the date the claim for refund was filed (plus the period of any extension the taxpayer obtained). In this case, § 6511(b)(2)(A) barred the taxpayer from obtaining a refund because the taxpayer had paid all of the tax more than three years before she filed her claim for refund. The taxpayer asserted that, notwithstanding the normal limitations periods, she was entitled to relief under § 6511(h), which suspends the running of the periods in § 6511(a), (b), and (c) during any period that the taxpayer is "financially disabled." The term "financially disabled" is defined as being "unable to manage … financial affairs by reason of a medically determinable phyiscal or mental impairment of the individual which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months." The taxpayer submited to the IRS a statement from her physician that the taxpayer had been diagnosed with a cognitive mental impairment that had lasted more than twelve months, had begun in 2007 and become progessively worse, and that had prevented the taxpayer from managing certain aspects of her financial affairs. The taxpayer's son submitted to the IRS a statement describing a durable power of attorney that appointed him as the taxpayer's agent effective after April 1, 2009 (shortly after the death of the taxpayer's husband on March 28, 2009). The son's statement indicated that he did not live near his mother and was unaware she needed his assistance until her symptoms became more pronounced in a later year. The District Court (Judge Wolford) held that the taxpayer was not entitled to relief under § 6511(h). The IRS's guidance on § 6511(h) is set forth in Rev. Proc. 99-21, 1999-1 C.B. 960. The revenue procedure requires, among other things, that the taxpayer submit (1) a physician's statement attesting to the specific time period during which the physical or mental impairment prevented the taxpayer from managing his or her financial affairs, and (2) a statement that no person was authorized to act on the taxpayer's behalf in financial matters during the specified period of disability. The items the taxpayer submitted, the court held, did not comply with these requirements. The statement of the taxpayer's physician did not identify the specific period of time during which the taxpayer was unable to manage her financial affairs, and her son's statement indicated that he was, in fact, authorized to act on her behalf in financial matters. Accordingly, the court held, the taxpayer's refund action had to be dismissed for lack of subject matter jurisdiction.

a. But another U.S. District Court declines to dismiss a taxpayer's refund action despite the taxpayer's failure to submit the specific documentation required by Rev. Proc. 99-21. Stauffer v. IRS, 120 A.F.T.R.2d 2017-6119 (9/29/17). The taxpayer did not file federal icome tax returns for the years 2006 through 2012. Upon the taxpayer's death at the age of 90 in 2012, his son was appointed as adminstrator of the estate. As administrator, the son filed the missing returns and sought a refund of tax for the year 2006 of more than $137,000. The IRS denied the claim as untimely under § 6511. The son filed an administrative appeal and asserted that the limitations periods of § 6511 had been tolled because his father had been financially disabled within the meaning of § 6511(h). With the administrative appeal, the son submitted a statement from the taxpayer's psychologist attesting that the taxpayer had suffered from a variety of ailments that had affected his mental capacity and had prevented him from managing his financial affairs from at least 2006 until his death in 2012. The IRS concluded that the taxpayer had not complied with Rev. Proc. 99-21, which requires that the taxpayer submit the statement of a "physician," and denied the claim as untimely. The revenue procedure provides that the term "physician" has the same meaning as in § 1861(r)(1) of the Social Security Act, 42 U.S.C. § 1395x(r), which sets forth five categories of professionals considered to be physicians, none of which includes psychologists. The District Court (Judge Wolf) held that the IRS had failed to establish that its adoption of the Social Security Act's definiton of a physician in Rev. Proc. 99-21 was the product of reasoned decision making as required by Administrative Procedure Act § 706(2)(A) and *Motor Vehicle Manufacturers Association of the United States v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983):

> The government … has not submitted any evidence of the IRS's rationale in adopting the definition in 42 U.S.C. § 1395x(r). … The IRS, therefore, has not provided any explanation for its decision, let alone a "rational connection between the facts found

> and the choice made." *State Farm*, 463 U.S. at 43. The IRS may conceivably view doctors without medical degrees to be generally unqualified to make the determination required under section 6511, and may have determined that, in view of the "need to fairly and efficiently process a potentially large number of [refund] claims," *Abston*, 691 F.3d at 996, a case-by-case determination of whether a given psychologist is nevertheless qualified is unwarranted. However, as explained earlier, at least where the IRS's reasoning is not obvious, the court may not supply an explanation for the IRS's choice that the agency itself has not given. *See State Farm*, 463 U.S. at 43.

The court also rejected the government's argument that the taxpayer was not entitled to relief under § 6511(h) because the taxpayer had submitted the psychologist's statement in the course of the administrative appeal, rather than with the claim for refund as required by Rev. Proc. 99-21. When refund claims are technically deficient, the court noted, courts generally accept the missing information at a later stage. Accordingly, the court denied the government's motion to dismiss without prejudice.

3. Shouldn't the limitations periods on seeking tax refunds be simpler? Another case in which a taxpayer loses the ability to obtain a refund because of a limit on the amount of tax recoverable. Borenstein v. Commissioner, 149 T.C. No. 10 (8/30/17). The taxpayer filed a timely extension request for her 2012 federal income tax return and paid a total of $112,000 towards her 2012 federal tax liability. All of her payments, which she made through estimated tax payments and a payment with her extension request, were deemed to be made on April 15, 2013. She did not file her 2012 until August 29, 2015, after she had received a notice of deficiency for 2012. Her return reflected a tax liability of $79,559, which the IRS agreed was correct. Thus, she had overpaid her 2012 federal tax liability by $38,447. In response to the notice of deficiency, the taxpayer filed a petition in the Tax Court. The issue before the court was whether the taxpayer was entitled to a credit or refund of the overpayment. The Tax Court (Judge Lauber) held that she was not. Under § 6512(b)(1), the Tax Court has jurisdiction to determine an overpayment if it has jurisdiction by virtue of a notice of deficiency. In this case, the court had deficiency jurisdiction because the IRS had issued a notice of deficiency and the taxpayer had filed a timely petition. Section 6512(b)(3), however, imposes a limit on the amount of tax that can be refunded. This provision states that only the portion of the tax paid within one of three specific time periods is allowed as a credit or refund. The parties agreed that the relevant period was that set forth in § 6512(b)(3)(B), which refers to tax paid

> within the period which would be applicable under section 6511(b)(2), (c), or (d), if on the date of the mailing of the notice of deficiency a claim had been filed (whether or not filed) stating the grounds upon which the Tax Court finds that there is an overpayment.

In other words, the court must treat the taxpayer as having filed a hypothetical claim for refund on the date the notice of deficiency was mailed. The question is what amount of tax the taxpayer could have recovered through this hypothetical refund claim taking into account the limits of § 6511(b)(2), (c), or (d). Of these, only § 6511(b)(2) was relevant. This provision states that a taxpayer can recover tax paid within either a two-year or a three-year period ending on the date the taxpayer filed the claim for refund. The three-year look-back period applies when the taxpayer files the refund claim "within 3 years from the time the return was filed." The two-year look-back period applies in all other cases. In this case, the court reasoned, § 6512(b)(3)(B) treats the hypothetical refund claim as having been filed on June 19, 2015, the date on which the notice of deficiency was mailed. This was *before* the taxpayer had filed her return for the year. Accordingly, the court held, the hypothetical refund claim could not be regarded as having been filed "within 3 years from the time the return was filed," and therefore the amount of tax recoverable was limited to the portion paid within the two-year period preceding June 19, 2015. All of the tax in question was deemed paid on April 15, 2013, and therefore the taxpayer was not entitled to a refund of any of the tax paid.

In reaching this conclusion, the court rejected arguments made by the taxpayer and by the Philip C. Cook Low-Income Taxpayer Clinic and the Harvard Federal Tax Clinic as amici curiae. They argued that a three-year look-back period applied by virtue of the final sentence of § 6512(b)(3)(B), which states:

> [W]here the date of the mailing of the notice of deficiency is during the third year after the due date (with extensions) for filing the return of tax and no return was filed before such date, the applicable period under subsections (a) and (b)(2) of section 6511 shall be 3 years.

The court agreed with the IRS that the parenthetical expression "(with extensions)" modifies the term "due date." The extended due date was October 15, 2013. The court reasoned that "the third year" referred to in § 6512(b)(3)(B) began on October 15, 2015. The IRS mailed the notice of deficiency on June 19, 2015, which was, the court concluded, during the second year after the extended due date, not the third year. Accordingly, this final sentence in § 6512(b)(3)(B), in the court's view, did not trigger a three-year look-back period.

4. The time period for the IRS to return wrongfully levied funds, and for taxpayers to bringing 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.

F. Liens and Collections

1. A taxpayer cannot challenge in a CDP hearing the imposition of a penalty under § 6707A for failure to report participation in a listed transaction after being provided the opportunity for a conference with IRS Appeals. Keller Tank Services II, Inc. v. Commissioner, 848 F.3d 1251 (10th Cir. 2/21/17). Section 6330(c)(2)(B) permits a taxpayer to challenge the existence or amount of the taxpayer's underlying tax liability in a CDP hearing only "if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability." In this case, the IRS determined that the taxpayer was subject to a penalty under § 6707A for failure to report participation in a listed transaction. The taxpayer filed a protest and had a telephone conference with an IRS Appeals Officer, who decided that the penalty should be sustained. The IRS then assessed the tax and issued a final notice of intent to levy, in response to which the taxpayer requested a CDP hearing. In the CDP hearing, the IRS Settlement Officer took the position that § 6330(c)(2)(B) precluded the taxpayer from challenging the underlying tax liability because the pre-assessment conference with IRS Appeals was an opportunity to dispute the liability within the meaning of the statute. Following the CDP hearing, the IRS issued a notice of determination upholding the collection action and the taxpayer filed a petition in the Tax Court. In an unpublished order, the Tax Court (Judge Carluzzo) granted the government's motion for summary judgment and held that, under the relevant regulation (Reg. § 301.6330-1(e)(3), Q&A E2), which the court previously had upheld in *Lewis v. Commissioner*, 128 T.C. 48 (2007), the taxpayer's opportunity for a conference with IRS Appeals prior to the assessment of the tax was a prior opportunity to dispute the underlying tax liability for purposes of § 6330(c)(2)(B). In an opinion by Judge Matheson, the U.S. Court of Appeals for the Tenth Circuit affirmed. Under the relevant regulation, the court explained, for taxes not subject to deficiency procedures, a prior opportunity for a pre-assessment conference with IRS Appeals is an opportunity to dispute the underlying liability that precludes a later challenge of the liability in a CDP hearing. 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, § 6330(c)(2)(B), is ambiguous, and in step two that Reg. § 301.6330-1 is a reasonable interpretation of the statute.

a. The Fourth Circuit agrees. Iames v. Commissioner, 850 F.3d 160 (4th Cir. 3/7/17). In an opinion by Judge Wilkinson, the U.S. Court of Appeals for the Fourth Circuit reached the same conclusion as the Tenth Circuit in *Keller Tank Services, II, Inc. v. Commissioner*, 848 F.3d 1251 (10th Cir. 2/21/17), i.e., that the taxpayer's opportunity for a conference with IRS Appeals prior to the assessment of the tax in question was a prior opportunity to dispute the underlying tax liability for purposes of § 6330(c)(2)(B). The Fourth Circuit explained:

> It is clear that the option to request a hearing with the Office of Appeals before the Commissioner assesses the tax counts as "an opportunity to dispute [one's] tax liability." First, taxpayers in these hearings have a genuine chance to explain why they should not be held to the amount requested by the Commissioner. Second, the Office of Appeals is an independent decisionmaker. As the Tax Court noted in *Lewis*, the law establishing Section 6330 also "mandate[d] that an independent appeals function exist within the IRS," Lewis, 128 T.C. at 59, suggesting that the Office of Appeals is "more than just a rubber stamp for the Commissioner's determinations," *id*. at 60. Finally, the Office of Appeals conducts both the preassessment hearing and the CDP hearing. We conclude that the former precludes the latter when it comes to tax liability.

The court also addressed § 6330(c)(4), which provides in part that an issue may not be raised at a CDP hearing if "the issue was raised and considered at a previous hearing under section 6320 or in any other previous administrative or judicial proceeding" and "the person seeking to raise the issue participated meaningfully in such hearing or proceeding." The court held that § 6330(c)(4) also barred the taxpayer from challenging his liability in the CDP hearing.

b. As does the Seventh Circuit. Our Country Homes Enterprises, Inc. v. Commissioner, 855 F.3d 773 (7th Cir. 5/3/17). In an opinion by Judge Kanne, the U.S. Court of Appeals for the Seventh Circuit reached the same conclusion as the Fourth and Tenth Circuits in a case involving the § 6707A penalty for failure to report participation in a listed transaction, i.e., that the taxpayer's opportunity for a conference with IRS Appeals prior to the assessment of the tax in question was a prior opportunity to dispute the underlying tax liability for purposes of § 6330(c)(2)(B). Like the Fourth Circuit, the Seventh Circuit held that § 6330(c)(4) also barred the taxpayer from challenging its liability in the CDP hearing.

2. The Fifth Circuit upholds an order of foreclosure and sale with respect to a residence despite an ownership interest held by the taxpayer's children. United States v. Davis, 119 A.F.T.R.2d 2017-529 (5th Cir. 3/9/17). The government successfully established in a prior proceeding in federal district court in 2008 that S.P. Davis was jointly and severally liable under § 6672 for a penalty equal to the amount of unpaid federal employment taxes owed by three medical companies that he co-owned. Mr. Davis was ordered to pay to the government $3,327 per month. When he failed to comply with the order, the government filed suit in 2012 in federal district court pursuant to § 7403 to foreclose federal tax liens on the residence that Mr. Davis owned in Louisiana as community property with his wife. His wife died intestate in 2013. As a result of her death, Mr. Davis remained the owner of 50 percent of the residence and acquired a right, known as a "usufruct" under Louisiana law, in the other 50 percent. A usufruct is a right to enjoy property belonging to another similar to a life estate in common law jurisdictions. The two adult children of Mr. Davis and his wife each inherited a 25 percent ownership interest, known under Louisiana law as a naked ownership interest, in the portion of the property in which Mr. Davis had a usufruct. Mr. Davis moved for partial summary judgment in the District Court and argued that, if the house were sold, his two children each should be entitled to one-fourth of any sale proceeds that remain after satisfaction of a prior mortgage held by a bank, which the government conceded had priority over the federal tax lien. The District Court denied the motion and entered an order of foreclosure and sale. In a per curiam opinion, the U.S. Court of Appeals for the Fifth Circuit affirmed. The court rejected Mr. Davis's argument that the District Court erred in failing to exercise its discretion to prohibit the sale and seizure of the residence. The court referred to *United States v. Rodgers*, 461 U.S. 677 (1983), in which the U.S. Supreme Court concluded that § 7403 leaves room for the exercise of reasoned discretion to decline to order a sale of the property, but cautioned that this discretion "should be exercised rigorously and sparingly, keeping in mind the Government's paramount interest in prompt and certain collection of delinquent taxes." In light of Mr. Davis's failure to comply with the order to make monthly payments, the court concluded, it could not say that the District Court had committed reversible error in refusing to exercise its limited discretion. The rights of the two children in the property, the court reasoned, were inferior to the federal tax lien, which attached to the entire community property while their mother was alive. The residence was subject to seizure and sale because, under Louisiana law, which determines the property interests to which the federal tax lien attached, the tax lien in question was a separate obligation incurred during the community property regime that can be satisfied from community property even after termination of the regime.

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.

4. Don't get your hopes up if the IRS cashes the check. It doesn't mean they accepted the offer in compromise. Whitesell v. Commissioner, T.C. Memo. 2017-84 (5/18/17). After they filed a petition in the Tax Court, the taxpayer and his wife submitted Form 656-L, Offer in Compromise (Doubt as to Liability) with a check for $3 million for their federal income tax liabilities for 2006 through 2012. The taxpayers modified Form 656-L by crossing out certain items and making handwritten notations. The IRS deposited the check and, after sending an initial letter informing them that it was returning their offer in compromise (OIC), sent a letter confirming that it had "closed its file on their OIC and was in the process of refunding their $3 million deposit because of the modified terms and conditions." The taxpayers argued that, under the Uniform Commercial Code, the IRS had accepted their OIC when it negotiated the check and did not reject the OIC within 90 days of receipt. The Tax Court (Judge Paris) held that there was no objective manifestation of mutual assent by the parties to settle the taxpayers' federal tax liabilities and therefore no settlement for the court to enforce. The court observed that the IRS is not bound by state statutes such as the UCC and that the IRS does not necessarily accept an offer by cashing a check. The court also noted that the IRS had followed its own guidelines regarding handling payments or deposits submitted with an OIC by depositing the check and later refunding the amount submitted when the IRS rejected the taxpayers' OIC.

5. The Tax Court has jurisdiction to review the IRS's determination to uphold an accuracy-related penalty in a CDP hearing, even though it would not have deficiency jurisdiction over the penalty, which related to adjustments to partnership items of a TEFRA partnership. McNeill v. Commissioner, 148 T.C. No. 23 (6/19/17). The taxpayer invested in a distressed asset/debt (DAD) tax shelter by purchasing an 89.1 percent interest in GUISAN, LLC , which was classified for federal tax purposes as a partnership. GUISAN was a member of LABAITE, LLC, a TEFRA partnership. LABAITE claimed a large loss in 2003 from the DAD transaction, of which the taxpayer's share was more than $10 million. In a partnership-level audit of LABAITE, the IRS issued to LABAITE's partners a notice of final partnership administrative adjustment (FPAA) that reflected an adjustment to LABAITE's partnership items and imposed an accuracy-related penalty under § 6662 with respect to the claimed loss. GUISAN was not the tax matters partner (TMP) of LABAITE. Nevertheless, the taxpayer, as TMP of GUISAN, caused GUISAN to bring an action in a U.S. District Court for review of the FPAA. The taxpayer made a deposit of $4.9 million, which was sufficient to satisfy the taxpayer's liability only for the asserted deficiency and interest related to the disallowed loss; it did not satisfy the taxpayer's liability for the asserted accuracy-related penalty. The U.S. District Court subsequently dismissed the action on the taxpayer's own motion and, in doing so, declined to adjudicate any partner-level defenses. Because the accuracy-related penalty had not been paid, the IRS assessed the penalty and ultimately issued both a final notice of intent to levy and a notice of federal tax lien filing. In response, the taxpayer requested a collection due process hearing. In the CDP hearing, the IRS settlement officer (1) took the position that the taxpayer could not raise partner-level defenses to the accuracy-related penalty because the taxpayer had had a prior opportunity to contest the liability, and (2) issued a notice of determination upholding the proposed collection action. The taxpayer filed a petition in the Tax Court. Pursuant to §§ 6221 and 6230(a)(2)(A)(i), the Tax Court's deficiency jurisdiction does not extend to penalties that relate to adjustments to partnership items. The regulations issued under § 6221 provide that "[p]artner-level defenses to such items can only be asserted through refund actions following assessment and payment." Reg. § 301.6221-1(c). Because the asserted accuracy-related penalty in this case was based on an adjustment to partnership items, the Tax Court would not have jurisdiction in a deficiency proceeding to rule on the taxpayer's claimed partner-level defenses to the penalty. Nevertheless, the Tax Court (Judge Paris) held that it had jurisdiction to review the IRS's notice of determination. In 2006, Congress amended § 6330(d)(1) to make the Tax Court the only court in which a taxpayer can seek review of an IRS notice of determination issued after a CDP hearing. As amended, § 6330(d)(1) provides that "the Tax Court shall have jurisdiction with respect to such matter." In prior decisions, the court explained, it had interpreted this amendment as conferring jurisdiction on the court to review collection determinations even when the court lacked original jurisdiction over the underlying liability. "With respect to petitioner's section 6662(a) accuracy-related penalty, this penalty is another example of an item not subject to the Court's deficiency jurisdiction under section 6221 but nonetheless reviewable by the Court in the context of its section 6330 jurisdiction." The court ruled only on the question of jurisdiction and will issue a separate opinion on the merits.

- The taxpayer invested in a DAD tax shelter during 2002 as well, and successfully asserted partner-level defenses to the accuracy-related penalty for that year in a refund action. See *McNeill v. United States*, 119 A.F.T.R.2d 2017-943 (D. Wyo. 2/24/17).

G. <u>Innocent Spouse</u>

1. Publix: "Where Shopping is a Pleasure." And, if you secretly sell $200,000 of Publix stock to fund an extramarital affair, your ex is entitled to innocent spouse relief and a tax refund. Taft v. Commissioner, T.C. Memo. 2017-66 (4/18/17). The taxpayer, a registered nurse, was married to a man who worked for Publix Supermarkets, Inc.. Her husband received company stock as part of his compensation. Over many years, the stock grew in value to over $200,000. After he was fired by Publix, he began liquidating his stock in 2010 to fund an extramarital affair. He concealed from her both the stock transactions and his affair. Their longtime accountant prepared the couple's 2010 joint return, which reflected a $25,000 sale of Publix stock and approximately $200,000 in income from pensions and annuities. The return failed to reflect $4,874 in taxable dividends received by the husband. Because the taxpayer's husband did not want her to discover the stock liquidation, he directed their accountant to file their 2010 joint return electronically without the taxpayer's approval or review. Although the taxpayer was unaware of it, the IRS later assessed the additional tax due on the unreported dividends. After the taxpayer discovered the affair in 2011, she initiated divorce proceedings and discovered that her husband had liquidated all of his Publix stock and had wasted most of the family's retirement savings. The divorce became final in 2013, following which the taxpayer filed her 2012 return and claimed a refund of $1,570. The IRS withheld her refund and applied it to the unpaid joint liability for 2010 resulting from the unreported dividends. The taxpayer asserted a claim for innocent spouse relief from the 2010 liability by filing Form 8857, in response to which the IRS determined that she was entitled to relief under § 6015(c), which limits the requesting spouse's liability for any deficiency on the joint return to that portion of the deficiency attributable to the requesting spouse. According to the IRS, the entire deficiency was attributable to the taxpayer's former husband. However, because § 6015(g)(3) provides that a taxpayer who obtains innocent spouse relief under § 6015(c) cannot obtain a refund, the IRS declined to issue the taxpayer's requested refund. The Tax Court (Judge Vasquez) held that the taxpayer was entitled to innocent spouse relief under § 6015(b) and therefore was entitled to a refund. Generally, to obtain relief under § 6015(b), a joint filer must establish that: (1) there is an understatement of tax attributable to erroneous items of the nonrequesting spouse, (2) he or she did not know and had no reason to know of the understatement, (3) taking into account all facts and circumstances, it would be inequitable to impose joint and several liability on the requesting spouse, and (4) he or she requested innocent spouse relief within two years after the IRS began collection activities. The IRS took the position that the taxpayer had reason to know of the understatement (second element) and had not established that it would be inequitable to hold her liable (third element). To determine whether the taxpayer had reason to know of the understatement, the court applied a four-factor test that considers the requesting spouse's level of education, his or her involvement in the family's business and financial affairs, the presence of lavish or unusual expenditures compared to the family's prior spending patterns, and "the culpable spouse's evasiveness and deceit concerning the couple's finances." The court concluded that all four factors favored the taxpayer and that she therefore had no reason to know of the understatement of tax. The court also concluded that, taking into account the concealment undertaken by the taxpayer's former husband and the lack of any significant benefit to the taxpayer from the understatement, it would be inequitable to impose liability on the taxpayer.

2. **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. Your time to petition the U.S. Tax Court began to run when we issued you our final determination [in January] and will end on Apr. 19, 2016. However, you may continue to work with us to resolve your tax matter." The taxpayer subsequently filed a petition in the Tax Court on April 19, 2016, and the 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 relief 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 Matuzak 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.

3. The taxpayer might have filed the wrong form to request innocent spouse relief, but it nevertheless was an "informal claim" for refund that allowed her to obtain a refund of amounts paid within the previous two years. Palomares v. Commissioner, 691 Fed.Appx. 858 (9th Cir. 5/31/17), *rev'g* T.C. Memo. 2014-243. The IRS applied the taxpayer's tax refunds, including those for 2006 and 2007, to an outstanding tax liability for 1996, a year during which the taxpayer had filed a joint return with her then-husband. In July 2008, with the assistance of a volunteer attorney, the taxpayer mistakenly filed Form 8379, Injured Spouse Allocation, which is used by a taxpayer filing a joint return to protect a refund on the joint return, rather than Form 8857, Request for Innocent Spouse Relief. The IRS responded two months later with a letter in which the IRS informed the taxpayer that she had improperly filed Form 8379 and that she might have intended to file Form 8857, a copy of which the IRS enclosed. The taxpayer did not file Form 8857 until September 2010. The IRS granted the taxpayer partial innocent spouse relief and issued refunds of tax the taxpayer had paid within the two-year period preceding her 2010 filing of Form 8857. However, the IRS denied her claim for refund of the 2006 and 2007 payments applied to the 1996 liability on the ground that her claim was untimely under § 6511(a), which requires a claim for refund to be filed within three years after the return is filed or within two years after the tax is paid, whichever is later. The taxpayer had not filed Form 8857 within three years of filing the 1996 joint return, which meant that she could recover only tax paid within the two-year period preceding her filing of a claim for refund through the request for innocent spouse relief. The Tax Court (Judge Gerber) held that the taxpayer could not obtain a refund of the 2006 and 2007 payments applied to the 1996 liability because (1) her September 2010 request for innocent spouse relief was filed more than two years after those taxes were paid, and (2) her July 2008 filing of Form 8379, Injured Spouse Allocation, could not be considered an "informal" claim for refund because it did not convey sufficient information to notify the IRS that the taxpayer was seeking relief from joint and several liability for the 1996 tax year and a refund of amounts applied against that liability. In a memorandum opinion, the U.S. Court of Appeals for the Ninth Circuit reversed. The Ninth Circuit reasoned that the taxpayer's July 2008 filing of Form 8379 fairly apprised the IRS that she was seeking innocent-spouse relief from her 1996 liability because the IRS—which had been applying her separate refunds to the 1996 joint liability—informed her that she had to file Form 8857 in order to request innocent spouse relief. Although the taxpayer's Form 8379 indicated that she was seeking a refund only of her 2007 overpayment, the court expressed the view that there was "no serious question that the IRS was on notice of her 2006 overpayment as well." The court remanded and directed the Tax Court to order the IRS to issue the refunds for 2006 and 2007.

H. Miscellaneous

1. The constitutional status of the Tax Court.

a. The Tax Court is an Article I court that is independent of the Executive and Legislative branches. Freytag v. Commissioner, 501 U.S. 868 (6/27/91). Justice Blackmun, speaking for the five-judge majority, held that the assignment of a complex tax shelter case by the Tax Court chief judge to a special trial judge (a) is permitted under § 7443A(b)(4) where the actual decision is rendered by a Tax Court judge, and (b) does not violate the Appointments Clause (U.S. Const. Art. II, § 2, cl. 2) because the special trial judge is an "inferior Officer" and the Tax Court is a[n Article I] "Court of Law." The majority characterized the Tax Court as exercising judicial power:

> The Tax Court exercises judicial, rather than executive, legislative, or administrative, power. It was established by Congress to interpret and apply the Internal Revenue Code in disputes between taxpayers and the Government. By resolving these disputes, the court exercises a portion of the judicial power of the United States.
>
> …

> The Tax Court's function and role in the federal judicial scheme closely resemble those of the federal district courts, which indisputably are "Courts of Law."
>
> …
>
> The Tax Court remains independent of the Executive and Legislative Branches. Its decisions are not subject to review by either the Congress or the President. Nor has Congress made Tax Court decisions subject to review in the federal district courts. Rather, like the judgments of the district courts, the decisions of the Tax Court are appealable only to the regional United States courts of appeals, with ultimate review in this Court.

- Four concurring justices, in an opinion written by Justice Scalia, thought that the Tax Court was a "Department" and its chief judge was a "Head of Department," so the Tax Court exercised executive power. Justice Scalia wrote:

> When the Tax Court was statutorily denominated an "Article I Court" in 1969, its judges did not magically acquire the judicial power. They still lack life tenure; their salaries may still be diminished; they are still removable by the President for "inefficiency, neglect of duty, or malfeasance in office." 26 U. S. C. § 7443(f). . . . How anyone with these characteristics can exercise *judicial* power "independent . . . [of] the Executive Branch" is a complete mystery. It seems to me entirely obvious that the Tax Court, like the Internal Revenue Service, the FCC, and the NLRB, exercises executive power.

b. The presidential power to remove Tax Court judges for cause does not infringe on the constitutional separation of powers with respect to adjudications of "pre-collection tax disputes." Kuretski v. Commissioner, 755 F.3d 929 (D.C. Cir. 6/20/14). In this collection due process case, the District of Columbia Circuit, in an opinion by Judge Srinivasan, held that the power in the U.S. President to remove Tax Court judges on grounds of "inefficiency, neglect of duty, or malfeasance in office" under § 7443(f) did not infringe on the constitutional separation of powers and result in Tax Court judges not being "free from alleged bias in favor of the Executive Branch." The taxpayers asked that § 7443(f) be struck down, the Tax Court's decision against them vacated, and the case remanded "for re-decision by a Tax Court judge free from the threat of presidential removal and hence free from alleged bias in favor of the Executive Branch." The D.C. Circuit held that it has been established that Congress can constitutionally assign to non-article III tribunals a category of cases involving "public rights" (including matters of taxation at the pre-collection stage); the Tax Court is an Article I court and, while its judges do exercise judicial power, they do not exercise the "'judicial power of the United States' under Article III." Even though *Freytag* [*v. Commissioner*, 501 U.S. 868 (1991)] held that the Tax Court is a "Court of Law," the D.C. Circuit held that "the judicial power of the United States is not limited to the judicial power defined under Article III." It further held that the Tax Court, as a legislative court, is nevertheless part of the Executive Branch of government, and therefore the President's power to remove Tax Court judges did not violate separation of powers principles:

> We need not explore the precise circumstances in which interbranch removal may present a separation-of-powers concern because this case does not involve the prospect of presidential removal of officers in another branch. Rather, the Kuretskis have failed to persuade us that Tax Court judges exercise their authority as part of any branch other than the Executive. Consequently, if a President were someday to exercise the authority under 26 U.S.C. § 7443(f) to remove a Tax Court judge for cause, the removal would be entirely consistent with separation-of-powers principles.

c. Congress speaks, but its meaning is far from clear. The 2015 Protecting Americans Against Tax Hikes Act, § 441, amended Code § 7441 by adding the following sentence: "The Tax Court is not an agency of, and shall be independent of, the executive branch of the Government." What Congress intended to achieve with this language is not entirely clear. The Joint Committee's explanation of the provision discusses *Kuretski v. Commissioner*, 755 F.3d 929 (D.C. Cir. 6/20/14), and states simply: "To avoid confusion about the independence of the Tax Court as an Article I court, the provision clarifies that the Tax Court is not an agency of the Executive Branch."

d. We need not decide which branch of government we're in, says the Tax Court, but we agree with the D.C. Circuit that the presidential power to remove Tax Court judges for cause does not infringe on the constitutional separation of powers. Battat v. Commissioner, 148 T.C. No. 2 (2/2/17). The taxpayers in this case filed a petition in the Tax Court in response to a notice of deficiency and moved to disqualify all Tax Court judges. The taxpayers made the same argument made by the taxpayers in *Kuretski v. Commissioner*, 755 F.3d 929 (D.C. Cir. 6/20/14), i.e., that the power in the U.S. President to remove Tax Court judges on grounds of "inefficiency, neglect of duty, or malfeasance in office" under § 7443(f) violates separation of powers principles. In a lengthy opinion that examines the history of the various statutory provisions that govern the Tax Court and prior judicial decisions that address the Tax Court's constitutional status, the Tax Court (Judge Colvin) denied the taxpayers' motion. In contrast to the approach of the court in *Kuretski*, which concluded that no separation of powers problem existed because the Tax Court is part of the Executive branch, the Tax Court concluded that it need "not … address the branch placement of the Tax Court …." Instead, the Tax Court reasoned that "even though Congress has assigned to the Tax Court a portion of the judicial power of the United States, *Freytag v. Commissioner*, 501 U.S. at 890, the portion assigned to the Tax Court includes only public law disputes and does not include matters which are reserved by the Constitution to Article III courts." Thus, the President's removal of a Tax Court judge would not affect "any matter within the portion of 'the judicial Power of the United States' that is necessarily exercised by Article III judges." The taxpayers in this case resided in Florida at the time they filed their petition, and therefore any appeal of this decision will be heard by the U.S Court of Appeals for the Eleventh Circuit.

e. The Tax Court reiterates its holding in *Battat v. Commissioner* and holds that the accuracy-related penalties imposed by § 6662A do not violate the Eighth Amendment. Thompson v. Commissioner, 148 T.C. No. 3 (2/2/17). The taxpayers in this case, like those in *Battat v. Commissioner*, 148 T.C. No. 2 (2/2/17), moved to disqualify the Tax Court judge on the ground that the power in the U.S. President to remove Tax Court judges on grounds of "inefficiency, neglect of duty, or malfeasance in office" under § 7443(f) violates separation of powers principles. The Tax Court (Judge Wherry) denied the motion in reliance on the court's decision in *Battat.* The Tax Court also rejected the taxpayers' argument that the penalty imposed by § 6662A on any reportable transaction understatement violates the Excessive Fines Clause of the Eighth Amendment to the Constitution. Although the taxpayers apparently represented to the court that any appeal of the court's decision would be heard by the U.S. Court of Appeals for the Eleventh Circuit, the court's opinion states that the taxpayers resided in California when they filed their petition and that any appeal therefore would be heard by the U.S. Court of Appeals for the Ninth Circuit.

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

- Judge Kavanaugh's opinion found six problems with the 2011 regulations: (1) tax return preparers were not "representatives" because they are not "agents" and, thus, lack "legal authority to act on the taxpayer's behalf"; (2) the preparation and filing of a tax return did not constitute "practice … before the Department of the Treasury" because that term implies "an investigation, adversarial hearing, or other adjudicative proceeding"; (3) the history of the statutory language originally enacted in 1884 "indicated that the statute contemplated representation in a contested proceeding"; (4) the regulation was inconsistent with the "broader statutory framework," (?!) in which Congress had enacted a number of statutes specifically directed at tax-return preparers and imposing civil penalties, which would not have been necessary if the 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. Although the IRS can require the use of PTINs, it cannot charge for them. The IRS needs to pay the fees back, says a federal district court. Don't spend the money just yet, though. The government likely will appeal, and the class action lawyers will ask for their cut. Steele v. United States, 119 A.F.T.R.2d 2017-2065 (D.D.C. 6/1/17). In this class action lawsuit, the court (Judge Lamberth) held that, although the IRS has statutory authority to require the use of PTINs by those who prepare tax returns for compensation, it cannot charge fees for issuing PTINs. Charging fees, the court reasoned, is "equivalent to imposing a regulatory licensing scheme and [under *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2/11/14)] the IRS does not have such regulatory authority."

- In a subsequent order, the court declared all fees charged by the IRS for issuing PTINs unlawful, permanently enjoined the United States from charging such fees, and ordered the United States to refund all PTIN fees paid from September 1, 2010 to the present. *See Steele v. United States*, 120 A.F.T.R.2d 2017-5145 (D.D.C. 7/7/17).

3. The Tenth Circuit stirs the previously muddied water on whether a late-filed return is a "return" that will permit tax debt to be discharged in bankruptcy proceedings. In re Mallo, 774 F.3d 1313 (10th Cir. 12/29/14), *cert denied*, 135 S. Ct. 2889 (6/29/15). In an opinion by Judge McHugh, the Tenth Circuit held, with respect to taxpayers in two consolidated appeals, that a late return filed after the IRS had assessed tax for the year in question was not a "return" within the meaning of 11 U.S.C. § 523(a) and, consequently, the taxpayers' federal tax liabilities were not dischargeable in bankruptcy. The facts in each appeal were substantially the same. The taxpayers failed to file returns for the years 2000 and 2001. The IRS issued notices of deficiency, which the taxpayers did not challenge, and assessed tax for those years. The taxpayers subsequently filed returns, based on which the IRS partially abated the tax liabilities. The taxpayers then received general discharge orders in chapter 7 bankruptcy proceedings and filed adversary proceedings against the IRS seeking a determination that their income tax liabilities for 2000 and 2001 had been discharged. Section 523(a)(1) of the Bankruptcy Code excludes from discharge any debt for a tax or customs duty:

(B) with respect to which a return, or equivalent report or notice, if required—

> (i) was not filed or given; or
>
> (ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of filing of the petition;

An unnumbered paragraph at the end of Bankruptcy Code § 523(a), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, provides that, for purposes of § 523(a):

> the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared under section 6020(a) of the Internal Revenue Code … but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code ….

The court examined a line of conflicting cases in which the courts had applied a four-factor test, commonly known as the *Beard* test (*Beard v. Commissioner*, 793 F.2d 139 (6th Cir. 1986)), to determine whether a late-filed return constitutes a "return" for purposes of 11 U.S.C. § 523(a) and concluded that it did not need to resolve that issue. Instead, the court concluded that, unless it is prepared by the IRS with the assistance of the taxpayer under § 6020(a), a late return is not a "return" because it does not satisfy "the requirements of applicable nonbankruptcy law (including applicable filing requirements)" within the meaning of the language added to the statute in 2005.

- In reaching its conclusion, the Tenth Circuit agreed with the analysis of the Fifth Circuit in *In re McCoy*, 666 F.3d 924 (5th Cir. 2012), in which the Fifth Circuit concluded that a late-filed Mississippi state tax return was not a "return" within the meaning of 11 U.S.C. § 523(a).

- The Tenth Circuit's interpretation of 11 U.S.C. § 523(a) is contrary to the IRS's interpretation, which the IRS made clear to the court during the appeal. The IRS's interpretation, reflected in Chief Counsel Notice CC-2010-016 (9/2/10), is that "section 523(a) does not provide that every tax for which a return was filed late is nondischargeable." However, according to the Chief Counsel Notice, a debt for tax assessed before the late return is filed (as in the situations before the Tenth Circuit in *In re Mallo*) "is not dischargeable because a debt assessed prior to the filing of a Form 1040 is a debt for which is return was not 'filed' within the meaning of section 523(a)(1)(B)(i)."

a. The First Circuit aligns itself with the Fifth and Tenth Circuits and applies the same analysis to a late-filed Massachusetts state income tax return. In re Fahey, 779 F.3d 1 (1st Cir. 2/18/15). In an opinion by Judge Kayatta, the First Circuit aligned itself with the Fifth and Tenth Circuits and concluded that a late-filed Massachusetts state income tax return was not a "return" within the meaning of 11 U.S.C. § 523(a). In a lengthy dissenting opinion, Judge Thompson argued that the majority's conclusion was inconsistent with both the language of and policy underlying the statute: "The majority, ignoring blatant textual ambiguities and judicial precedent, instead opts to create a per se restriction that is contrary to the goal of our bankruptcy system to provide, as the former President put it in 2005, 'fairness and compassion' to 'those who need it most.'"

b. A Bankruptcy Appellate Panel in the Ninth Circuit disagrees with the First, Fifth, and Tenth Circuits. The Ninth Circuit now might have an opportunity to weigh in. In re Martin, 542 B.R. 479 (B.A.P. 9th Cir. 12/17/15). In an opinion by Judge Kurtz, a Bankruptcy Appellate Panel in the Ninth Circuit disagreed with what it called the "literal construction" by the First, Fifth and Ninth Circuits of the definition of the term "return" in Bankruptcy Code § 523(a). The court emphasized that the meaning of the language in the unnumbered paragraph at the end of Bankruptcy Code § 523(a), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which provides that "the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements)," must be determined by taking into account the context of the surrounding words and also the context of the larger statutory scheme. Taking this context into account, the court reasoned, leads to the conclusion that the statutory language does not dictate that a late-filed return automatically renders the taxpayer's income tax liability non-dischargeable. "Why Congress would want to treat a taxpayer who files a tax return a month or a week or even a day late—possibly for reasons beyond his or her control—so much more harshly than a taxpayer who never files a tax return on his or her own behalf [and instead relies on the IRS to prepare it pursuant to § 6020(a)] is a mystery that literal construction adherents never adequately explain." The court also rejected the IRS's interpretation, reflected in Chief Counsel Notice CC-2010-016 (9/2/10) that, although not every tax for which a return is filed late is nondischargeable, a debt for tax assessed before the late return is filed (as in the situation before the court) is not dischargeable because the tax debt is established by the assessment and therefore arises before the return was filed. Instead, the court concluded that binding Ninth Circuit authority predating the 2005 amendments to Bankruptcy Code § 523(a) requires applying the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) to determine whether a late-filed return constitutes a "return" for purposes of 11 U.S.C. § 523(a). The court concluded that the Bankruptcy Court, which had held that the taxpayers' late-filed returns were "returns" within the meaning of the statute, had relied on a version of the *Beard* test that did not reflect the correct legal standard. Accordingly, the court remanded to the Bankruptcy Court for further consideration.

c. The Eleventh Circuit declines to decide whether a late-filed return always renders a tax debt nondischargeable in bankruptcy. In re Justice, 817 F.3d 738 (11th Cir. 3/30/16). In an opinion by Judge Anderson, the Eleventh Circuit declined to adopt what it called the "one-day-late" rule embraced by the First, Fifth and Tenth Circuits because it concluded that doing so was unnecessary to reach the conclusion that the taxpayer's federal income tax liability was nondischargeable in bankruptcy. The taxpayer filed his federal income tax returns for four tax years after the IRS had assessed tax for those years and between three and six years late. The court concluded that it need not adopt the approach of the First, Fifth and Tenth Circuits because, even if a late-filed return can sometimes qualify as a return for purposes of Bankruptcy Code § 523(a), a return must satisfy the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) in order to constitute a return for this purpose, and the taxpayer's returns failed to satisfy this test. One of the four factors of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The Eleventh Circuit joined the majority of the other circuits in concluding that delinquency in filing a tax return is relevant to whether the taxpayer made such an honest and reasonable attempt. "Failure to file a timely return, at least without a legitimate excuse or explanation, evinces the lack of a reasonable effort to comply with the law." The taxpayer in this case, the court stated, filed his returns many years late, did so only after the IRS had issued notices of deficiency and assessed his tax liability, and offered no justification for his late filing. Accordingly, the court held, he had not filed a "return" for purposes of Bankruptcy Code § 523(a) and his tax debt was therefore nondischargeable.

d. The Ninth Circuit holds that a taxpayer's tax debt cannot be discharged in bankruptcy without weighing in on the issue whether a late-filed return always renders a tax debt nondischargeable. In re Smith, 828 F.3d 1094 (9th Cir. 7/13/16). In an opinion by Judge Christen, the Ninth Circuit held that the tax liability of the taxpayer, who filed his federal income tax return seven years after it was due and three years after the IRS had assessed the tax, was not dischargeable in bankruptcy. The government did not assert the "one-day-late" rule embraced by the First, Fifth and Tenth Circuits. Accordingly, the Ninth Circuit looked to its prior decision in *In re Hatton*, 220 F.3d 1057 (9th Cir. 2000), issued prior to the 2005 amendments to the Bankruptcy Code on which the First, Fifth and Tenth Circuits relied. In *In re Hatton*, the Ninth Circuit had adopted the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) to determine whether the taxpayer had filed a "return" for purposes of Bankruptcy Code § 523(a). The fourth factor of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The Ninth Circuit concluded that the taxpayer had not made such an attempt:

> Here, Smith failed to make a tax filing until seven years after his return was due and three years after the IRS went to the trouble of calculating a deficiency and issuing an assessment. Under these circumstances, Smith's "belated acceptance of responsibility" was not a reasonable attempt to comply with the tax code.

The court noted that other circuits similarly had held that post-assessment filings of returns were not honest and reasonable attempts to satisfy the requirements of the tax law, but refrained from deciding whether any post-assessment filing could be treated as such an honest and reasonable attempt.

e. The Third Circuit also declines to consider whether a late-filed return always renders a tax debt nondischargeable and instead applies the *Beard* test. Giacchi v. United States, 856 F.3d 244 (3d Cir. 5/5/17). In an opinion by Judge Roth, the Third Circuit held that the tax liability of the taxpayer, who filed his federal income tax returns for 2000, 2001, and 2002 after the IRS had assessed tax for those years, was not dischargeable in bankruptcy. The court declined to consider whether the "one-day-late" rule embraced by the First, Fifth and Tenth Circuits is correct. Instead, the court applied the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) to determine whether the taxpayer had filed a "return" for purposes of Bankruptcy Code § 523(a). The fourth factor of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The court stated:

> Forms filed after their due dates and after an IRS assessment rarely, if ever, qualify as an honest or reasonable attempt to satisfy the tax law. This is because the purpose of a tax return is for the taxpayer to provide information to the government regarding the amount of tax due. … Once the IRS assesses the taxpayer's liability, a subsequent filing can no longer serve the tax return's purpose, and thus could not be an honest and reasonable attempt to comply with the tax law.

4. 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.[1]

5. The IRS establishes a new fast-track mediation procedure for offer-in-compromise and trust fund recovery penalty cases in the Small Business/Self-Employed division. Rev. Proc. 2016-57, 2016-49 I.R.B. 786 (11/18/16). This revenue procedure establishes a fast-track mediation procedure, known as SB/SE Fast Track Mediation—Collection (FTMC), that replaces the fast-track mediation procedure set forth in Rev. Proc. 2003-41, 2003-1 C.B. 1047. The prior fast-track mediation procedure was available to taxpayers with cases in either examination or collection, but use of the program was infrequent, especially for cases in examination after the IRS in 2011 implemented a fast-track settlement program for examination cases in the Small Business/Self Employed Division. See Announcement 2011-15, 2011-4 I.R.B. 430 (12/30/10). The new FTMC program preserves fast-track mediation for cases in collection. According to the revenue procedure, "FTMC may be used only when all other collection issues are resolved but for the issue(s) for which FTMC is being requested. The issue(s) to be mediated must be fully developed with clearly defined positions by both parties so the unagreed issues can be resolved quickly (usually within 30 or 40 calendar days)." The revenue procedure provides examples of when FTMC is and is not appropriate. For example, in OIC cases, FTMC is appropriate to determine issues such as the value of a taxpayer's assets (including those held by third parties), and in trust fund recovery penalty cases for issues such as whether a person was required to collect, truthfully account for, and pay over income, employment or excise taxes. A request for FTMC is made after an issue has been fully developed (and before collection has made a final determination regarding the issue) by submitting Form 13369, which must be signed by both the taxpayer (or authorized representative) and the Collection Group Manager. Written summaries of both the taxpayer's and collection's positions must accompany the form. The request is submitted to IRS Appeals and, if the request for FTMC is approved, the case is assigned to an Appeals employee who serves as a mediator. The Appeals mediator does not have settlement authority and serves only as a facilitator. The revenue procedure notes that the prohibition on *ex parte* communications between Appeals and other IRS employees does not apply to

[1] We thank Christine Speidel, staff attorney with Vermont Legal Aid and Director of the Vermont Low-Income Taxpayer Clinic, for alerting us to this development and for writing the summary of it.

communications arising in FTMC because Appeals personnel "are not acting in their traditional Appeals settlement role," but provides that communications by either party with the Appeals mediator outside the mediation session are prohibited. The revenue procedure also provides that "[t]he parties to the mediation may not make a stenographic record, audio or video tape recording, or other transcript of the mediation session." Following the mediation session, the Appeals mediator will prepare a brief written report. The revenue procedure is effective 11/18/16. Rev. Proc. 2003-41, 2003-1 C.B. 1047, is obsoleted.

6. The Seventh Circuit's advice to law firms: don't wait until the last day to file a Tax Court petition and then mail an envelope without an official postmark! Nevertheless, the petition in this case was timely. Tilden v. Commissioner, 846 F.3d 882 (7th Cir. 1/13/17), *rev'g* T.C. Memo 2015-188 (9/22/15). The last day for the taxpayer, who was represented by counsel, to file a Tax Court petition was April 21, 2015. A member of the law firm's staff printed a label from Stamps.com dated April 21, 2015 and stated that she delivered the envelope to the Postal Service in Salt Lake City, Utah, on that date. The Tax Court received the petition on April 29. The Tax Court (Judge Armen) dismissed the petition as having been untimely filed by relying on Reg. § 301.7502-1(c)(1)(iii)(B)(3), which provides:

> If the envelope has a postmark made by the U.S. Postal Service in addition to a postmark not so made, the postmark that was not made by the U.S. Postal Service is disregarded, and whether the envelope was mailed in accordance with this paragraph (c)(1)(iii)(B) will be determined solely by applying the rule of paragraph (c)(1)(iii)(A) of this section [regarding envelopes nearing U.S. postmarks].

The envelope with the taxpayer's petition was entered into the Postal Service's tracking system for certified mail on April 23, which the Tax Court treated as a postmark and therefore the date of filing. In an opinion by Judge Easterbrook, the Seventh Circuit reversed and remanded. The regulation applied by the Tax Court, the Seventh Circuit reasoned, applies only when the envelope bears both a U.S. Postal Service postmark and a non-U.S. Postal Service postmark, which was not the case here. In the court's view, the Tax Court should have applied the rules of Reg. § 301.7502-1(c)(1)(iii)(B)(1)-(2), which address situations in which an envelope bears only a non-U.S. Postal Service postmark. Generally, these rules treat the date of the private postmark as the date of mailing if the item is received by the relevant agency not later than the time when a properly addressed and mailed envelope sent by the same class of mail would ordinarily be received if it were postmarked at the same point of origin by the U.S. Postal Service. The court also held that the time limit set forth in § 6213(a) for filing a Tax Court petition is jurisdictional. Finally, the court admonished the law firm for its handling of the situation:

> [W]e have to express astonishment that a law firm (Stoel Rives, LLP, of Salt Lake City) would wait until the last possible day and then mail an envelope without an official postmark. A petition for review is not a complicated document; it could have been mailed with time to spare. And if the last day turned out to be the only possible day (perhaps the firm was not engaged by the client until the time had almost run), why use a private postmark when an official one would have prevented any controversy? A member of the firm's staff could have walked the envelope to a post office and asked for hand cancellation. The regulation gives taxpayers another foolproof option by providing that the time stamp of a private delivery service, such as FedEx or UPS, is conclusive.

a. Wouldn't it be less stressful just to go to the Post Office counter and get a hand-stamped certified mail receipt? In a reviewed opinion, the Tax Court has adopted the Seventh Circuit's approach in *Tilden* to determining the filing date of petitions mailed and bearing a private postmark. Pearson v. Commissioner, 149 T.C. No. 20 (11/29/17). The facts in this case were substantially the same as those in *Tilden v. Commissioner*, 846 F.3d 882 (7th Cir. 1/13/17). The last day for the taxpayer to file a Tax Court petition was April 22, 2015. An administrative assistant at the law firm representing the taxpayer deposited an envelope containing the petition at a U.S. Post Office with sufficient postage prepaid through Stamps.com with a Stamps.com postage label bearing the date April 21, 2015. The envelope was sent by certified mail but did not bear a U.S. Postal Service postmark. The U.S. Postal Service entered the envelope into its tracking system for certified mail on Apr. 23, 2015. The Tax Court received the petition on April 29, 2015. In a reviewed opinion (13-1-2) by Judge Lauber, the Tax Court held that the petition had been timely filed and denied the IRS's motion to dismiss. The Tax Court agreed with the Seventh Circuit that the date appearing on "a Stamps.com postage label, like the output of a private postage meter, is a 'postmark[] not made by the United States Postal Service'" for purposes of § 7502(b). Accordingly, the court held, the governing regulation is Reg. § 301.7502-1(c)(1)(iii)(B)(1), which addresses situations in which an envelope bears only a non-U.S. Postal Service postmark. Under this provision, the date of the private postmark is treated as the date of mailing if the item is received by the relevant agency not later than the time when a properly addressed and mailed envelope sent by the same class of mail would ordinarily be received if it were postmarked at the same point of origin by the U.S. Postal Service. In this case, the court reasoned, the regulation was satisfied because the Stamps.com postage label bore a date that was on or before the filing deadline and the item had been received by the court within the time it would have been received had it been postmarked at the same point of origin by the U.S. Postal Service. Alternatively, the court held, the petition was timely under Reg. § 301.7502-1(c)(1)(iii)(B)(2). This provision states that an item bearing only a private postmark is treated as mailed on the postmark date, even if it is received after the date when it would ordinarily have been received had it been mailed with an official postmark, if the taxpayer establishes that (1) the item "was actually deposited in the U.S. mail … on or before the last date … prescribed for filing the document," (2) "the delay in receiving the document … was due to a delay in the transmission of the U.S. mail," and (3) the cause of the delay. The court also reaffirmed that the 90-day period of § 6213(a) during which a taxpayer can file a petition with the court is jurisdictional.

- Judge Buch wrote a concurring opinion joined by Judges Marvel, Foley, Vasquez, Goeke, Holmes, Paris, Lauber, Nega, Pugh, and Ashford. Judge Buch reviewed the various methods of affixing postage to an item and concluded that this review "makes clear that there is no practicable difference among 'official' U.S. Postal Service mailing labels, postage meters, and internet-based postage." He reasoned that the risk a person might print a label on one day and mail the item on another day is no different regardless of the method of affixing postage.

- Judge Gustafson dissented in an opinion joined by Judge Morrison. In Judge Gustafson's view, a postage label that an individual prints on his or her own printer through the means of an internet vendor such as Stamps.com and places on an item is not a "'postmark[] not made by the United States Postal Service" within the meaning of § 7502(b). The dissenting opinion relies in part on the definition of the term "postmark" in Webster's Third New International Dictionary, which defines the term as "an official postal marking on a piece of mail; specif: a mark showing the name of the post office and the date and sometimes the hour of mailing and often serving as the actual and only cancellation." Although the dissenting opinion is not clear on this point, presumably Judge Gustafson viewed the item in question as not bearing a postmark, which would preclude it from being timely filed under § 7502(b) and the implementing regulations.

7. Although the IRS clearly messed up in disclosing the taxpayers' return information, its liability was limited to $1,000 and punitive damages were not available. Minda v. United States, 851 F.3d 231 (2d Cir. 3/24/17). Following an audit of the taxpayers, an IRS employee prepared an examination report proposing adjustments to their 2007 tax liability. The IRS sent the report, which included the taxpayer's names, social security numbers, and financial information, to the wrong party. The attorney for the person who received it submitted a letter to the IRS concerning the disclosure and sent a copy of the letter to the taxpayers. The taxpayers brought this action pursuant to § 7431(a)(1), which permits a taxpayer whose return or return information has been unlawfully disclosed to bring a civil action against the United States for damages. Section 7431(c) provides in part that, in the event of an unlawful disclosure, the United States is liable for the greater of (1) "$1,000 for each act of unauthorized inspection or disclosure of a return or return information with respect to which such defendant is found liable," or (2) the sum of any actual damages and, "in the case of a willful inspection or disclosure or an inspection or disclosure which is the result of gross negligence, punitive damages." In the District Court, the government conceded its liability and the District Court awarded statutory damages to each of the taxpayers in the amount of $1,000. On appeal, the taxpayers, who suffered no actual damages, argued that they were entitled to $1,000 for each *item* of return information disclosed in the examination report. They also argued that they were entitled to punitive damages. In an opinion by Judge Chin, the U.S. Court of Appeals for the Second Circuit affirmed. The court rejected the taxpayers' argument they were entitled to $1,000 for the IRS's disclosure of each item of return information as contrary to the plain language of the statute, which authorizes damages for "each act" of disclosure. The court also held that they were not entitled to punitive damages—which are available only for a willful disclosure or a disclosure due to gross negligence—because "nothing in the record suggest[ed] that this was anything other than the result of simple negligence or carelessness."

8. The IRS announces that certain ITINS will expire after 2017. In news release IR-2017-109 (6/21/17), the IRS announced that ITIN numbers with middle digits 70, 71, 72 or 80 will expire at the end of 2017, and that it is accepting renewal applications from affected taxpayers. The IRS is sending over a million renewal notices to these taxpayers beginning in August 2017. See IRS News Release IR-2017-128 (8/8/17).

a. The IRS makes changes to the Acceptance Agent program. In 2016 and 2017, the IRS made changes to its Acceptance Agent procedures to assist taxpayers in renewing or obtaining ITINs. Certified Acceptance Agents (CAA) can now authenticate the passport and birth certificate for dependents. See New ITIN Acceptance Agent Program Changes. Also, lack of access to Acceptance Agents oversees was a concern and the subject of a National Taxpayer Advocate legislative recommendation in her 2016 Annual Report to Congress. In April 2017 the IRS announced that it would permit taxpayers to use CAAs located abroad (see IRS e-News for Tax Professionals Issue 2017-16), and it rescinded the termination of foreign CAAs. See NTA Fiscal Year 2018 Objectives Report to Congress, Volume One, Area of Focus No. 7, p. 73, n. 25.[2]

9. Less is more — or just less? Notice 2017-38, 2017-30 I.R.B. 147 (7/7/17), 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). On February 24, 2017, President Trump issued Executive Order 13777 directing virtually all agencies of the executive branch of the federal government to "alleviate unnecessary regulatory burdens" through a process described in the Executive Order. Then, 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. Finally, the above-cited 2017-2018 Priority Guidance Plan, which emphasizes that all projects included in the plan will be "guided by the burden-reducing principles and policies described in the aforementioned Executive Orders, incorporates the eight regulatory recommendations made in the second report. Specifically, the eight sets of regulations and the actions recommended with respect thereto, along with a few related updates, 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).

[2] We thank Christine Speidel, staff attorney with Vermont Legal Aid and Director of the Vermont Low-Income Taxpayer Clinic, for writing the summary of the ITIN and Certified Acceptance Agent developments.

These regulations have been the subject of much criticism and debate. Accordingly, official notice of withdrawal of the regulations was published in the Federal Register on October 20. 2017. REG-163113-02, 82 F.R. 48779 (10/20/17). There is no mention in the notice of withdrawal 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. Although 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 and earnings-stripping transactions by large multinational corporate groups. One part of the regulations imposed onerous documentation rules for large corporate groups issuing intercompany debt. Implementation of these documentation rules (Reg. § 1.385-2) 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 earnings-stripping (Reg. § 1.385-3) connected with corporate inversion transactions (*see* IRC § 7874; T.D. 9761, 81 F.R. 40810 (4/8/16)) should be retained pending enactment of future tax reform legislation. Nonetheless, in *Chamber of Commerce v. IRS*, 120 A.F.T.R.2d 2017-5967 (W.D. Tex. 9/29/17), the U.S. District Court of the Western District of Texas (Judge Yeakel) ruled upon cross-motions for summary judgment that the IRS did not comply with the Administrative Procedure Act ("APA") with respect to a portion of the anti-inversion regulations and held that this portion of the regulations (Temp. Reg. § 1.7874-8T) therefore was set aside because it was issued unlawfully.

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.

10. Due date of Forms W-2, W-3, and 1099-MISC that report nonemployee compensation: temporary and proposed regulations address the revised due date. T.D. 9821, Return Due Date and Extended Due Date Changes, 82 F.R. 33441 (7/20/17). Treasury and the IRS have issued proposed, temporary, and final regulations regarding the due date for forms in the Form W-2 series, Form W-3 series, and Forms 1099-MISC that report nonemployee compensation. The Protecting Americans from Tax Hikes Act of 2015 ("2015 PATH Act"), § 201, amended Code § 6071(c) to require that Forms W-2 and W-3 and any returns or written statements required to report nonemployee compensation (such as Form 1099-MISC) be filed by January 31 of the year after the calendar year to which the returns relate. The effect of this change was to require these information returns to have the same due date as employee and payee statements and to eliminate the extended filing date for electronically filed returns under § 6071(b). These regulations implement this statutory directive and provide that these information returns must be filed by January 31 of the calendar year for which the information is being reported, regardless of whether the returns are filed on paper or electronically.

- Information returns on Form 1099-MISC that do not report nonemployee compensation are not affected by this change and are due on February 28 of the year following the calendar year for which the information is being reported, or on March 31 if filed electronically.

- The temporary regulations apply to information returns filed on or after July 20, 2017, but the statutory amendments made by the 2015 PATH Act apply to information returns relating to calendar years beginning in 2016. Thus, the changes to the due date were effective for information returns filed in 2017 with respect to calendar year 2016.

11. Temporary regulations implement the 5-½ month automatic extension of time to file income tax returns of trusts and non-bankruptcy estates. T.D. 9821, Return Due Date and Extended Due Date Changes, 82 F.R. 33441 (7/20/17). Treasury and the IRS have issued proposed, temporary, and final regulations that provide an automatic 5-½ month extension of time for trusts and non-bankruptcy estates to file an income tax return on Form 1041. Previously, Reg. § 1.6081-6(a)(1) provided an automatic 5-month extension. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(b)(2), directs the Treasury to modify relevant regulations to provide that the maximum extension of time for the returns of trusts filing Form 1041 is 5-½ months (ending on September 30 for calendar-year taxpayers). Pursuant to this statutory directive, Temp. Reg. § 1.6081-6T(a)(1) provides that trusts and non-bankruptcy estates required to file an income tax return on From 1041 are allowed an automatic 5-½ month extension by filing a timely application. No extension beyond the automatic extension is permitted.

- The temporary regulations apply to applications for an automatic extension of time to file an estate or trust income tax return on or after July 20, 2017, but the statutory amendments made by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 apply to returns for taxable years that begin after December 31, 2015. Accordingly, the preamble to the temporary regulations provides that taxpayers can elect to apply the regulations to returns filed for periods beginning after December 31, 2015.

- The temporary regulations do not amend the rule for income tax returns on Form 1041 for bankruptcy estates of individuals proceeding under chapters 7 or 11, provided by Reg. § 1.6081-6T(a)(2), which provides an automatic 6-month extension.

12. The IRS has provided extensions of filing and payment due dates for those in areas affected by Hurricanes Harvey, Irma, and Maria. In news release IR-2017-160 (9/26/17), the IRS has summarized the relief announced in a series of prior news releases for those in areas affected by Hurricanes Harvey, Irma, and Maria. The relief is available to individuals and businesses anywhere in Florida, Georgia, Puerto Rico, and the Virgin Islands, as well as parts of Texas. (Parts of Puerto Rico qualify for the Hurricane Irma relief, and all of Puerto Rico qualifies for the Hurricane Maria relief. Hurricane Maria struck Puerto Rico just after September 15, 2017, so in theory there are parts of Puerto Rico that do not qualify for relief from September 15 due dates.) The prior news releases are IR-2017-135 (8/28/17) (relief in Texas for Harvey), VI-2017-01 (9/8/17) (relief in Virgin Islands for Irma), PR-2017-01 (9/12/17) (relief in Puerto Rico for Irma), IR-2017-150 (9/12/17) (relief in Florida for Irma), IR-2017-155 (9/15/17), (expanded relief in Florida for Irma), IR-2017-156 (9/19/17) (expanding Irma relief to all of Georgia).

Deadlines extended to January 31, 2018. For those in affected areas, the following due dates have been extended to January 31, 2018: (1) the September 15, 2017, and January 16, 2018, due dates for quarterly estimated tax payments; (2) the September 15, 2017, due date for certain returns, such as those for calendar-year partnerships that filed timely extension requests for 2016; (3) the October 16, 2017, due date for 2016 individual returns for individuals who filed timely extension requests; (4) the October 31, 2017, due date for quarterly payroll and excise tax returns; and (5) the November 15, 2017, due date for 2016 returns of calendar-year tax-exempt organizations that filed timely extension requests. Note: individuals who filed a timely request for an extension of time to file their 2016 returns do not obtain any relief for tax payments related to the 2016 return because those payments were due on April 18, 2017.

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 during the first fifteen days of the disaster period. The specific dates vary according to the location.

Relief provided automatically. 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.

a. The IRS has provided similar extensions of filing and payment due dates for those affected by California wildfires. In news release IR-2017-172 (10/31/17), the IRS has extended to January 31, 2018, several filing and payment due dates that occurred beginning on October 8, 2017, for those in areas affected by California wildfires. The relief is available to individuals and businesses in the counties of Butte, Lake, Mendocino, Napa, Nevada, Sonoma and Yuba, as well as firefighters and relief workers who live elsewhere. The due dates extended include the October 16, 2017, due date for 2016 individual returns for individuals who filed timely extension requests, the October 31, 2017, due date for quarterly payroll and excise tax returns, and the January 16, 2018, due date for quarterly estimated tax payments. 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 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

Dececember 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.

13. A portion of the anti-inversion regulations must be set aside because of the government's failure to comply with the Administrative Procedure Act, says a federal district court. Chamber of Commerce v. IRS, 120 A.F.T.R.2d 2017-5967 (W.D. Tex. 9/29/17). The U.S. District Court for the Western District of Texas (Judge Yeakel) ruled upon cross-motions for summary judgment that the IRS did not comply with the Administrative Procedure Act ("APA") with respect to a portion of the anti-inversion regulations issued under § 7874 (see T.D. 9761, 81 F.R. 20858 (4/8/16)). In particular, Judge Yeakel determined that Temp. Reg. § 1.7874-8T (which provides a computational rule for determining a "surrogate foreign corporation") is a substantive or legislative regulation, not an interpretive regulation. Therefore, the District Court determined that the IRS should have complied with the APA's 30-day notice-and-comment procedure before declaring the rule effective immediately as a temporary regulation. Judge Yeakel thus held as "unlawful and set aside" Temp. Reg. § 1.7874-8T over the IRS's objection that the Chamber of Commerce lacked standing and that the lawsuit violated the Anti-Injunction Act. Where this leaves the IRS with respect to the anti-inversion regulations and Temp. Reg. § 1.7874-8T is anyone's guess.

- On November 27, 2017, the government filed a notice of appeal in the U.S. Court of Appeals for the Fifth Circuit.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

B. Self-employment Taxes

1. Advice for those wishing to minimize self-employment tax liability through the S corporation "Edwards/Gingrich loophole"—failure to have the S corporation contract with those making the payments can be fatal. Fleischer v. Commissioner, T.C. Memo. 2016-238 (12/29/16). The taxpayer, a financial consultant who developed investment portfolios, formed an S corporation of which he was the sole shareholder and the president, secretary, and treasurer. He entered into an employment agreement with the S corporation, pursuant to which he was paid an annual salary. In each of the years in question, the taxpayer included just under $35,000 in gross income as compensation for services and reported nonpassive income on Schedule E ranging from $11,924 to $147,642. The taxpayer did not report any self-employment tax due. The gross receipts of the S corporation were largely attributable to a representative agreement into which the taxpayer entered with Linsco/Private Ledger Financial Services (LPL) and a broker contract into which he entered with MassMutual Financial Group. The taxpayer entered into both contracts himself, i.e., the S corporation was not a party to either contract. In fact, the taxpayer entered into the contract with LPL before the S corporation came into existence. The IRS issued a notice of deficiency in which the IRS asserted that the taxpayer should have reported the gross receipts as self-employment income on Schedule C attached to his individual income tax returns for the years in issue. The Tax Court (Judge Paris) agreed with the government. The court framed the question as "who controls the earning of the income" and stated that two elements must be satisfied for a corporation (rather than its service-provider employee) to be the controller of the income: (1) the individual providing the services must be an employee of the corporation whom the corporation can direct and control in a meaningful sense, and (2) a contract or similar indicium recognizing the corporation's controlling position must exist between the corporation and the person or entity using the services. In this case, the court reasoned, the second element was not satisfied because there was no contract or other indicium that the S corporation exhibited control over the taxpayer. The court rejected the taxpayer's argument that it was impossible for LPL and MassMutual to enter into contracts with the S corporation because the corporation was not a registered entity under the securities laws and regulations.

2. ♪♫Doctor, doctor, give me the news he's got a [good] case the IRS will lose.♫♪ The distributive share of income of a physician-member of an LLC operating a surgery center was passive income and not subject to self-employment tax. Hardy v. Commissioner, T.C. Memo. 2017-16 (1/17/17). The taxpayer, a plastic surgeon who performed surgeries in various facilities, paid $163,974 to become a member of a limited liability company (classified for federal tax purposes as a partnership) with a 12.5 percent interest. The seven other members of the LLC also were physicians. The LLC, referred to as MBJ, operated a surgery center equipped for physicians to perform procedures that required either local or general anesthesia. The taxpayer performed approximately 50 percent of his surgeries in his office (located next to MBJ), 20 percent at MBJ, and the remainder at other facilities. MBJ hired its own employees, none of whom were shared with the taxpayer's practice, and the taxpayer never managed MBJ and had no day-to-day responsibilities there. Patients who elected to have their surgeries performed at MBJ paid three separate fees: (1) for the services of the surgeon performing the surgery, (2) for the services of an anesthesiologist, and (3) a facility fee payable to MBJ. The taxpayer received distributions from MBJ regardless of whether he performed any surgeries there and his distribution was not dependent on the number of surgeries he performed at MBJ. For years prior to 2008, the taxpayer (whose return was prepared by a CPA) reported his distributive share of MBJ's income as nonpassive. For the years 2008 through 2010, the taxpayer reported his distributive share of MBJ's income as passive income and paid self-employment tax. The IRS issued a notice of deficiency disallowing the taxpayer's passive activity loss deduction for each of these years. The Tax Court (Judge Buch) held that the taxpayer's distributive share of MBJ's income was passive income. The court concluded that the taxpayer did not materially participate in MBJ's activity of operating a surgery center and rejected the IRS's arguments that the taxpayer either had already or was required to group his ownership interest in MBJ with his medical practice. The court analyzed Reg. § 1.469-4(f) and Technical Advice Memorandum 201634022 (8/19/16), which involved facts similar to those of the taxpayer and his interest in MBJ. The court concluded: "While some facts support treating [the taxpayer's] ownership interest in MBJ and his medical practice as a single economic unit, the weight of the evidence supports treating them as separate units."

- The court also held that the taxpayer's distributive share of MBJ's income for the years in question was not subject to self-employment tax. (The court permitted the taxpayer to amend the pleadings to conform to the evidence presented at trial in order to make this argument.) Under § 1402(a), a partner's distributive share of partnership income generally is treated as net earnings from self-employment, but § 1402(a)(13) excludes from this treatment the distributive share of income of a limited partner (other than guaranteed payments for services). The court discussed its decision in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), in which the court held that partners in a law firm organized as a limited liability partnership were subject to self-employment tax on their distributive share of partnership income because that income was derived from legal services performed by the partners in their capacity as partners, and therefore "they were not acting as investors in the law firm." In contrast, the court reasoned, the taxpayer in this case was an investor in MBJ:

> Although [the taxpayer] performs surgeries at MBJ, he is not involved in the operations of MBJ as a business. In contrast to the partners in [*Renkemeyer*], who are lawyers practicing law and receiving distributive shares based on those fees from practicing law, [the taxpayer] is receiving a distribution based on the fees that patients pay to use the facility. The patients separately pay [the taxpayer] his fees as a surgeon, and they separately pay the surgical center for use of the facility in the same manner as with a hospital.

a. Mamma Mia! I guess I should have been a doctor if I wanted to avoid employment taxes! A law firm member-manager's distributive share of income in excess of a

base-salary-equivalent guaranteed payment was subject to self-employment taxes. Castigliola v. Commissioner, T.C. Memo. 2017-62 (4/12/17). Unlike the doctor in *Hardy v. Commissioner*, T.C. Memo. 2017-16 (1/17/17), the taxpayers in this case did not qualify for the § 1402(a)(13) "limited partner" exclusion from self-employment tax. The taxpayers were members of a law firm organized as a member-managed Mississippi professional limited liability company ("PLLC"). The PLLC had not made an S election and hence was treated as a partnership for federal tax purposes. For tax years 2008 through 2010, the taxpayers received guaranteed payments ($125,000 to $150,000 each) that were commensurate with a survey of salaries paid other attorneys in the Pascagoula, Mississippi area. (Note: The Social Security wage base limitation was $102,000 for 2008, and $106,800 for 2009 and 2010.) The profits of the law firm PLLC in excess of the guaranteed payments were allocated and distributed to the taxpayers according to their unwritten operating agreement. (Note: The opinion does not indicate the amount of the excess profits over the guaranteed payments, but the total deficiency for all three taxpayers for all three years was approximately $50,000. Rough math thus would indicate that the excess over the guaranteed payments was approximately $500,000 per year.) The Tax Court (Judge Paris) relied heavily upon *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011) to hold that the "member-manager" taxpayers were not equivalent to "limited partners" and therefore could not qualify for the § 1402(a)(13) exclusion from self-employment tax. The court declined, though, to uphold the IRS's assertion of substantial understatement and negligence penalties against the taxpayers. With respect to the negligence penalty, the court concluded that the taxpayers, through their reliance on their CPA, had established a reasonable cause, good faith defense for the years in issue, which pre-dated the court's decision in *Renkemeyer*. Bottom line: It appears to us that it is virtually impossible for lawyers practicing in a law firm taxed as a partnership to claim an exclusion from self-employment tax under the § 1402(a)(13) "limited partner" exclusion. Absent clear guidance from Congress, however, these cases may continue to be litigated in the context of LLCs and LLPs. Subchapter S corporations, on the other hand, apparently may continue to play the self-employment tax game.

3. 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 (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.*

4. 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 Greenberg v. United States*, 46 F.3d 239, 244 (3rd Cir. 1994); *Denbo v. United States*, 988 F.2d 1029, 1033 (10th Cir. 1993); *Godfrey v. United States*, 748 F.2d 1568, 1577 (Fed. Cir. 1984) . . . But the Second Circuit recognizes an exception to § 6672(a) liability when a responsible person "believed that the taxes were in fact being paid, so long as that belief was, in the circumstances, a reasonable one." *Id.* (citation and internal quotation marks omitted). The Fifth Circuit has also held that taxpayers who act with reasonable cause may be able to defeat a finding of willfulness. *See Conway v. United States*, 647 F.3d 228, 234, 235 (5th Cir. 2011) (finding that reasonable reliance on the advice of counsel may constitute reasonable cause under some circumstances).

C. Excise Taxes

XII. TAX LEGISLATION

A. Enacted

1. Congress enacts a big break for small employers that offer health reimbursement arrangements. The 21st Century Cures Act ("Cures Act"), Pub. L. No. 114-255, was signed by the President on 12/13/16. Among other changes, the Cures Act made several modifications to the rules related to health reimbursement arrangements. These include (1) exempting health reimbursement arrangements that meet the definition of a Qualified Small Employer Health Reimbursement Arrangement (QSEHRA) from the § 4980D excise tax; (2) imposing new reporting requirements related to QSEHRAs; (3) requiring the inclusion in an employee's gross income of payments or reimbursements under a QSEHRA for employees that do not have minimum essential coverage; (4) limiting or potentially eliminating the § 36B premium tax credit for employees covered by a QSEHRA; and (5) requiring that the employer's cost for a QSEHRA be taken into account in determining the applicability of the Cadillac Tax. These changes generally are effective for years beginning after 12/31/16.

2. Veterans have extra time to claim refunds for taxes improperly withheld from amounts received for combat-related injuries. The Combat-Injured Veterans Tax Fairness Act of 2016 (2016 CIVTFA), Pub. L. No. 114-292, was signed by the President on 12/16/16. Section 104(a)(4) and (b) exclude from gross income amounts received as a pension, annuity, or similar allowance for a combat-related injury. In *St. Clair v. United States*, 778 F. Supp. 894 (E.D. Va. 1991), the court held that a lump sum disability-related severance payment received by a veteran was excluded from the recipient's gross income under § 104(a)(4). Despite these authorities, since 1991, the Department of Defense has withheld taxes from severance pay for wounded veterans. The 2016 CIVTFA directs the Secretary of Defense to ensure that taxes are not withheld prospectively. In addition, the legislation directs the Secretary of Defense, within one year of the date of enactment, to identify all severance payments from which taxes were improperly withheld, notify each recipient of the improper withholding, and provide each recipient with instructions on filing amended returns to recover these amounts. The legislation extends the limitations period of § 6511(a) on filing claims for refund to the date that is one year after the required notification of improper withholding and eliminates the restriction of § 6511(b)(2) that would normally apply on the amount of tax recoverable.

3. Congress provides tax relief for those 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. This legislation: (1) provides a 40 percent credit for employers in areas affected by the hurricanes who paid or incurred wages with respect to employees during specified periods despite becoming inoperable; (2) makes access to retirement funds easier for victims of the hurricanes by allowing distributions of up to $100,000 without the normal 10 percent penalty for early withdrawals, allowing those who receive such distributions to recontribute them within three years in a rollover, and increasing the normal limits on plan loans; (3) allowing deduction of certain casualty losses that exceed $500 without regard to the normal threshold of 10 percent of adjusted gross income; (4) permitting certain individuals to use prior-year earned income for purposes of detemining eligibility for the earned income tax credit and child tax credit; and (5) allowing individuals and corporations to deduct charitable contributions for relief efforts targeted at victims of the hurricanes in excess of the normal limits that apply.

4. 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.

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

Recent Developments in Federal Income Taxation

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State Bar of Texas Tax Section
Tax Law in a Day
February 9, 2018

Selected Highlights of the Tax Cuts and Jobs Act

- Accounting
  - Increased ability of C corporations to use cash method [p.5. A.3]
    - C corporations, and partnerships with C corporation partners, can use cash method if average annual gross receipts over 3 prior years do not exceed $25 million.
    - Applies even if inventory is material income-producing factor.
    - Change in accounting method treated as made with IRS consent.
  - Expanded exception to the UNICAP rules [p.8, D.2]
    - Available to taxpayers who meet the $25 million gross receipts test (above).
    - Available to those who produce and those who acquire for resale
  - Revenue recognition by accrual method taxpayers [p. 8, D.3]
    - No later than recognized in “applicable financial statement”
    - Codification of deferral method for advance payments

2

Selected Highlights of the Tax Cuts and Jobs Act

- Business
  - No deduction for entertainment [p.10, D.2]
  - **No deduction for qualified transportation fringes [p.10, D.3]**
  - **New deduction for 20 percent of "qualified business income" for sole proprietors, partners, and S corporation shareholders [p.11, D.4]**
  - Limited deduction of business interest expense [p.13, D.5]
  - Repeal of § 199 deduction for domestic production [p.13, D.6]
  - **Increased limits and expansion of property eligible for § 179 [p.15, E.2.a]**
  - **100 percent § 168(k) bonus first-year depreciation [p.16, E.2.b]**
  - **Credit for wages paid during period of family and medical leave [p.18, F.2]**
  - **Changes to NOL rules [p.19, H.1]**

3

Selected Highlights of the Tax Cuts and Jobs Act

- Business Income and Deductions
  - No deduction for qualified transportation fringes [p.10, D.3]
    - Applies to amounts paid or incurred after 2017
    - Ability of employees to exclude transportation fringes <u>not</u> affected
    - Exception: qualified bicycle commuting reimbursements before 2026 are
      - Deductible by employer
      - Included in income of the employee

4

20% Deduction for Qualified Business Income
2017 TCJA § 11011
Outline: item D.4, page 11

- TCJA § 11011 adds Code § 199A, which generally allows a 20% deduction for "qualified business income."
- Available to individuals, estates, and trusts for taxable years beginning after 2017 and before 2026
- Applies at the individual level
  - At partner or shareholder level for partnerships and S corps
  - Deduction is on Form 1040
  - Deduction is *not* an above-the-line deduction
  - Deduction reduces taxable income
  - Deduction is available both to those who itemize and those who take the standard deduction
  - Does *not* reduce self-employment tax

5

20% Deduction for Qualified Business Income
2017 TCJA § 11011
Outline: item D.4, page 11

- Qualified business income is produced by a "qualified trade or business"
- QTB is any trade or business *other than:*
  - Trade or business of performing services as an employee, or
  - A specified service trade or business
    - (Note: SSTB exclusion does *not* apply if taxable income is below specified thresholds—$315,000 for MFJ and $157,500 for all others)
- Specified service trade or business:
  - "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"
  - Note architects and engineers are excluded

6

20% Deduction for Qualified Business Income
2017 TCJA § 11011
Outline: item D.4, page 11

- Qualified business income:
  - Generally is net income from a qualified trade or business
  - Does *not* include:
    1. Income not effectively connected with the U.S. trade or business
    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
    6. Qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income

7

20% Deduction for Qualified Business Income
2017 TCJA § 11011
Outline: item D.4, page 11

- Determining the amount of the § 199A deduction:
  - Sum of 3 buckets
  - Apply 2 limitations
- Bucket 1: for each qualified trades or business, the lesser of:
  1. 20 percent of the qualified trade or business income, or
  2. The greater of:
     1. 50 percent of the W–2 wages, or
     2. 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.

8

20% Deduction for Qualified Business Income
2017 TCJA § 11011
Outline: item D.4, page 11

- Bucket 2: 20 percent of the sum of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income.
- Bucket 3: lesser of
  1. 20 percent of qualified cooperative dividends, or
  2. Taxable income reduced by net capital gain.
- Limitation 1:
  - Sum of Bucket 1 and Bucket 2 cannot exceed 20 percent of the amount by which the taxpayer's taxable income exceeds the sum of the taxpayer's net capital gain and qualified cooperative dividends.
- Limitation 2:
  - Sum of Buckets 1, 2 and 3 cannot exceed taxpayer's taxable income reduced by the taxpayer's net capital gain.

9

20% Deduction for Qualified Business Income
2017 TCJA § 11011
Outline: item D.4, page 11

- Key consideration:
  - Is the taxpayer's taxable income (without the § 199A deduction) below or above the $157,500/$315,000 thresholds?
  - If below:
    - Specified service businesses are still eligible for the deduction
    - Limitation of W-2 wages/capital does not apply
  - If above:
    - Portion of income from specified service business eligible is phased out (and disappears at $207,500/$415,000)
    - Limitation of W-2 wages capital phases in and fully applies at $207,500/$415,000.
- Observation: if the wages/capital limit does not apply, there's an incentive for S corporation shareholders to minimize salary

10

Increased Limits Under § 179
2017 TCJA § 13101
Outline: item E.2.a, page 15

- Basic limit: $ 1 million (increased from $520,000)
- Phase-out threshold: $2.5 million
- Limit for SUVs remains at $25,000
- Applies to property placed in service in TY beginning after 2017
- Definition of qualified real property revised

11

Bonus Depreciation Under § 168(k)
2017 TCJA § 13201
Outline: item E.2.b, page 16

- 100% for property *acquired and placed in service* after September 27, 2017
  - Percentage declines beginning in 2023
  - Property acquired on or before September 27, 2017, is eligible for only 50% if placed in service in 2017, 40% in 2018, 30% in 2019
- <u>Used</u> property is now eligible for bonus depreciation if *acquired and placed in service* after September 27, 2017

12

Selected Highlights of the Tax Cuts and Jobs Act

- Business Income and Deductions
  - Credit for wages paid during period of family and medical leave [p.18, F.2]
    - Credit ranges from 12.5% to 25% of wages
    - Available only for employees whose compensation does not exceed 60% of threshold for highly compensated employees.
  - NOL Changes [p. 19, H.1]
    - "Excess business losses" of noncorporate taxpayers disallowed
    - NOLS not carried back (only forward); capped at 80% taxable inc.
    - NOLs do not expire

13

Selected Highlights of the Tax Cuts and Jobs Act

- Investment Gain and Income
  - Like-Kind Exchanges (Section 1031) [p.23, E.2]
    - Limited to real property for taxable years beginning after 2017

14

Selected Highlights of the Tax Cuts and Jobs Act

- Compensation Issues
  - Meals provided at employer-provided eating facilities [p.29, A.2.a]
    - No more exception to 50% limitation on meals if meals qualify as a de minimis fringe (overrules *Jacobs* case) for amounts paid after 2017
    - Deduction of meals at employer-operated eating facilities disallowed entirely after 2025.
  - Moving expenses in connection with work not deductible; reimbursements not excludable by employees. [p.30, A.7]
  - Qualified equity grants by private corporations [p.37, C.2]
  - No more unwinding Roth IRA conversions [p.39, D.3]

15

Selected Highlights of the Tax Cuts and Jobs Act

- Individuals
  - Reduced rates of tax on ordinary income [p.40, A.1]
  - Little change in capital gain rates [p.41, A.2]
  - Increased standard deduction ($24,000 for MFJ) [p.50, D.9]
  - No personal exemption deduction [p.50, D.10]
  - Limited deduction for state and local property, income, and sales taxes ($10,000) [p.51, D.11]
  - **Mortgage interest deduction-only $750k acquisition debt [p.51, D.12]**
  - **No deduction for interest on home equity loans [p.51, D.12]**
  - No deduction for most personal casualty losses [p.52, D.14]
  - **No deduction for miscellaneous itemized deductions [p.22, C.1]**
  - Overall limitation on itemized deduction (§ 68) repealed [p.52, D.15]
  - **Increased child tax credit [p.52, D.16]**
  - No deduction for alimony (agreements after 2018) [p.53, E.2]
  - Increased AMT exemptions and phase-out thresholds [p.54, G.1]

16

Mortgage Interest Deduction
2017 TCJA § 11043
Outline: item D.12, page 51

- Limit on acquisition indebtedness reduced from $1 million to $750,000.
  - Applies to debt incurred after December 15, 2017
  - Refinancing of existing indebtedness after that date subject to old limit to extent new debt does not exceed refinanced debt.
  - Effective for tax years beginning after 2017 and before 2026
- Interest on home equity indebtedness no longer deductible
  - Applies to interest paid in tax years beginning after 2017 and before 2026.
  - Potential trap: the cash-out refinance
    - Will result in home equity indebtedness if cash proceeds not invested in the home.

17

Miscellaneous Itemized Deductions
2017 TCJA § 11045
Outline: item C.1, page 22

- For taxable years beginning after 2017 and before 2026, miscellaneous itemized deductions are not deductible.
- Includes:
  - Investment-related expenses
  - Unreimbursed employee business expenses
  - Tax preparation fees

18

Child Tax Credit
2017 TCJA § 11022
Outline: item D.16, page 52

- Increased from $1,000 to $2,000 per child
- Refundable portion of credit increased from $1,000 to $1,400 per child
- Phase-out of the credit begins at:
  - MFJ: AGI of $400,000 (increased from $110,000)
  - All others: $200,000 (increased from $75,000 for single filers)
- New nonrefundable credit for dependents other than a qualifying child.
- All provisions apply for tax years beginning after 2017 and before 2026.

19

Selected Highlights of the Tax Cuts and Jobs Act

- Corporations
  - Expansion of eligible beneficiaries of electing small business trusts [p.56, D.3]
  - 21% flat corporate tax rate [p.65, H.5]
  - Repeal of corporate AMT [p.65, H.6]
  - Reduced corporate dividends-received deduction [p.65, H.7]
    - 100% deduction unchanged
    - 80% deduction reduced to 65%
    - 70% deduction reduced to 50%

20

Selected Highlights of the Tax Cuts and Jobs Act

- Partnerships
  - Three-year holding period for carried interests [p. 65, B.1]
  - Legislative reversal of Tax Court's *Grecian Magnesite Mining* decision, which held that a foreign partner was not subject to U.S. tax on the sale of a U.S. partnership interest [p. 71, D.1.a]
  - No more technical terminations of partnerships [p. 71, D.2]
  - Automatic § 754 election in certain circumstances [p.72, F.1]

21

Selected Highlights of the Tax Cuts and Jobs Act

- Exempt Organizations and Charitable Giving
  - Increased limit on deduction of certain charitable contributions [p. 93, B.9.a]
- Tax Procedure
  - Repeal of Affordable Care Act penalty [p. 102, A.10]
- Estate and Gift Taxation
  - Increased basic exclusion amount ($11.2 million for decedents dying in 2018) [p. 134, B.1]

22

International Tax

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Updates

* Foreign asset reporting
* International Corporate Tax
* US Individuals abroad
* Foreign Individuals in the US
* Tax Treaties
* An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (“AAPRPTIIVCRBFY”, or, more likely, the “2017 Tax Reform Act”).

2018 Tax-Inflation Amounts
Rev. Proc. 2017-58

* Annual gift tax exclusion amount increases by $1,000 to $15,000 (the last increase of $1,000 was in 2013).
* Annual gift tax exclusion for gifts to non-citizen spouses increases by $3,000 to $152,000 ($1,000 increase in 2017).
* The foreign earned income exclusion increases by $2,000 to $104,100, up from $102,100 ($800 increase in 2017).
* The Code § 877A expatriation exemption is increased by $14,000 to $713,000 from $699,000 ($6,000 increase in 2017).

2018 Tax-Inflation Amounts
Rev. Proc. 2017-58

* The "hurdle" average annual net income tax bill for the five prior years ending before expatriation increases by $3,000 to $165,000 from $162,000 ($1,000 increase in 2017).
* Recipients of gifts from foreign corporations and partnerships must report these gifts if the aggregate value of gifts received in the taxable year exceeds increases by $314 from $15,797 to $16,111 ($126 increase in 2017).
* The Code § 4161(b)(2)(A) tax on arrow shafts is $0.51 per shaft, up $0.01 from last year.

Reporting Obligations

These forms are not (generally) used to collect or impose additional tax, but substantial penalties exist for non-filing.

* FinCEN 114 — Foreign Bank Account Report ("FBAR") to report foreign bank accounts with more than $10,000
* IRS Form 926 — Return by a U.S. Transferor of Property to a Foreign Corporation
* IRS Form 3520 — Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts
* IRS Form 3520-A — Annual Information Return of Foreign Trust With a U.S. Owner
* IRS Form 5713 — International Boycott Report

More(!)Reporting Obligations

* IRS Form 8621—Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund
* IRS Form 8858—Information Return of U.S. Persons With Respect To Foreign Disregarded Entities
* IRS Form 8865—Return of U.S. Persons With Respect to Certain Foreign Partnerships
* IRS Form 8938—Statement of Foreign Financial Assets

Because of space limitations, this list doesn't attempt to be complete.

Reporting Updates

* *Crawford v. Dep't of Treasury*, 120 AFTR 2d 2017-5544, 868 F.3d 438 (6th Cir. 2017).
  * Sen. Rand Paul & co. can't block enforcement of FATCA, the IGAs, and the FBAR reporting requirements.
* IRS Notice 2017-46
  * IRS provides safe-harbors for Foreign Financial Institutions that must report TINs of U.S. taxpayers as required by FATCA.
* *Gubser v. IRS*, 119 AFTR 2d 2017-1128 (5th Cir. 2017)
  * IRS is not required for FBAR penalty purposes to prove taxpayer's willfulness by clear and convincing evidence.

Reporting Updates

- *Bedrosian v. United States,* 120 AFTR 2d 2017-5832 (D.C. PA 2017).
  - Taxpayer entitled to refund of FBAR penalty.
- *U.S. v. Pomerantz,* 119 AFTR 2d 2017-2113 (D.C. WA 2017).
  - Because Canadian resident/dual U.S.-Canadian citizen taxpayer was not a U.S. resident, suit to collect FBAR penalties against him could be brought in any U.S. district court.
- *Flume v CIR,* TC Memo 2017-21.
  - U.S. Tax Court upholds total penalties of $110,000 for late filed Forms 5471.
- Revised Form I-9 Released on 7/17/2017, expires on 8/31/2019

Reporting Updates

- FATCA FAQs, General Compliance updated
- Don’t use these codes on Form 1042 per Post Release Changes to Forms RDA 2017 02 01 2017 1042S:
  - Code 33 - Joint account withholding rate pool
    Code 36 - Qualifying dividend equivalent offsetting payments to U.S. persons
    Code 37 - Nonqualifying dividend equivalent payments to U.S. persons - Undisclosed
    Code 38 - Other qualifying dividend equivalent offsetting payments (ECI)

Corporate Updates

* *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Comm'r*, 149 T.C. No. 3 (2017).
  * The Tax Court rejected Rev. Rul. 91-32 to hold that the gain recognized by Grecian Magnesite is effectively connected with a U.S. trade or business only to the extent the partnership is engaged in a U.S. trade or business.
  * But this resulted was repealed by the 2017 Tax Reform Act
* *Trusted Media Brands Inc. v. U.S.,* 120 AFTR 2d 2017-5959 (D.C. NY 2017).
  * The ten-year refund period under Code § 6511(d)(3) doesn't apply when amending a return to change from the foreign tax credit to a deduction for foreign taxes paid. Once the foreign tax credit has been elected, the taxpayer may not take a deduction.

Corporate Updates

* *Starr International Company, Inc. V. U.S.*, 120 AFTR 2d 2017-5488 (D.C. DC 2017)
  * The Competent Authority, which is part of the IRS's Large Business and International Division, didn't act arbitrarily or capriciously in denying the taxpayer discretionary relief under the U.S.-Swiss Treaty.
* TD 9812
  * IRS issued final regulations regarding the identification of foreign corporate stock that is disregarded when determining the ownership of a foreign corporation as a surrogate foreign corporation.

Mitigating U.S. Income Tax

* Foreign Tax Credit—Form 1116 and Form 1118
  * A credit (or an itemized deduction) for taxes paid to a foreign country or U.S. possession if the same income is also subject to U.S. tax.
* Foreign Earned Income Exclusion (FEIE)
  * Up to $102,100 of foreign earned income in 2017
  * Up to $104,100 of foreign earned income in 2018
  * Or foreign earned income less foreign housing exclusion
  * Requirements
    * Qualified Individual—either a citizen or resident alien
    * Have foreign earned income
    * Meet the Bona Fide Residence Test or the Physical Presence Test
    * "Tax Home" in a foreign country
    * Valid Election on Form 2555 or Form 2555-EZ

Foreign Tax Credit

Foreign Income	Foreign Tax Rate	Foreign Tax	US Tax (40% rate)	US Foreign Tax Credit	Total Tax (F + US)
$100	0%	0	$40	0	$40
$100	15%	$15	$25	$15	$40
$100	25%	$25	$15	$25	$40
$100	35%	$35	$5	$35	$40
$100	45%	$45	0	$40	$45

Foreign Earned Income Exclusion

Income Type ($100 of each)	Foreign Tax Rate	Foreign Tax	US Tax Rate	US Tax
Foreign Earned Income	10%	$10	0*	$0 ($0 credit)
US Earned Income	0%	0	40%*	$40*
Dividends (US)	0%	0	20%	$20
Dividends (F)	10%	$10	20%	$10 ($10 credit)
Interest (US)	0%	0	40%	$40
Interest (F)	5%	$5	40%	$35 ($5 credit)

* Wages are subject to U.S. Social Security and Medicare taxes

US Individual Abroad Updates

* Rev. Proc. 2017-26, 2017-13 IRB.
  * U.S. residents of South Sudan will qualify for a waiver of residency requirements for FEIE because of adverse or dangerous conditions in 2016.
* *Acone v. Comm'r*, T.C. Memo. 2017-162 (2017).
  * An airline pilot was not a "qualified individual" for purposes of the FEIE while working for a Korean airline when the record showed his tax home was the U.S. and he wasn't a bona fide resident of South Korea.
* *Thompson v. Comm'r,* 120 AFTR 2d 2017-5485 (9th Cir. 2017).
  * Married couple did not meet requirements for the FEIE.

US Individual Abroad Updates

* *Qunell v. Comm'r*, TC Summary Opinion 2016-86.
  * Taxpayer denied FEIE while living on a military facility in Afghanistan, his family did not visit him there, and there was no suggestion that he traveled within Afghanistan other than as required by his employment.
* *Lock et ux. v. Comm'r*, TC Summary Opinion 2017-10.
  * Taxpayer denied FEIE while working in Iraq, but tax home remained in the U.S.
* *Jesse A. Linde, et ux. v. Comm'r*, TC Memo 2017-180.
  * Taxpayer was entitled to FEIE while working for government contractor in Iraq as a helicopter pilot. His tax home was in Iraq, and he as a bone fide resident.

Income Tax Residents

* Objective Test
  * U.S. Citizens
  * Legal Permanent Resident (a.k.a. the "Green Card" Test)
  * Substantial Presence Test
    * 31 days in the tax year in question
    * 183 days over the current tax year and the previous two tax years calculated using a weighted average
  * First-year election
    * Must be substantially present in the subsequent tax year

Income Tax Residents

* Exceptions to the Substantial Presence Test
  * Certain exempt individuals, including students, teachers, athletes, & government employees
  * Individuals with medical conditions
  * Demonstrate a “Closer Connection” to another county (Form 8840)
  * Treaty-based exception (Form 8833)

Substantial Presence Test

	Days Present in the United States	Fraction Counted	Days Counted
Non-Resident for 2015			
2013	120	1/6	20
2014	120	1/3	40
2015	120	1	120
		Total	180
Resident for 2015			
2013	120	1/6	20
2014	150	1/3	50
2015	120	1	120
		Total	190

Substantial Presence Test

	Days Present in the United States	Fraction Counted	Days Counted
Medical Exception – Non-Resident for 2015			
2013	120	1/6	20
2014	150, but 30 for medical reasons	1/3	40
2015	120	1	120
		Total	180
All on student visa – Non-Resident for 2015			
2013	180	1/6	0
2014	180	1/3	0
2015	180	1	0
		Total	0

Income Taxation of Nonresident Aliens

- Effectively Connected Income (“ECI”)
  - Net-basis taxation for business income
- Gains from the Sale of Real Property—FIRPTA
  - Subject to mandatory 15% withholding, and taxed as ECI
  - Certain taxpayers are subject to 10% withholding
- Fixed, Determinable, Annual, or Periodical Income (“FDAP”)
  - All income other than gains from sale of property or income excluded from gross income (e.g., dividends, interest, pensions and annuities, alimony, rent, and royalties)
  - Gross-basis taxation subject to mandatory 30% withholding
- Gains from the Sale of Non-Real Property—Not Taxed

Foreign Individuals in the US Updates

* *Liljeberg, et al, v. Comm'r*, 148 TC No. 6 (2017).
  * Nonresident students may deduct costs for travel health insurance only as allowed by Code § 213(a) as part of participating in the U.S. State Department. Summer Work Travel Program .
  * Other expenses may not be deducted because students were not "away from home" within the scope of Code § 162(a)(2).
* *Pei Fang Guo v. Comm'r*, 149 TC No. 14 (2017).
  * Unemployment received by Canadian citizen/nonresident alien was not exempt as "dependent personal services" under the U.S.-Canada treaty's exclusion for wages, salaries or because it was neither salary nor wages.

Foreign Gifts & Code § 6039F

* Even though the gifts are not necessarily subject to US Estate Tax or Gift Tax, if a US person must report on Form 3520 the receipt of either of the following:
  * More than $100,000 from a nonresident alien individual or a foreign estate.
  * More than $15,797 in 2017 or more than $16,111 in 2018 from foreign corporations or foreign partnerships (including foreign persons related to such foreign corporations or foreign partnerships) that are treated as gifts.

Foreign Gifts & Code § 6039F

* Code § 6677 imposes penalties if Form 3520 is not filed. The initial penalty is equal to the greater of $10,000 or:
  * 35% of the gross value of any property transferred to a foreign trust for failure by a U.S. transferor to report the creation of or transfer to a foreign trust or
  * 35% of the gross value of the distributions received from a foreign trust for failure by a U.S. person to report receipt of the distribution or
  * 5% of the gross value of the portion of the trust's assets treated as owned by a U.S. person for failure by the U.S. person to report the U.S. owner information.

U.S. Income Tax Treaty System

* The U.S.A. is a party to 58 bilateral income tax treaties with 68 countries.
  * The U.S.–U.S.S.R. income tax treaty remains in effect for members of the Commonwealth of Independent States that have not negotiated and ratified new treaties.
  * The U.S.–China income tax treaty does not apply to Hong Kong.
* Four additional treaties (Chile, Hungary, Poland, Vietnam) and four protocols (Japan, Luxembourg, Spain, & Switzerland) have been signed but not approved by the Senate.

Income Tax Treaties

IRS

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- Corporations
- Partnerships
- International Businesses
- Small Businesses & Self-Employed

International Businesses Topics

- Individual Taxpayer
- Income Tax Treaties
- KYC Rules
- **International Businesses Home**

United States Income Tax Treaties - A to Z

The United States has tax treaties with a number of foreign countries. Under these treaties, residents (not necessarily citizens) of foreign countries are taxed at a reduced rate, or are exempt from U.S. taxes on certain items of income they receive from sources within the United States. These reduced rates and exemptions vary among countries and specific items of income. Under these same treaties, residents or citizens of the United States are taxed at a reduced rate, or are exempt from foreign taxes, on certain items of income they receive from sources within foreign countries. Most income tax treaties contain what is known as a "saving clause" which prevents a citizen or resident of the United States from using the provisions of a tax treaty in order to avoid taxation of U.S. source income.

If the treaty does not cover a particular kind of income, or if there is no treaty between your country and the United States, you must pay tax on the income in the same way and at the same rates shown in the instructions for the applicable U.S. tax return.

Many of the individual states of the United States tax income which is sourced in their states. Therefore, you should consult the tax authorities of the state from which you derive income to find out whether any state tax applies to any of your income. Some states of the United States do not honor the provisions of tax treaties.

This page provides links to tax treaties between the United States and particular countries. For further information on tax treaties refer also to the Treasury Department's Tax Treaty Documents page.

-

A

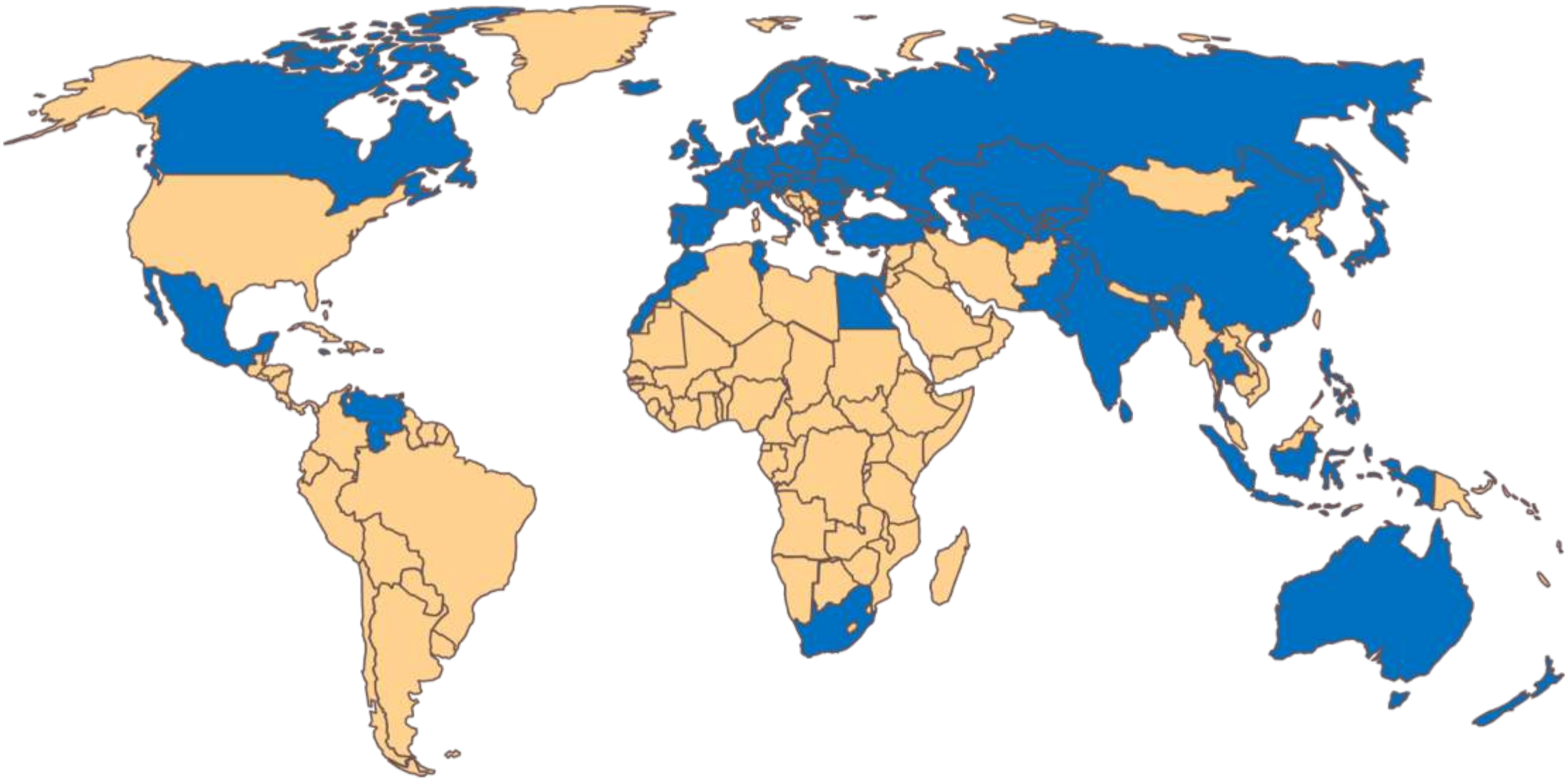
Armenia
Australia
Austria
Azerbaijan

B

Bangladesh
Barbados
Belarus
Belgium
Bulgaria

Available at http://ow.ly/TGSdp

Income Tax Treaty Partners



U.S. Income Tax Treaties

* *Cole v. Comm'r.*, T.C. Summ. Op. 2016-22.
  * U.S. citizen gets caught by the U.S.-Israel Savings Clause.
* *Topsnik v. Comm'r.*, 146 T.C. No. 1 (2016).
  * You must be a resident to claim treaty benefits.
* *McManus v. U.S.*, 119 AFTR 2d 2017-955, 130 Fed. Cl. 613 (Ct. Fed. Cl. 2017).
  * Merely paying Ireland's "domicile levy," does not qualify a taxpayer as a "resident of contracting state" under the US-Ireland income tax treaty.

Transfer Tax Residents

- Transfer Taxes are imposed on U.S. citizens and residents
- Residents are those who are domiciled and primarily residing in the U.S.A. with no definite present intention of leaving, regardless of the time actually present. Treas. Reg. §§ 20.0-1(b), 25.2501-1(b).
- Not a bright-line rule like the Substantial Presence Test, but a facts-and-circumstances test
- All others are considered a "nonresident not a citizen of the United States"

U.S. Estate Taxation of Nonresidents

* Estate Tax applied to property located in the U.S.A.
  * Stock in U.S. corporations (whether or not publicly traded)
  * Real property in the U.S.A.
  * Tangible property in the U.S.A. (e.g., cash in a safe deposit box)
  * Uncertain treatment of foreign partnership interests
  * Revocable trusts
  * $60,000 estate tax exemption
  * Nonrecourse debt on U.S. property results in only net value included in U.S. estate

U.S. Estate & Gift Tax Treaties

- Corporations
- Partnerships
- International Businesses
- Small Businesses & Self-Employed

Small Business/Self-Employed Topics

- A-Z Index for Business
- EINs
- Forms & Pubs
- Industries/Professions
- Online Learning
- Operating a Business
- Self-Employed
- Starting a Business

Estate & Gift Tax Treaties (International)

Country	Separate Estate	Separate Gift	Combined E & G	Other	Signed	Transfers made on or after:	Comments	
Australia	No	Yes	No	No	5305	12/14/53		PR-UC
Australia	Yes	No	No	No	5305	01/07/54	old *	PR-UC
Austria	No	No	Yes	No	8206	07/01/83	new *	
Belgium	Yes	No	No	No	5405	not yet	old	no effect
Canada	No	No	No	1995 Protocol	9503	11/09/95 **	estate tax only	PR-UC
Denmark	No	No	Yes	No	8304	11/07/84	new	
Finland	Yes	No	No	No	5203	12/18/52	old	PR-UC
France	No	No	Yes	No	7811	10/01/80	new	PR-UC (Protocol)
Germany	No	No	Yes	No	8012	01/01/79	new	PR-UC (Protocol)
Greece	Yes	No	No	No	5002	12/30/53	old	PR-UC
Ireland	Yes	No	No	No	4909	12/20/51	old	
Italy	Yes	No	No	No	5503	10/26/56	old	PR-UC
Japan	No	No	Yes	No	5404	04/01/55	old	PR-UC
Netherlands	Yes	No	No	No	6907	02/03/71	new	
Norway	Yes	No	No	No	4906	12/11/51	old	PR-UC
South Africa	Yes	No	No	No	4704	07/15/52	old	
Sweden	No	No	Yes	No	8306	09/05/84 (through 12/31/07)	new (terminated 01/01/08)	
Switzerland	Yes	No	No	No	5107	09/17/52	old	PR-UC
U.K.	No	No	Yes	No	7810	11/11/79	new	

* old or new refers to whether the treaty has the "old" situs rules, or the "new" provisions that generally restrict the U.S. to taxing nonresident aliens' U.S. real estate and business property.

** the 1995 Protocol had retroactive effect to TAMRA. Claims for refund based upon the treaty had to be filed by 11/09/96.

"**PR-UC**" in comments section above refers to a pro-rata unified credit provision. (The pro-rata unified credit provisions in the German and French treaties apply only to estate tax, not to gift tax.)

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Page Last Reviewed or Updated: 04-May-2016

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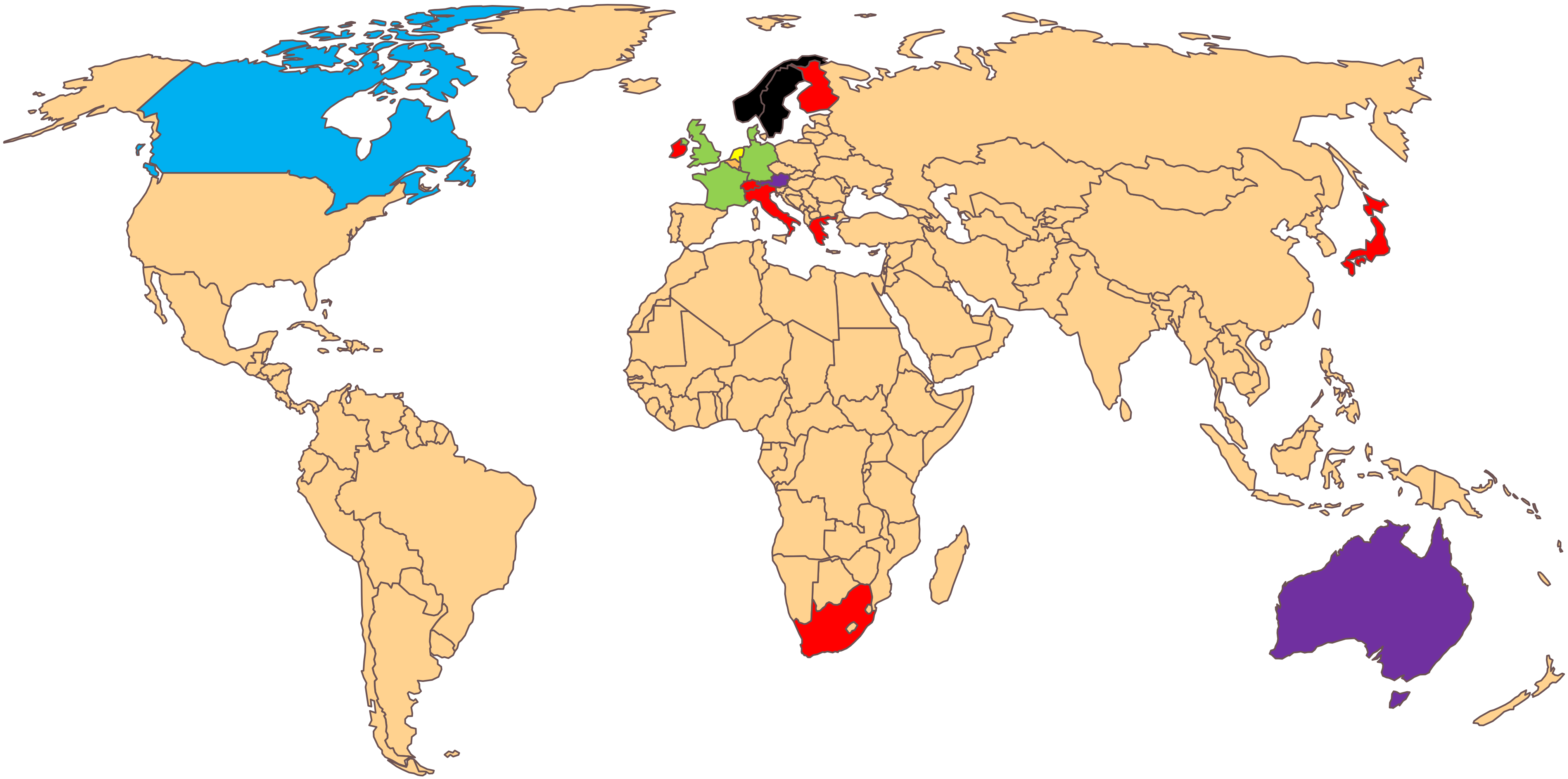
Estate & Gift Tax Treaties

- ***7 Situs-Type Treaties***
  - ***Allocation taxation of assets to jurisdictions based on the situs of the assets.***
  - ***Treaties with Australia, Belgium, Finland, Greece, Ireland, Italy, Japan, Norway, South Africa, & Switzerland.***
- ***6 Domicile-Type Treaties***
  - ***Allocate taxation of assets to jurisdictions based on the domicile of the taxpayer.***
  - ***Treaties with Austria, Denmark, France, Germany, Netherlands, Sweden, & the United Kingdom.***
  - ***Protocol Amending United States-Canada Income Tax Treaty.***

U.S. Estate & Gift Tax Treaties



Code § 877A Expatriation

* U.S. citizens and long-term U.S. residents who cease to be permanent U.S. residents may be "Covered Expatriates."
* Three-prong test to not be a Covered Expatriate:
  * Your average annual net income tax bill for the five prior years ending before expatriation under $162,000 in 2017 and $165,000 in 2018.
    * This amount is adjusted for inflation.
  * Your net worth must be under $2,000,000 or less on your expatriation date.
    * This amount is not adjusted for inflation.
  * You must certify on Form 8854 that you've complied with all U.S. federal tax filing obligations for 5 years preceding date of expatriation.

Code § 877A Expatriation

* What happens if you don't jump through the hoops?
  * Income tax on mark-to-market valuation of assets on the day before expatriation ($699,000 exemption in 2017, and $713,000 in 2018)
  * 30% withholding tax on deferred compensation and the present value of "specified tax deferred accounts," and the taxable portion of distributions from non-grantor trusts.
* *Topsnik v. Comm'r.*, 143 T.C. No. 12 (2014).
  * If you fail to properly surrender your Green Card, then you haven't left the U.S. tax system.

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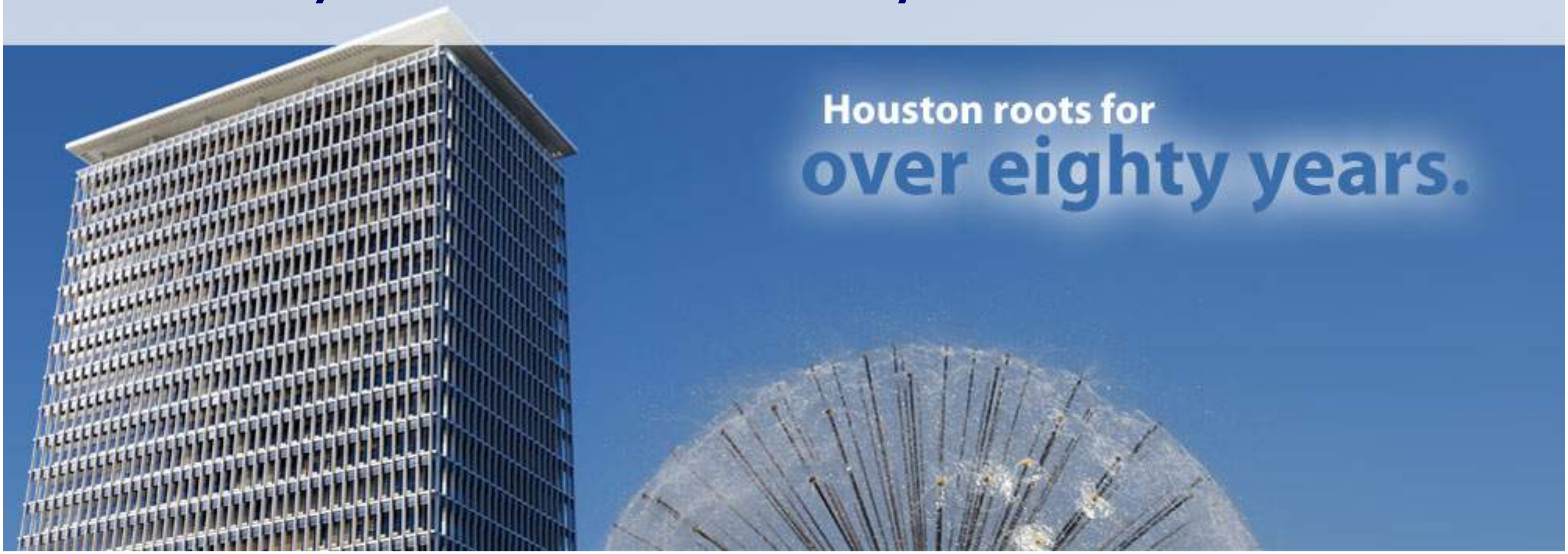

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Tax Reform Act - Impact on Private Equity

20 December 2017

Authors: Robert W. Phillpott, Ron J. Scharnberg, Michael P. Bresson, Derek S. Green, Matt Hunsaker, Richard A. Husseini, Matthew L. Larsen, Jon Lobb, Don J. Lonczak, Josh Mandell, Stephen D. Marcus, Jeff Munk, Renn G. Neilson, Jon Nelsen and Tamar C. Stanley

Firm Thought Leadership

With the passage of the tax reform act (formerly known as the Tax Cuts and Jobs Act or the "Act") by Congress this week and the expectation that President Trump will sign it into law, many of the changes to the Internal Revenue Code (the Code) that impact private equity funds and their investors that have been discussed in connection with tax reform will now go into effect, including the treatment of carried interest, reduction in tax rates, limitations on interest deductions, and the move to a territorial tax system. These changes could impact the taxation of private equity investors and portfolio companies, and as a result, could change the preferred operating and acquisition structures with respect to their portfolio companies.

We plan to discuss the tax reform changes as they specifically relate to private equity in more detail in a webinar that is scheduled for the week of January 8th. Until then, the following is a high-level summary of certain changes and potential impacts that the Act will have on private equity.

Carried Interest

Under the Act, certain carried interests will have to be held for more than three years in order to qualify for long-term capital gain rates (for which the highest rate of 20% remains the same). If the applicable carried interests (or any underlying assets) are not held for more than three years, then the gain recognized from the sale of such interests (or gain allocated with respect to such interests from the sale of such underlying assets) will be treated as short-term capital gain, which is subject to ordinary income tax rates (for which the highest individual rate is 37% under the Act). While these changes will need to be considered and monitored, such changes may not be applicable in many situations because private equity funds generally have an investment horizon of more than three years.

Reduction in Tax Rates

New Effective C Corporation Tax Rate

The Act permanently reduces the corporate tax rate to a flat 21% beginning in 2018. When combined with the maximum 20% tax rate on qualified dividends paid by a C corporation to an individual shareholder, the effective tax rate on income of a C corporation distributed to its shareholders will be 36.8% (or 39.8% after the 3.8% Medicare tax on dividends).

New Effective Partner Tax Rate

The Act reduces the maximum individual tax rate to 37%, beginning in 2018 (subject to sunset at the end of 2025). In addition, the Act provides in certain cases a deduction to individual partners generally equal to 20% of the partnership's U.S. business income (the "Section 199A Deduction"). However, for an individual partner with income over $315,000 (or $157,500 if the partner does not file joint returns), the Section 199A Deduction is subject to a limit based either on W-2 wages paid or W-2 wages paid plus a capital element. In such a case, the Section 199A Deduction is limited to an amount equal to the greater of (a) 50% of the W-2 wages paid with respect to a "qualified trade or business" and (b) the sum of 25% of the W-2 wages with respect to the "qualified trade or business" plus 2.5% of the unadjusted basis (determined immediately after an acquisition) of all "qualified property" held by the "qualified trade or business" at the close of the relevant tax year.

Table of Effective Tax Rates Before and After the Act

As the table below shows assuming an individual partner is in the highest tax bracket, the effective tax rate spread between a C corporation and a partnership has been decreased slightly if the full Section 199A Deduction is available or even flips in the extreme case if no Section 199A Deduction is available.

Private Equity Tax Reform Table

Observations

Prior to the Act, the 48% (or 50.47% after the 3.8% Medicare tax on dividends) effective double tax rate, combined with the premium that could be received for tax basis step-up on exit, often resulted in private equity funds preferring to have their portfolio companies classified as pass-through entities for U.S. federal income tax purposes (e.g., partnerships or disregarded entities). While the Act also reduces the highest individual tax rate to as low as 29.6% for pass-through business income for taxpayers entitled to the full amount of the Section 199A Deduction, the relative advantage that partnerships had over C corporations has been reduced and can even be eliminated in cases where the Section 199A Deduction is materially limited. As a result, private equity funds with individual investors will need to consider the impact of the reduced rates and the anticipated Section 199A Deductions to determine the optimal structure for investing in and disposing of their portfolio companies.

Interest Deduction Limitation

The Act imposes a new limitation on interest expense deductions for all business taxpayers, including private equity funds and their portfolio companies, for all tax years beginning in or after 2018 if average annual gross receipts for the three-tax-year period ending with the prior tax period exceed $25 million. The Act limits net interest expense deductions of an entity to 30% of its "adjusted taxable income." "Adjusted taxable income" is taxable income computed without regard to:

- business interest expense,

- business interest income,
- the 20% deduction for pass-through entities,
- net operating losses, and
- for taxable years prior to 2022, depreciation, amortization, and depletion.

The limitation is calculated and applied separately for each entity, in a manner that is intended to avoid double-counting. For example, in calculating the limitation on a private equity fund’s ability to deduct its own interest expense, the fund would take into account net income allocated to it from a subsidiary partnership only if the subsidiary partnership’s interest expense fell short of 30% of the subsidiary partnership’s adjusted taxable income, and in proportion to that shortfall. Similarly, an investor of the fund would take into account net income allocated to it from the fund in calculating the limitation on the investor’s interest expense only if the fund's interest expense fell short of 30% of the fund's adjusted taxable income, and in proportion to that shortfall.

Disallowed interest expense allocated to an investor can be carried forward indefinitely, to a year in which the investor's share of the fund's interest expense does not exceed 30% of the investor's share of the fund's adjusted taxable income. The disallowed interest expense immediately reduces the investor's basis in the fund, but any amounts that remain unused upon disposition of the interest in the fund are restored to basis immediately prior to disposition.

This interest deduction limitation could result in less debt being used in certain leveraged acquisition structures with respect to portfolio companies and dividend recapitalizations. Private equity funds now will need to take this interest deduction limitation into account in modeling the expected tax impacts and benefits of debt, and this limitation could lead to the use of more preferred equity.

Bonus Depreciation

Under the Act, the bonus depreciation percentage is generally increased to 100% (from its current level of 50%) for property placed in service after September 27, 2017 and before 2023. After 2022, the bonus depreciation percentage is phased-down to 80% for property placed in service in 2023, 60% for property placed in service in 2024, 40% for property placed in service in 2025, and 20% for property placed in service in 2026. Importantly, the Act expands the availability of bonus depreciation to non-original use property, as long as it is the taxpayer's first use. Accordingly, a portfolio company that acquires assets may be able to deduct a significant portion of the purchase price, as compared to the acquisition of the equity interest of a target business.

Sale of Foreign Investor’s Interest

Under the Act, gain or loss realized by a foreign corporation or a foreign individual from the sale or exchange of an interest in a partnership engaged in a U.S. trade or business is treated as effectively connected with a U.S. trade or business to the extent that the sale of all the partnership assets would have produced effectively connected gain or loss. This provision applies to sales, exchanges, and dispositions occurring on or after November 27, 2017. This provision repeals the result in Grecian Magnesite Mining v. Commissioner, 149 T.C. No. 3 (2017), where the Tax Court held that a foreign partner was not subject to U.S. tax on sale of a partnership interest, rejecting the holding of Rev. Rul. 91-32 to the contrary.

After the Tax Court's decision in Grecian Magnesite, private equity funds and their investors were considering alternative structures for the foreign investors to hold their investments in the fund. As a result of the legislative repeal of Grecian Magnesite, those structures should no longer be pursued.

Territorial Corporate Tax System

Another one of the more notable changes in the Act is the shift in the corporate tax system from a worldwide tax to a territorial tax system. Under this new territorial system, a U.S. corporation generally will not be subject to U.S. federal income tax on dividends received from foreign corporations or gains recognized from the disposition of foreign corporation stock to the extent that such dividends or gains are attributable to foreign earnings and profits and the U.S. corporation owns 10% or more of the foreign corporation. This is a significant change from the worldwide tax system currently in place, which would subject a U.S. corporation to U.S. federal income tax at 35% on such dividends or gains and then allow the U.S. corporation a foreign tax credit for foreign taxes incurred on such foreign earnings and profits. This worldwide system ultimately resulted in foreign earnings and profits being subjected to a minimum worldwide tax rate of 35%. The new territorial system will generally cause most foreign earnings and profits to not be subject to any additional U.S. corporate tax.

Under the worldwide tax system, portfolio companies that operated in pass-through entities generally preferred to hold foreign operations through foreign entities that were also pass-through vehicles for U.S. federal income tax purposes. Such a structure allowed individual investors to be able to claim foreign tax credits to offset the U.S. federal income tax liability attributable to the foreign operations, which helped prevent double taxation of the foreign earnings and profits. This shift to a territorial tax system, together with the inapplicability of the Section 199A Deduction previously discussed to non-U.S. business income, could lead to a preference by funds to have their portfolio companies with foreign operations hold such operations through foreign corporations wholly-owned by a U.S. corporation, even if the portfolio company operates in pass-through form with respect to its U.S. business and operations. This structure may allow the foreign earnings and profits to be taxed at an effective worldwide tax rate that is lower than the highest individual rate of 37%.

TAX SECTION
State Bar of Texas

December 1, 2017

Via e-mail: OIRA_Submission@OMB.EOP.gov;
Via e-mail: PRA@treasury.gov

(Notice, 82 Fed. Reg. 50733)

Office of Information and Regulatory Affairs
Office of Management and Budget
Attention: Desk Officer for Treasury
New Executive Office Building, Room 10235
Washington, D.C. 20503

Treasury PRA Clearance Center
1750 Pennsylvania Ave., N.W., Suite 8142
Washington, D.C. 20220

Re: Comments on Burden Estimate Regarding Form 8971 – Information Regarding Beneficiaries Acquiring Property from a Decedent

Dear Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury ("Treasury") in the Notice requesting comments regarding the burden estimate or any other aspect of the information collection, including suggestions for reducing the burden, with respect to Form 8971 (Information Regarding Beneficiaries Acquiring Property from a Decedent) which was developed by the Internal Revenue Service ("IRS") to fulfill reporting requirements imposed under section 6035 of the Internal Revenue Code of 1986, as amended ("Code").

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS

1414 Colorado Street, Austin, Texas 78701
(512) 427-1463 or (800) 204-222

COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

Respectfully submitted,

Stephanie M. Schroepfer

Stephanie M. Schroepfer, Chair
State Bar of Texas, Tax Section

SS/lab
Enclosure

COMMENTS ON BURDENS REGARDING FORM 8971

These comments on the burdens regarding Form 8971, including the associated Schedule A (the "Comments"), are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Celeste C. Lawton, Co-Chair of the Estate and Gift Tax Committee, Laurel Stephenson, Co-Chair of the Estate and Gift Tax Committee, Matthew S. Beard, Vice-Chair of the Estate and Gift Tax Committee, Corey M. Junk, a member of the Tax Section, and Carol G. Warley, Vice-Chair of the Estate and Gift Tax Committee. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Henry Talavera, Co-Chair of the Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas, has approved these Comments on behalf of COGS. Lora Davis reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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I. INTRODUCTION

These Comments are provided in response to the Treasury's request for comments regarding Form 8971 (including the associated Schedule(s) A), which is used to report the estate tax value of property distributed from an estate to the IRS and via Schedule A to each beneficiary receiving property from the estate.

Code § 6035[1] requires executors of an estate or other persons who are required to file an estate tax return to report to the IRS and to each beneficiary receiving property from an estate the estate tax value of the property. Form 8971 and Schedule A were developed by the IRS to fulfill these reporting obligations. Because these forms are a byproduct of Code § 6035 and the Proposed Regulations under Code § 6035 (the "Proposed Regulations"), it is necessary to address the burdens imposed by the Proposed Regulations, which burdens are materialized through Form 8971 and Schedule A. We appreciate the opportunity to make suggestions to reduce the burden in connection with the preparation and filing of Form 8971 and Schedule A.

To reduce such burdens, as discussed in more detail below, we respectfully request that the Office of Management and Budget, along with Treasury and the IRS, consider the following.

1. Providing an alternate method for reporting assets not yet acquired by a beneficiary by the due date of Schedule A of Form 8971 to that imposed by Proposed Regulation § 1.6035-1(c)(3) and reflected in the Form 8971 Instructions, which is to list on that beneficiary's Schedule A all items of property that could be used, in whole or in part, to fund his or her bequest. In addition to the current method, we suggest that the alternate method should permit the disclosure on that beneficiary's Schedule A of the dollar amount of his or her interest in the estate as of the decedent's date of death (or the alternate valuation date pursuant to Code § 2032, as applicable) with the requirement that a Supplemental A be filed to report the actual assets ultimately distributed to the beneficiary in satisfaction of that claim.

2. Excepting property distributed in kind to a beneficiary to satisfy a pecuniary bequest from the reporting requirements.

3. Allowing for an automatic six-month extension of time to furnish Schedule(s) A to the beneficiaries of an estate and file copies of such along with the Form 8971 with the IRS. We suggest that this could be accomplished by permitting taxpayers to simply check a box on the estate tax return.

4. Removing any supplemental Form 8971 filing requirements with respect to subsequent transfers.

We greatly appreciate the opportunity to work with your office and hope these comments provide relevant analysis for your review. Thank you for your consideration.

II. UNDUE BURDEN IMPOSED BY REQUIREMENT THAT ASSETS NOT YET ACQUIRED BY A BENEFICIARY BY THE DUE DATE OF FORM 8971 BE REPORTED ON SCHEDULE A

We respectfully recommend that the IRS consider expanding the reporting requirements provided in Proposed Regulation § 1.6035-1(c)(3) to include an optional reporting method of a dollar amount of a beneficiary's interest (valued as of the decedent's date of death or the alternate valuation date pursuant to Code § 2032, as applicable) rather than reporting all assets that could be distributed to a beneficiary to reduce the burden on taxpayers and to improve the accuracy of information collected by Schedule A to Form 8971. Based upon our experience, we

[1] All references herein to the "Code §" are to the Internal Revenue Code of 1986, as amended.

also suggest that permitting this alternative will prevent the provision and collection of unnecessary and potentially confusing information.

The nature of assets in the larger estates that will be subject to the filing requirement under Code § 6035(a)(1) are often complicated in nature. In that regard, the distribution of assets, along with the decisions regarding the division of those assets, is not often accomplished prior to the deadline for Schedule A. A beneficiary cannot have a basis consistency reporting requirement with respect to assets such person has yet to receive from an estate. If no distribution of assets has been made to a beneficiary by the filing due date, then the property "acquired" from the estate at that time is simply a claim equal to the value of the assets allocable to the beneficiary on the estate tax return, which could be reported as a dollar amount equal to the value of such claim, without the need to identify specific assets in connection with the claim.

We suggest that when the later distribution of assets from the estate actually occurs, the executor would then file a supplemental Schedule A to report the assets that were actually distributed to each beneficiary. In complex estates, this approach would arguably reduce the compliance burden on the executor and reduce or eliminate confusion for beneficiaries who would otherwise receive information that is not needed or relevant at the time initially received. We also suggest that the supplemental Schedule A later filed by the executor will result in accurate information being provided to both the IRS and the beneficiary at a time when it will be needed, without creating unnecessary confusion and collection of superfluous information.

We understand that the IRS has acknowledged that it may be challenging to determine which assets to report on Schedule A by the due date. Accordingly, Proposed Regulation § 1.6035-1(c)(3) provides that if an executor has not determined which assets a beneficiary will receive by the due date, the executor must list on the beneficiary's Schedule A all items of property "…that the executor could use to satisfy that beneficiary's interest." Under this approach, no supplemental Schedule A will need to be prepared as long as the beneficiary received the value information on the initial Schedule A for each item he or she actually received.

Although we do not believe that this approach will be appropriate in every situation, we acknowledge that some executors, due to the nature of an estate and its beneficiaries, may be able to easily comply with the rule in the Proposed Regulations and recommend that this reporting method be retained as an alternative option for reporting on Schedule A. For those estates that can easily comply with this requirement, our proposed alternative should reduce the compliance burden on the executor and the beneficiaries, while providing the necessary information to the IRS in an efficient manner.

Accordingly, to reduce the burden on taxpayers and to prevent the provision and collection of unnecessary and potentially confusing information, we request that the reporting options be revised to permit either of the aforementioned reporting methods.

III. UNDUE BURDEN IMPOSED BY FORM 8971 DUE TO REQUIREMENT THAT SCHEDULE A INCLUDE ESTATE TAX VALUE OF PROPERTY DISTRIBUTED IN KIND TO SATISFY CERTAIN PECUNIARY BEQUESTS

We respectfully suggest that the IRS consider expanding the exception to the reporting requirements provided in Proposed Regulation § 1.6035-1(b)(1)(iv) to include in kind satisfactions of pecuniary bequests based upon date of distribution values. We believe that our suggestion will reduce the burden on taxpayers and improve the accuracy of information collected by Schedule A to Form 8971.

The Proposed Regulations provide exceptions for certain types of property that do not need to be reported on Schedule A, including but not limited to, the exception provided in Proposed Regulation § 1.6035-1(b)(1)(iv) for "[p]roperty sold, exchanged, or otherwise disposed of (and, therefore, not distributed to a beneficiary) by the estate in a transaction in which capital gain or loss is recognized." When property of an estate is distributed in kind to satisfy a pecuniary bequest using that property's date of distribution value, the estate will recognize either (a) a taxable gain to the extent that the property's fair market value upon distribution exceeds its estate tax value (i.e., the value of the property that is reported on Schedule A) or (b) a loss to the extent its date of distribution value is less than its estate tax value. As a result of the estate recognizing gain or loss (whether capital in nature or some other type of gain or loss) on the distribution, the beneficiary will receive a basis in the property equal to its fair market value as of the distribution date, rather than its estate tax value.

Nevertheless, the Proposed Regulations require the executor to deliver to such a beneficiary a Schedule A reporting the estate tax value of the property distributed in satisfaction of that bequest. We suggest that providing this information on Schedule A to the beneficiary and IRS in this situation does not achieve the purpose of Schedule A, which is to provide both with the initial basis of any property received by the beneficiary. We suggest that providing this information has no utility or value to anyone because it is irrelevant to the beneficiary's initial basis in the property received, while its provision to the IRS and the beneficiary causes considerable expense and an undue financial burden on the taxpayer. Further, we suggest in our experience that it could cause the beneficiary to incorrectly report such person's basis at a later time. Accordingly, we believe that the requirement to report such assets on Schedule A under the Proposed Regulations imposes an undue and unnecessary financial burden on taxpayers and should, therefore, be eliminated.

IV. UNDUE BURDEN IMPOSED BY FORM 8971 DUE TO THE TIMING OF THE DUE DATE FOR ITS FILING

We respectfully suggest that the IRS consider exercising its discretion pursuant to Code § 6081 to permit an executor to request an automatic six-month extension of time to fulfill the reporting requirements pursuant to Code § 6035. We believe that our suggestion will reduce the burden on taxpayers and improve the accuracy of information collected by the IRS.

Proposed Regulation § 1.6035-1(d) generally requires that the executor furnish a Schedule A to each beneficiary of the estate and file Form 8971 and the Schedule(s) A with the IRS within 30 days after the Form 706 is due. Pursuant to Code § 6081, the IRS has authority to grant a reasonable extension of time for filing any return, statement or other document required under the Code or regulations thereunder. We respectfully suggest that the IRS consider exercising that discretion to permit the executor to request an automatic six-month extension of time to furnish the Schedule(s) A to the beneficiaries of an estate and file copies of such, along with the Form 8971, with the IRS by checking a box requesting that election on the estate tax return.

We respectfully assert that allowing executors this additional time to fulfill the reporting and filing requirements with respect to Form 8971 and Schedule(s) A would reduce the need for supplemental filings to correct errors. Also, allowing executors this additional time will enable them to better determine the specific assets to be used in funding pecuniary bequests and satisfying residuary bequests so that only those assets actually distributed to a beneficiary will be reported on his or her Schedule A. Having additional time for filing will enable executors to provide beneficiaries in receipt of those bequests with Schedule(s) A containing meaningfully specific information relating solely to assets they have received (or will receive) rather than providing an excessive amount of what may ultimately be irrelevant information that relates solely to assets the beneficiary has not received (and may never actually receive). Accordingly, we believe providing for an automatic extension of time to file Form 8971 and Schedule(s) A will reduce the burden on taxpayers and assist in providing the IRS in collecting more accurate information.

V. UNDUE BURDEN IMPOSED BY FORM 8971 DUE TO ADDITIONAL REPORTING REQUIREMENTS RELATED TO SUBSEQUENT TRANSFERS

We believe that the requirement to report subsequent transfers of certain estate assets under Proposed Regulation § 1.6035-1(f) results in undue burden on and potentially duplicative reporting by taxpayers. As a result, we respectfully suggest that this requirement be removed.

Proposed Regulation § 1.6035-1(f) provides that if all or any portion of property that previously was reported or is required to be reported on an information return is transferred (by gift or otherwise) by the recipient in a transaction in which a related transferee determines its basis, in whole or in part, by reference to the recipient/transferor's basis, then the recipient/transferor must, no later than 30 days after the date of the transfer, file with the IRS a supplemental information return and statement (i.e., Form 8971 and Schedule A) and furnish a copy of the same supplemental statement (i.e., Schedule A) to the transferee. Thus, the recipient/transferor who acquires property from a decedent and then subsequently transfers that property by gift could potentially be required to file both a gift tax return ("Form 709") and a supplemental Form 8971 and Schedule A. In such instance, we suggest that such duplicative reporting is unnecessarily burdensome for the recipient/transferor, as well as the IRS, because the recipient/transferor's adjusted basis of the gift is already required to be reported on Schedule A of the Form 709.

Finally, Proposed Regulation § 1.6035-1(f) expands the scope of Code § 6035 beyond the statutory language. Code § 6035(a)(1) provides that the executor of any estate required to file an estate tax return shall furnish to the Secretary and to each person acquiring any interest in property included in the decedent's gross estate for federal estate tax purposes a statement identifying the value of each interest in such property as reported on such return. Code § 6035 does not apply to a recipient/transferor who acquires property from a decedent and subsequently transfers it, regardless of the value of the property at the time of transfer or whether the transfer is required to be disclosed on a gift tax return. However, Proposed Regulation § 1.6035-1(f) nonetheless imposes reporting requirements with respect to gifts and certain other previously-described transfers to related parties. We suggest that this requirement is inconsistent with Code § 6035 for the reasons previously outlined and causes an undue burden on taxpayers.

Accordingly, we respectfully request that the reporting requirements with respect to Schedule A be limited to reporting information within the scope of Code § 6035 by removing the additional reporting requirements relating to subsequent transfers contained in Proposed Regulation § 1.6035-1(f).

TAX SECTION
State Bar of Texas

December 7, 2017

Via U.S. Priority Express Mail and E-mail to Teresa.Bostick@cpa.texas.gov

Teresa G. Bostick
Director, Tax Policy Division
P.O. Box 13528
Austin, Texas 78711-3528

RE: Comments on Proposed Amendments to 34 Tex. Admin. Code § 3.287, concerning exemption certificates

Dear Ms. Bostick:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed comments pertaining to the proposed amendments to 34 Tex. Admin. Code § 3.287. The proposal appeared in the November 10, 2017, edition of the Texas Register.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF

1414 Colorado Street, Austin, Texas 78701
(512) 427-1463 or (800) 204-222

THE TAX SECTION WHO PREPARED THEM.

We commend the Texas Comptroller of Public Accounts for the time and thought that has been put into preparing the proposed amendments to 34 Tex. Admin. Code § 3.287, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Stephanie Schroepfer

Stephanie M. Schroepfer, Chair
State Bar of Texas, Tax Section

Enclosure

COMMENTS ON PROPOSED AMENDMENTS TO 34 TEX. ADMIN. CODE § 3.287

These comments on the proposed amendments to 34 Tex. Admin. Code § 3.287 ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Sam Megally, Chair of the State and Local Tax ("SALT") Committee of the Tax Section of the State Bar of Texas. The Committee on Government Submissions of the Tax Section of the State Bar of Texas has approved these Comments. Ira Lipstet, Vice-Chair of the Committee on Government Submissions, reviewed these Comments and made substantive suggestions on behalf of such Committee.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: December 7, 2017

I. INTRODUCTION

These Comments are in response to the publication of proposed amendments to 34 Tex. Admin. Code § 3.287, concerning exemption certificates (the "Proposed Amendments" or the "Proposal").

We recognize and appreciate the time and thoughtful work invested by the Comptroller's office in preparing the Proposed Amendments. We also appreciate the efforts of the Comptroller to survey existing authority and update existing rules. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Comptroller personnel in this endeavor.

II. COMMENTS REGARDING PROPOSED AMENDMENTS

A. We Recommend That Proposed Rule 3.287(e)(1) Be Limited to Divergent Use in Texas

The first sentence of Proposed Rule 3.287(e)(1) reads as follows:

> (1) When an item purchased under a valid exemption certificate is used in a taxable manner, whether the use is in Texas or outside the state, the purchaser is liable for payment of sales tax based on the value of the tangible personal property or taxable service for the period of time used.

We recommend that this sentence be revised to make clear that only divergent use in Texas results in the purchaser owing Texas sales tax, and only for the period of time the item is used in a divergent manner in Texas. Texas sales tax should not apply to an item purchased under a valid exemption certificate, subsequently moved outside of Texas, and only then used in a divergent manner, though use tax in the state to which the item was moved may apply.

B. We Recommend That Proposed Rule 3.287(d)(1) Be Revised To Clarify That Exemption Certificates Are Not Required in Certain Situations

Proposed Rule 3.287(d)(1) provides: "All gross receipts of a seller [~~retailer~~] are presumed subject to sales or use tax unless a valid and properly completed resale or exemption certificate is accepted by the seller. Resale certificates are addressed in detail in §3.285 of this title."

We are concerned that this language is overbroad inasmuch as it could create a presumption of taxability even in situations in which one is not appropriate. While we are mindful that the proposed change tracks the language of Texas Tax Code § 151.054(a), we believe if applied literally in the audit context, it could lead to significant (and perhaps essentially unenforceable) administrative burdens for taxpayers. For example, an exemption certificate is not needed to claim the occasional sale exemption. Furthermore, receipts from sales of non-taxable items—including services not specifically enumerated by statute—are simply excluded from sales tax. Requiring an exemption certificate for each of the myriad number of services transactions which occur that are not subject to Texas sales tax would not be practical.

Though the statute and the Proposed Rule refer to gross receipts of "sellers"—which, as defined in Texas Tax Code § 151.008, are persons engaged in the business of making sales of "taxable items"—it is not appropriate for the Comptroller to presume in all instances that the entirety of every seller's gross receipts are taxable; indeed, many "sellers" sell both taxable items and items that are excluded entirely from tax.

We recommend that Proposed Rule 3.287(d)(1) be revised to clarify that it applies only to (1) sales of taxable items (2) for which an exemption certificate is required to claim the exemption.

C. We Recommend That Proposed Rule 3.287(d)(4) Be Revised To Require Auditors To Document The Date on Which Exemption Certificates Were Provided

Proposed Rule 3.287(d)(4) requires the Comptroller to independently verify exemption certificates obtained after the start of an audit. A frequent point of contention in administrative hearings is determining the date on which a taxpayer obtained exemption certificates. In some cases, a taxpayer may assert that exemption certificates had been obtained prior to initiation of the audit and were available when the audit commenced. If the certificates were provided to the auditor at the beginning of the audit, that would demonstrate that they must have been obtained by the taxpayer earlier, and no independent verification should be required. However, we have experienced circumstances in which an auditor may later claim that the exemption certificates were provided after commencement of the audit, and the auditor therefore presumes the taxpayer must have obtained the certificates after the audit commenced. The effect of such a presumption is to subject the exemption certificates to independent verification. Consequently, the actual date the certificates were provided to the auditor may be critical in establishing whether an independent verification is required.

To facilitate resolution of these disputes, we recommend that Proposed Rule 3.287(d)(4) be revised to require an auditor to maintain documentation identifying the date on which the taxpayer provided an exemption certificate.

D. We Recommend That Proposed Rule 3.287(d)(4) Be Revised To Provide Guidance on The Verification Process When Exemption Certificates Are Obtained After An Audit Commences

Proposed Rule 3.287(d)(4) requires the Comptroller to independently verify exemption certificates obtained after the start of an audit and provided no later than 60 days after the date written notice requesting the certificates is received from the Comptroller. The Rule, however, does not provide any guidance on what procedures must be followed to conduct this required verification. The absence of standard procedures often leads to disparate treatment of taxpayers by auditors.

We recommend that Proposed Rule 3.287(d)(4) be revised to provide standard procedures for conducting an independent verification.

III. REQUEST FOR ROUNDTABLE DISCUSSION

Before proceeding to adopt the Proposal, we respectfully request that the Comptroller's office convene a roundtable discussion of interested taxpayers and practitioners to address issues relating to the Comptroller's efforts to update Rule 3.287. We would welcome the opportunity to participate in such a meeting.

IV. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these Comments provide relevant analysis for your review. Thank you for your consideration.

TAX SECTION OF
THE STATE BAR OF TEXAS

2017 – 2018 CALENDAR

July 2017	
Tuesday 07/04/17	**July 4th Holiday**
Monday 07/10/17	**Officer's Retreat** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010
Thur - Sat 07/13/17 – 07/15/17	**Texas Bar College** Summer School Moody Gardens Hotel Galveston, TX
Saturday 07/15/17	**Tax Section Budget Deadline** (Budget must be submitted to State Bar of Texas)
Tuesday 07/18/17	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00 a.m.
Monday 07/24/17	**SBOT Chair and Treasurer Training** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
August 2017	
Friday 08/04/17	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 (48th Floor) 10:30 a.m. – 12:30 p.m. w/lunch Dial In: 866-203-7023 Conference Code: 713-651-5591# Security Passcode: None – at the prompt press *
Thursday, 08/10/17	**Officer's Meeting** 4:00 p.m.

Thur – Tues 08/10/17 – 08/15/17	**American Bar Association Annual Meeting** New York Hilton Midtown, New York City, New York
Tuesday 08/15/17	**Government Submissions (COGS) Call with Committee Chairs** Dial –in: 800-525-8970; Conference Code 2143975538# Henry Talavera 9:00-9:30 a.m.
Thur – Fri 08/17/17 – 08/18/17	**Advanced Tax Law Course** Hilton Houston Post Oak, Houston, Texas
Sept 2017	
Friday 09/01/17	**Deadline for Submissions to State Bar of Texas Board of Directors Meeting Agenda**
Monday 09/04/17	**Labor Day Holiday**
Friday 09/15/2017	**Deadline for Appointment of Tax Section Nominating Committee**
Monday 09/15/17	**Submission Deadline – Texas Tax Lawyer (Fall Edition)** Submit to TTL Editor: Michelle Spiegel michelle.spiegel@nortonrosefulbright.com
Thur - Sat 09/14/17 – 0916/17	**American Bar Association Section of Taxation Joint Fall CLE Meeting** Hilton Austin, Austin Texas
Monday 09/18/17	**Tax Court Pro Bono Calendar Call-Houston**
Tuesday 09/19/17	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Wed - Fri 09/20/17 – 09/22/17	**Rosh Hashanah (Religious Holiday)**
Thursday 09/21/17	**Comptroller Annual Meeting Briefing** Either Travis building or Stephen F. Austin office building (venue to be established)
Wednesday 09/27/17	**Officer's Meeting** 4:00 p.m.
Fri - Sat 09/29/17 – 09/30/17	**Yom Kippur (Religious Holiday)**

Oct 2017	
Monday 10/02/17	**Tax Court Pro Bono Calendar Call-Dallas**
Thur - Fri 10/05/17 – 10/06/17	**Sukkot (Religious Holiday)**
Monday 10/09/17	**Columbus Day Holiday**
Thursday 10/12/17	**Officer's Meeting** 4:00 p.m.
Monday 10/16/17	**Tax Court Pro Bono Calendar Call-El Paso**
Tuesday 10/17/17	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Wednesday 10/18/17	**Outreach to Law Schools/SMU Dedman School of Law**
Thursday 10/19/17	**Tax Court Pro Bono Calendar Call-Lubbock**
Thursday 10/19/17	**Outreach to Law Schools/Texas Tech School of Law**
Sun - Wed 10/22/17 – 10/25/17	**Council on State Taxation (COST) 48th Annual Meeting** Orlando, Florida
Friday 10/27/17	**Council of Chairs Meeting** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
?	**National Association of State Bar Tax Sections ("NASBTS") Annual Meeting**
Monday 10/30/17	**Tax Court Pro Bono Calendar Call-Dallas**

Nov 2017	
Thursday 11/02/17	**20th Annual International Tax Symposium** Cityplace Events Dallas, TX 8:00 a.m.-5:00 p.m. followed by networking reception
Friday 11/03/17	**20th Annual International Tax Symposium** **Co-Sponsored with the University of Houston Law Center** University of Houston Student Center South, 4455 University Drive Houston, TX 77204 8:00 a.m.-5:00 p.m. followed by a networking reception
Wednesday 11/08/17	**Webinar "International Tax Law In A Day"** 8:30 a.m. – 2:00 p.m.
Thursday 11/09/17	**Webcast "International Tax Symposium"** 8:00 a.m. – 5:00 p.m.
Thursday 11/09/17	**Officer's Meeting** 4:00 p.m.
Friday 11/10/17	**Veterans Day Holiday**
Monday 11/13/17	**Tax Court Pro Bono Calendar Call-Houston**
Mon - Tues 11/13/17 – 11/14/17	**Austin Chapter CPA Annual Tax Conference**
Friday 11/17/17	**Meeting of Council** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 (Floor TBD) 10:30 a.m. – 12:30 p.m. w/lunch Dial In: 866-203-7023 Conference Code: 713-651-5591# Security Passcode: None – at the prompt press *
Friday 11/17/17	**Annual Meeting Deadline for submitting to SBOT date and time preferences for CLE programs, section meetings, council meetings, socials and special events**
Tuesday 11/21/17	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.

Thursday 11/23/17	**Thanksgiving Day Holiday**
Monday 11/27/17	**Tax Court Pro Bono Calendar Call-Dallas**
Dec. 2017	
Tuesday 12/12/17	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Tuesday 12/12/17	**COST Regional Meeting** Atlanta, Georgia
Wed - Fri 12/13/17 – 12/15/17	**UT Law Annual Taxation Conference**
Wed - Wed 12/13/17 – 12/20/17	**Chanuka (Other Holiday)**
Thursday 12/14/17	**Officer's Meeting** 4:00 p.m.
Monday 12/25/17	**Christmas (Other Holiday)**
Jan. 2018	
Monday 01/01/18	**New Year's Day Holiday**
Tuesday 01/02/18	**Nomination Period Opens for 2017 Outstanding Texas Tax Lawyer Award** • Nominations due April 1, 2018 • Nomination forms to be posted on website • Submit nomination forms to Tax Section Secretary: Charolette Noel
Monday 01/08/18	**Pro Bono Tax Court Calendar Calls-Houston and San Antonio**
Thursday 01/11/18	**Officer's Meeting** 4:00 p.m.
Friday 01/12/18	**Deadline for receipt of information for SBOT Board of Director's Meeting Agenda**
Friday 01/12/18	**Annual Meeting Deadline: Submit programming for the registration brochure, CLE topics, speakers, and speaker contact information and firms**

Monday 01/15/18	**Martin Luther King Jr. Day (Holiday)**
Friday 01/19/18	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 51st Floor (Crooker) 10:30 a.m. – 12:30 p.m. w/lunch Dial In: 866-203-7023 Conference Code: 713-651-5591# Security Passcode: None – at the prompt press *
Tuesday 01/23/18	**Application Period Opens for Law Student Scholarship Program**
Tuesday 01/23/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Friday 01/26/18	**Leadership Academy application due for the 2018-2019 class**
Friday 01/26/18	**Submission Deadline – Texas Tax Lawyer (Winter Edition)** Submit to TTL Editor: Michelle Spiegel michelle.spiegel@nortonrosefulbright.com
Feb. 2018	
Thursday 02/01/18	**Register and make guest room reservations for Annual Meeting (www.texasbar.com/annualmeeting)**
Monday 02/05/18	**Pro Bono Tax Court Calendar Call - Dallas**
Thursday 02/08/18	**Outreach to Law School/Texas A & M**
Friday, 02/09/18	**Tax Law in a Day CLE** Westin Oaks Galleria 5011 Westheimer Road Consulate Room – Third Floor of the Tower Houston, TX 77056
Thur - Sat 02/08/18 – 02/10/18	**American Bar Association Section of Taxation Midyear Meeting** Hilton San Diego, San Diego CA
?	**Leadership Academy Class of 2018-2019 Announced**
Monday 2/12/18	**Pro Bono Tax Court Calendar Call - Houston**

Thursday 02/15/18	**Officer's Meeting** 4:00 p.m.
Monday 02/19/18	**George Washington's Birthday (Holiday)**
Tuesday 02/20/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Wednesday 02/21/18	**International Fiscal Association Oil & Gas Meeting** Houston, Texas
Wednesday 02/21/18	**Outreach to Law School/Baylor Law School**
Thur - Fri 02/22/18 – 02/23/18	**International Fiscal Association Annual Conference** Houston, Texas
Friday 02/23/18	**Council of Chairs Meeting and Section Representative Election** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
Monday 02/26/18	**Pro Bono Tax Court Calendar Call – El Paso**
Wednesday 02/28/18	**Outreach to Law School / St. Mary's**
March 2018	
Thursday 03/01/18	**Nomination Deadline for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members**
Friday 03/02/18	**Annual Meeting Deadline: Order special awards, council and chair plaques, food and beverage and audio visuals**
Sun - Wed 03/04/18 – 03/07/18	**Annual Meeting of Unclaimed Property Professionals Organization (UPPO)** Tampa, Florida
Monday 03/05/18	**Pro Bono Tax Court Calendar Calls – Dallas and Houston**
Thursday 03/08/18	**Officer's Meeting** 4:00 p.m.
Monday 03/19/18	**Pro Bono Tax Court Calendar Call – San Antonio**

Tuesday 03/20/18	**Outreach to Law School/University of Texas**
Tuesday 03/20/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Wednesday 03/21/18	**Federal Tax Workshop** Presented by the State Bar of Texas Tax Section / Texas Federal Tax Institute / Dallas Bar Association Tax Section Bolo Mansion, Pavilion West Ballroom 2101 Ross Avenue Dallas, TX 75201
Wednesday 03/21/18	**2018 State Bar of Texas Property Tax Committee Meeting & Legal Seminar** Thompson Conference Center University of Texas Austin, Texas
Wednesday, 03/28/18	**Outreach to Law Schools/University of Houston**
Thur 03/29/18	**Outreach to Law Schoosl/Texas Southern University**
Fri – Sun 03/30/18 – 04/01/18	**Good Friday, Passover, Easter Sunday (Religious Holiday)**
April 2018	
Monday 04/02/18	**Nominations for Outstanding Texas Tax Lawyer Due to Charolette Noel** Email**:** (cfnoel@jonesday.com)
Monday 04/02/18	**Law Student Scholarship Application Deadline**
Monday 04/2/18	**Nominating Committee Report Due to Council**
Tuesday, 04/3/18/	**Outreach to Law Schools/South Texas College of Law**
Wednesday, 04/4/18	**Outreach to Law School/University of North Texas, Dallas**
Thursday 04/12/18	**Officer's Meeting** 4:00 p.m.
Friday 04/13/18	**Submission Deadline – Texas Tax Lawyer (Spring Edition)** Submit to TTL Editor: Michelle Spiegel michelle.spiegel@nortonrosefulbright.com

Monday 04/16/18	**Tax Court Pro Bono Calendar Call-Dallas**
Tuesday 04/17/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Friday 04/20/18	**Meeting of Council** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 10:30 a.m. – 12:30 p.m. w/lunch Dial In: 866-203-7023 Conference code: 713-651-5591# Security passcode: None - at the prompt press * Note: Council Vote and Selection of Recipient of 2017 Outstanding Texas Tax Lawyer Award
Friday 04/20/18	**Council Vote and Selection of Recipient of 2017 Outstanding Texas Tax Lawyer Award**
Friday 04/27/18	**Annual Meeting Deadline: course materials for app; CLE articles, PowerPoints, speaker bios and photos**
May 2018	
Thur - Sat 05/10/18 – 05/12/18	**American Bar Association Section of Taxation May Meeting** Grand Hyatt, Washington, DC
Tuesday 05/15/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Thursday 05/17/18	**Officer's Meeting** 4:00 p.m.
Monday 05/28/18	**Memorial Day Holiday**
June 2018	
?	**Annual Texas Federal Tax Institute** Hyatt Hill Country Resort San Antonio, TX
Thursday 06/14/18	**Officer's Meeting** 4:00 p.m.

Tuesday 06/19/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970 Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Thur - Fri 06/21/18 – 06/22/18	**SBOT Annual Meeting** Marriott Marquis Hotel 1777 Walker Street Houston, TX 77010 (713) 654-1777
Thursday 06/21/18	**Tax Section Council Planning Retreat** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, TX 77010 Crooker Conference Room 51st Floor 12:00 p.m. - 4:30 p.m.
Thursday 06/21/18	**2018 Tax Section Annual Meeting Speaker's Dinner** Grappino's 2817 W. Dallas Street Houston, TX (713) 528-7002
Thursday 06/21/18	**Presentation of Outstanding Texas Tax Lawyer** Award Presentation at State Bar Annual Meeting, Speakers' Dinner Grappino's 2817 W. Dallas Street Houston, TX (713) 528-7002
Friday 06/22/18	**2018 Tax Section Annual Meeting Program** Marriott Marquis Hotel 1777 Walker Street Houston, TX 77010 (713) 654-1777
Friday 06/22/18	**Presentation of 2018 Tax Legend Award** Award Presentation During Tax Section Annual Meeting Program Marriott Marquis Hotel 1777 Walker Street Houston, TX 77010 (713) 654-1777

TAX SECTION

STATE BAR OF TEXAS

LEADERSHIP ROSTER

2017-2018

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TAX SECTION
THE STATE BAR OF TEXAS
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2017-2018

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