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
May 2, 2018

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I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

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

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

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

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

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

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

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

E. **Depreciation & Amortization**

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

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

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—
>
> > (1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
> >
> > (2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,
>
> shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation arrangement).

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

a. **"The problem with the view that Section 1234A should be understood to reach Section 1231 property is that *the Code's plain language flatly forecloses it*," says the Eleventh Circuit.** CRI-Leslie, LLC v. Commissioner, 882 F.3d 1026 (11th Cir. 2/15/18), *aff'g* 147 T.C. 217 (9/7/16). In a relatively brief but well written and even entertaining opinion by Judge Newsom, the U.S. Court of Appeals for the Eleventh Circuit affirmed the Tax Court's decision. The court recognized that, had the sale of the hotel gone through as planned, the taxpayer's gain from the sale would have been a § 1231 gain and therefore eligible to be classified as long-term capital gain.

Because the sale did not go through, however, the characterization of the taxpayer's gain was governed by § 1234A. Pursuant to § 1221(a)(2), the court reasoned, assets that are "property used in the trade or business" and therefore subject to § 1231 are expressly excluded from the category of capital assets. The plain langauage of § 1234A, the court emphasized, makes clear that it applies only to termination of rights with respect to a capital asset. "If, as CRI-Leslie acknowledges, the hotel isn't a 'capital asset' within the meaning of Section 1221, then Section 1234A's special rule … simply doesn't apply. That's it. End of case." The court rejected the taxpayer's argument that, although the language of § 1234A refers only to capital assets, Congress intended that § 1234A provide taxpayers with the same tax treatment whether the underlying property is sold or the contract to which the property is subject is terminated. The taxpayer emphasized portions of the legislative history of § 1234A in which Congress cited cases the result of which would be changed by § 1234A. These cases involved property subject to § 1231. The court acknowledged that the taxpayer's argument was "not without foundation" and seemed "to have attracted some scholarly supporters. *See*, *e.g.*, Boris I. Bittker, Martin J. McMahon & Lawrence Zelenak, *Federal Income Taxation of Individuals* ¶ 32.01[4][b] … ." But the court ultimately declined to adopt this view. "In a contest such as we have here, between clear statutory text and (even compelling) evidence of sub- or extra-textual 'intent,' the former must prevail."

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

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

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

3. **Warning: This case hot out of La La Land involving the short sale of a personal residence converted to rental property may short circuit your brain!** Simonsen v. Commissioner, 150 T.C. No. 8 (03/14/18). In a one-of-a-kind case of first impression interpreting an *almost* one-of-a-kind regulation, the Tax Court (Judge Holmes) ruled that both the IRS and the taxpayer got it wrong, so neither won. The case involved (1) a short sale of a principal residence converted to rental property, (2) satisfaction of a recourse mortgage that is treated as nonrecourse debt for federal income tax purposes due to a unique provision of California law, and (3) arcane tax regulations that result in neither gain nor loss being recognized upon a disposition of property. In other words, this is the kind of case that only pointed-headed tax professors like us can love!

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

The taxpayers' mistakes. For reasons that do not require elaboration, but in part due to the Forms 1099 received, the taxpayers mistakenly, but honestly, reported the short sale and the discharge of indebtedness on their 2011 federal income tax return as two separate transactions. This in turn led to the taxpayers erroneously reporting a $216,000 (approximately) loss deduction under § 165 and $219,000 (approximately) of excludible cancellation of indebtedness income under § 108(a)(1)(E) (qualified principal residence indebtedness). The taxpayers also made another mistake concerning the tax treatment of the short sale. California has an anti-deficiency statute applicable to certain owner-occupied residential real property. Thus, a lender may be able to foreclose on protected residential real property, but the lender cannot pursue a deficiency judgment if the value of the property is less than the principal amount of the debt. Therefore, due to California law, certain home mortgage indebtedness is treated as nonrecourse debt for federal income tax purposes even though it is treated as recourse debt for all other purposes.

The IRS's mistake. After auditing the taxpayers' 2011 federal income tax return, the IRS combined the short sale and discharge of indebtedness into one transaction, which is the correct approach under *2925 Briarpark, Ltd. v. Commissioner*, 163 F.3d 313 (5th Cir. 1999), *aff'g* T.C. Memo 1997-298. Accordingly, the IRS treated the taxpayers as having an amount realized on the short sale of approximately $566,000, but no discharge of indebtedness income. If the mortgage was nonrecourse indebtedness for federal income tax purposes, treating the entire principal amount of the debt as the amount realized is the correct approach under *Crane v. Commissioner*, 331 U.S. 1 (1947). At this point, though, the IRS's analysis went awry. The IRS, citing Reg. § 1.165-9(b)(2) (adjusted basis for loss purposes with respect to personal use property converted to rental property), treated the taxpayers' adjusted basis in the property at the time of sale as being only $495,000, the property's fair market at the time it was converted to rental property less allowable depreciation. Hence, the IRS's view was that the taxpayers actually had gain from the short sale (amount realized of $566,000 less adjusted basis of $495,000). This analysis (after denying the § 165 loss and taking into account the gain) led to a deficiency assessment against the taxpayers of $70,000 for 2011, which prompted the taxpayers to file a petition in Tax Court. The IRS's mistake was that it failed to consider the difference between the taxpayers' adjusted basis for determining gain and their adjusted basis for determining loss under Reg. § 165-9(b)(2), as Judge Holmes explained in his opinion.

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

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

V. PERSONAL AND INDIVIDUAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

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

1. **A taxpayer with four years of significant losses from a ranch in Texas prevailed in establishing that the activity was engaged in for profit.** Welch v. Commisioner, T.C. Memo. 2017-229 (11/20/17). The taxpayer had a B.S. degree in agricultural economics, a Ph.D from the University of Chicago in economics, and served as an economics professor for forty years at

several institutions, including the University of Chicago, Southern Methodist University, and UCLA. He had a number of business ventures. In 1987 he began purchasing land near Centerville Texas, and eventually developed it into an 8,700-acre ranch with 25 full-time employees. The activities at the ranch were extensive and consisted primarily of a cattle operation, a hay operation, and a horse operation. The taxpayer invested $9.6 million of his own funds as capital for the horse operation. He devoted about two-thirds of his assets and 80 percent of his annual income to the ranch, where he spent Thursday to Sunday of each week. The ranch incurred losses ranging from $2 million to $4 million in the years 2007 through 2010. The IRS disallowed the losses under § 183 on the basis that the taxpayer had not engaged in the ranch activity for profit. The Tax Court (Judge Paris) examined the factors set forth in Reg. § 1.183-2 as well as those developed in judicial decisions and concluded that the taxpayer had engaged in the ranching activity as a for-profit activity during the years in issue. Judge Paris concluded, among other things, that the taxpayer had operated the ranch in a business-like manner, had expertise and had surrounded himself with competent advisors and employees, and expended significant time and effort on the activity. She cautioned, however, that "the Court is not declaring Center Ranch a for-profit activity ad infinitum. If Center Ranch's future losses cannot be reined in, petitioner may again find his profit motives before this Court."

D. Deductions and Credits for Personal Expenses

E. Divorce Tax Issues

F. Education

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

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

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

The Sixth Circuit's decision (Summa (II)). In an opinion by Judge Sutton, the U.S. Court of Appeals for the Sixth Circuit reversed.[1] The court emphasized that "[t]he Internal Revenue Code allowed Summa Holdings and the Benensons to do what they did." The issue was whether the 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

[1] Although the Tax Court had both disallowed Summa Holdings' deductions for the commissions paid to the DISC and upheld imposition of the 6 percent excise tax of § 4973 on the deemed excess Roth IRA contributions made by Summa Holdings' shareholders, Summa Holdings appealed to the Sixth Circuit only the disallowance of its deductions. The shareholders have appealed to the First and Second Circuits the issue whether they made excess Roth IRA contributions. Those appeals are currently pending.

option. The court concluded that the IRS's recharacterization of Summa Holding's transactions as dividends followed by Roth IRA contributions did not capture economic reality any better than the taxpayer's chosen structure of DISC commissions followed by dividends to the DISC's shareholders.

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

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

Notably, though, the Tax Court declined to impose penalties on the taxpayers because they relied on independent professional advice in connection with setting up the FSC and their Roth IRAs.

- *Dissenting opinion.* Four Judges (Holmes, Foley, Buch, and Morrison) dissented, with some joining only parts of the dissenting opinion written by Judge Holmes. Judge Holmes reasoned that the majority should have followed the Sixth Circuit's decision in *Summa Holdings* instead of engaging in "judge-made doctrine." In our view, Judge Holmes's dissenting opinion is both entertaining and insightful, summing up the conflicting opinions in *Summa I*, *Summa II*, and *Mazzei* as follows: "What's really going on here is that the Commissioner doesn't like that the Mazzeis took two types of tax-advantaged entities and made them work together." Judge Holmes also aptly observed:

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

and decide the cases based on his views of the statute's intent, not the Code's plain language.

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

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

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

1. **The IRS has finally recognized that partnership returns are filed electronically. Section 754 elections no longer require a partner's signature.** REG-116256-17, Streamlining the Section 754 Election Statement, 82 F.R. 47408 (10/12/17). If a partnership wishes to make a § 754 election, the current regulations (Reg. § 1.754-1(b)) require the partnership to attach to its return a written statement that (i) sets forth the name and address of the partnership making the election, (ii) is signed by one of the partners, and (iii) contains a declaration that the partnership elects under § 754 to apply the provisions of §§ 734(b) and 743(b). Many partnership returns are filed electronically with § 754 elections that, in the IRS's view, do not comply with the requirement that the election be signed by one of the partners. As a result, the IRS has received many requests for so-called "9100 relief" to make a late § 754 election. In these proposed regulations, the IRS proposes to eliminate the requirement that a partnership's § 754 election be signed by one of the partners. Pursuant to these amendments, a § 754 election must comply only with the other two requirements to be a valid election. This change will be effective upon the publication of final regulations in the Federal Register, but the preamble to the proposed regulations states that taxpayers can rely on these proposed amendments now. Therefore, partnerships filing their returns electronically with an otherwise valid § 754 election need not request 9100 relief.

F. Partnership Audit Rules

G. Miscellaneous

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. **Successful private colleges and universities really must be in the dog house because, in addition to taxing them for highly-paid coaches, Congress has decided to tax their endowments too! And, just to keep us on our toes, the legislative history says the statute turns on the number of an institution's "tuition paying" students, but § 4968 simply reads "students."** The 2017 Tax Cuts and Jobs Act, § 13701, adds § 4968 which imposes a new 1.4 percent annual excise tax upon the net investment income of certain private colleges and universities and affiliated organizations with endowments worth $500,000 or more per full-time student. The excise tax imposed by new § 4968 is similar in many respects to the annual excise tax imposed upon

private foundations under § 4940. In particular, new § 4968 applies to an "applicable educational institution" which is defined as institution: (i) that is an "eligible educational institution" as described in § 25A(f)(2) (which in turn refers to 20 U.S.C. § 1088); (ii) that has at least 500 students during the preceding taxable year more than 50 percent of which are in the U.S.; (iii) that is not described in the first section of § 511(a)(2)(B) (state colleges and universities); and (iv) that has assets (other than assets used directly in carrying out the institution's exempt purpose) with an aggregate fair market value as of end of the preceding taxable year of at least $500,000 per student. For this latter purpose, the number of students of an institution is based on the daily average number of full-time students attending the institution, with part-time students taken into account on a full-time student equivalent basis. Moreover, the legislative history of new § 4968 states that the $500,000 per student figure should be calculated based upon "tuition paying" students; however, the Senate Parliamentarian struck that language from § 4968 immediately before it was passed by the House and Senate. Whether regulations can fill in the gap is anybody's guess. New § 4968 is permanent and effective for taxable years beginning after 2017, again giving fiscal-year private colleges and universities time to cope.

a. Students negotiating for scholarships at private colleges and universities now have a little more leverage. The 2017 Tax Cuts and Jobs Act, § 13701, added § 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. As originally passed late in 2017, new § 4968 taxed private colleges and universities (and affiliates) with endowments worth $500,000 or more per "student" (as defined in the statute to account for full and part-time students); however, the legislative history of new § 4968 stated that the $500,000 per student figure should be calculated based upon "tuition-paying" students. The discrepancy between the statute and the legislative history was created because the Senate Parliamentarian struck the "tuition-paying" language from § 4968 immediately before the 2017 Tax Cuts and Jobs Act ultimately was passed by Congress. Thanks to the Bipartisan Budget Act of 2018, § 41109, though, § 4968 is amended to include the "tuition-paying" modifying language. Thus, only those private colleges and universities (and affiliates) with endowments worth $500,000 or more per tuition-paying student will be subject to the new 1.4 percent annual excise tax. In other respects, the excise tax imposed by new § 4968 is similar 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 an 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 tuition-paying 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. New § 4968 is permanent and effective for taxable years beginning after 2017, again giving fiscal-year private colleges and universities time to cope.

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

3. **Well, the IRS doesn't call it an "F" reorg, but that's what tax-exempts can do after this ruling.** Rev. Proc. 2018-15 , 2018-9 I.R.B. 379 (02/08/18). Obsoleting Rev. Rul. 67-390 and Rev. Rul. 77-469, the IRS has ruled in Rev. Proc. 2018-15 that reincorporations, redomestications, and certain other corporate restructurings involving exempt organizations do not require a new application for exemption (Form 1023) by the surviving entity. Under Rev. Proc. 2018-15, a "corporate restructuring" of a § 501(c) organization means "incorporation under the laws of a state, reincorporation of a corporation incorporated under the laws of one state under the laws of a different state, filing articles of domestication for a corporation incorporated under the laws of one state under the laws of a different state, or a statutory merger of one corporation with and into another corporation." If a § 501(c) organization engages in such a corporate restructuring after January 1, 2017, and the surviving organization is (1) a domestic business entity; (2) classified as a corporation under § 301.7701-2(b)(1) or (2); and (3) carries out the same purposes as the exempt organization that engaged in the corporate restructuring, then it does not need to file a new exemption application (Form 1023) with the IRS. Further, for § 501(c)(3) organizations (the most common type of tax-exempts under § 501(c)), the articles of organization of the surviving organization must continue to meet the organizational test of Reg. § 1.501(c)(3)-1(b), including § 1.501(c)(3)-1(b)(4) (regarding dedication of assets to exempt purposes). Thus, qualifying incorporations, reincorporations, redomestications, and mergers of most § 501(c) entities effectively are treated as "F" reorganizations, allowing the organization to continue its exempt status merely by notifying the IRS on the organization's annual Form 990. The organization's tax identification number also remains the same. Finally, Rev. Proc. 2018-15 does not apply to any corporate restructuring in which (1) the restructuring organization or the surviving organization is a disregarded entity, limited liability company, partnership, or foreign business entity; or (2) the surviving organization obtains a new EIN.

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

4. **The Tax Court has held that referral fees paid to an exempt organization by a debt collection firm are subject to UBIT because the fees were neither "royalties" nor for services "primarily for the convenience" of the organization's hospital-members.** New Jersey Council of Teaching Hospitals v. Commissioner, 149 T.C. No. 22 (12/20/17). The taxpayer was a § 501(c)(3) tax-exempt supporting organization that facilitated the common charitable activities of its members. The taxpayer's members were tax-exempt teaching hospitals in New Jersey. The taxpayer's revenue consisted of annual dues paid by its hospital-members for educational programs and other healthcare-related activities, as well as certain payments received from third parties that contracted with the taxpayer and the taxpayer's hospital-members. Essentially, the taxpayer would endorse certain third parties providing services to hospitals, and if a hospital-member contracted with the third party, then the taxpayer would receive specified payments from the third party. These third-party payments derived from credit card programs, internet providers, research and polling services, equipment maintenance firms, transportation providers, debt collection agencies, and group purchasing arrangements. The Service audited the taxpayer for the years 2004 through 2007, and determined that certain of the third-party payments received by the taxpayer constituted unrelated

business income. Specifically, the Service contended that payments received by the taxpayer from a debt-collection agency and a group purchasing program during the years at issue were taxable as unrelated business income. Accordingly, the Service determined that the taxpayer had a total UBIT deficiency of approximately $820,000 attributable to the years 2004 through 2007. The taxpayer contended, alternatively, that the payments from the debt collection agency were either "royalties" (excluded from UBIT by § 512(b)(2)), or from an activity conducted "primarily for the convenience" of the taxpayer's hospital-members (excludable because under § 513(a)(2) such an activity is not considered an unrelated trade or business). With respect to the payments received from the group purchasing arrangement, the taxpayer did not argue the "royalty" exception applied, but the taxpayer did argue that the "primarily for convenience" exception applied. The Tax Court (Judge Lauber) held for the IRS with respect to both types of payments. Regarding the taxpayer's contention that the payments from the debt collection agency were "royalties," Judge Lauber pointed to the taxpayer's agreement with the agency. The agreement did not purport to license any part of the taxpayer's intellectual property and, in fact, was labeled a "Service Agreement." Regarding the taxpayer's contention that even if the "royalty" exception did not apply, both the debt collection agency and group purchasing payments should be excluded from UBIT as revenue from an activity conducted "primarily for the convenience" of its hospital-members, Judge Lauber also agreed with the Service. Judge Lauber determined, based upon examples in the regulations as well as prior judicial decisions, that the "convenience" exception is targeted toward minor revenue-producing activities conducted by tax exempt organization for the benefit of individual members, employees, students, patients, etc. of the organization (e.g., on-campus bookstore, hospital pharmacy). Judge Lauber determined that the "convenience" exception should not apply to a revenue-generating service that addresses needs of institutional members of an exempt organization outside the core mission (in this case facilitating undergraduate and graduate education in teaching hospitals and innovative, efficient healthcare delivery) of the exempt organization. (In this latter regard, Judge Lauber cited several cases upholding the Service's position that payments made by insurance companies to trade associations whereby members purchase insurance are UBIT.) Finally, Judge Lauber reasoned that even if the taxpayer was correct that the payments from the debt collection agency and from the group purchasing arrangement made such third-party services more affordable and thereby "convenient" for its hospital-members, the taxpayer's dominant motive for obtaining the payments (over $2.2 million from 2004 to 2007) was revenue, not "primarily" for the convenience of its hospital-members.

B. Charitable Giving

X. TAX PROCEDURE

A. Interest, Penalties and Prosecutions

1. A majority of the Tax Court refuses to call a procedural foot-fault on the IRS, but not all the judges see it that way. Graev v. Commissioner, 147 T.C. No. 16 (11/30/16), *opinion vacated*, No. 30638-08 (U.S. Tax Court 3/30/17). The taxpayers had claimed a charitable contribution deduction for the donation of a facade conservation easement that ultimately was disallowed by the Tax Court (140 T.C. 377 (2013)). The IRS examining agent determined that the taxpayers were liable for the § 6662(h) 40 percent gross valuation misstatement penalty, and he prepared a penalty approval form for which he obtained written approval from his immediate supervisor. On that form only the § 6662(h) 40 percent penalty was asserted. The agent prepared a notice of deficiency that included the 40 percent penalty. However, before the notice of deficiency was issued, a Chief Counsel attorney reviewed a draft and, through a memorandum approved by his supervisor, the attorney advised that an alternative § 6662(a) 20 percent accuracy-related penalty should be added to the notice. The notice of deficiency was revised to include the 20 percent § 6662(a) accuracy-related penalty, the calculation of which in the notice of deficiency yielded a zero 20 percent penalty to avoid stacking with the 40 percent penalty. The notice of deficiency was issued as revised, but the revised notice with the alternative 20 percent penalty was not reviewed or approved by the examining agent's supervisor. After the IRS conceded that the 40 percent gross valuation misstatement penalty did not apply, it asserted the alternative 20 percent accuracy-related penalty as a non-zero amount, since the stacking issue no longer existed. The taxpayers argued that, because the notice of deficiency showed a zero amount for the § 6662(a) 20 percent penalty, the IRS failed to comply with the requirements of § 6751(a), which requires that a computation of the penalty be included in the notice of deficiency, and § 6751(b), which requires that the "initial determination of ... [the] assessment" of the penalty be "personally approved (in writing) by the immediate supervisor ... or such higher level official as the Secretary may designate," and that these failures barred assessment of the 20 percent penalty. In a reviewed opinion by Judge Thornton, the Tax Court (9-3-5) held that: (1) the notice of deficiency complied with the requirements of § 6751(a); (2) because the penalty had not yet been assessed, the taxpayers' argument that the IRS failed to comply with § 6751(b)(1) was premature; and (3) the 20 percent accuracy-related penalty for a substantial understatement applied. With respect to the first holding, regarding compliance with § 6751(a), the court reasoned as follows:

> The notice of deficiency clearly informed petitioners of the determination of the 20% penalty (as an alternative) and clearly set out the computation (albeit reduced to zero, as it had to be then, to account for the greater 40% penalty). The notice of deficiency thus complied with section 6751(a).
>
> Moreover, even if petitioners were correct that the IRS failed to include a computation of a penalty as required by section 6751(a), such a failure would not invalidate a notice of deficiency. In similar contexts this Court has held that procedural errors or omissions are not a basis to invalidate an administrative act or proceeding unless there was prejudice to the complaining party.

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

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

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

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

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

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

- In a lengthy opinion, Judge Holmes concurred in the result only. Judge Holmes advocated deciding this case under the rule of *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), pursuant to which the court applies the precedent of the U.S. Court of Appeals to which its decision can be appealed. Judge Holmes predicted that, by adopting the holding and reasoning of the Second Circuit in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 3/20/17), the majority decision will give rise to difficult issues of interpretation and "will even end up harming taxpayers unintentionally."

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

2. **♫♪Don't do the crime if you can't do the time."♫♪ Well, at least you won't have to pay interest or late-payment penalties on the restitution you pay.** Klein v. Commissioner, 149 T.C. No. 15 (10/3/17). The taxpayers, a married couple, pleaded guilty to filing a false tax return in violation of § 7206(1). They were sentenced to time in prison (27 months and 63 months) and ordered to pay to the IRS restitution with respect to the years 2003 to 2006 of more than $562,000. The U.S. District Court that sentenced the taxpayers rejected their arguments that the tax loss calculation on which the restitution was based did not take into account all allowable deductions and that the actual tax loss to the government was approximately $22,000. Pursuant to § 6201(4), the IRS assessed the full amount of restitution that had been ordered (more than $562,000) and the taxpayers ultimately paid it. The IRS also assessed interest and late-payment penalties on the restitution, both calculated beginning on the original due dates of the taxpayers' returns for 2003 through 2006. The IRS subsequently filed against each of them a notice of federal tax lien based on the interest and late-payment penalties, in response to which the taxpayers requested a collection due process hearing. In the CDP hearing, the taxpayers did not request a collection alternative and instead argued that they had paid the full amount of restitution that had been ordered. The IRS issued a notice of determination upholding the notices of federal tax lien, and the taxpayers sought review of the notice of determination in the Tax Court. The Tax Court (Judge Lauber), ruling on cross-motions for summary judgment, first held that, because the taxpayers had not received a notice of deficiency or otherwise had the opportunity to dispute the underlying tax liability (the interest and late-payment

penalties), § 6330(c)(2)(B) did not bar the taxpayers from disputing the underlying tax liability in the CDP hearing. Because the taxpayers were contesting the underlying tax liability, the court's standard of review was not abuse of discretion, but rather de novo. The court went on to hold that the relevant statutes did not permit the IRS to assess interest or additions to tax for late payment with respect to restitution ordered in a criminal proceeding. Section 6601(a) provides that interest shall be paid "[i]f any amount of tax imposed by this title … is not paid on or before the last date prescribed for payment" Section 6651(a)(3) imposes an addition to tax of .5 percent per month when there is a failure "to pay any amount in respect of any tax required to be shown on a return" within a specified time period. The provision that authorizes the IRS to assess restitution (§ 6201(4)), the court explained, permits the IRS to

> assess and collect the amount of restitution under an order pursuant to section 3556 of title 18, United States Code, for failure to pay any tax imposed under this title *in the same manner as if such amount were such tax* (emphasis added).

The language of (§ 6201(4)), the court concluded, makes clear that "[t]he amount of restitution is not a 'tax imposed by' title 26." Therefore, an assessment of restitution does not trigger interest under § 6601(a) or an addition to tax for late payment under § 6651(a)(3). The court rejected the IRS's argument that the legislative history of § 6201(4) supports a contrary conclusion. According to the court, the legislative history suggests that Congress's purpose in enacting § 6201(4) in 2010 was to allow the IRS to assess restitution simply as a mechanism to create an account receivable against which a taxpayer's payment of restitution could be credited. The court pointed out that the IRS can collect interest and late-payment penalties if it undertakes an audit to determine the taxpayers' civil tax liabilities for the years in question, which might be either lower or higher than the amount of restitution paid. As of the date of the court's opinion, the IRS had not begun audit procedures.

- In Muncy v. Commissioner, T.C. Memo. 2017-83 (5/17/17), the Tax Court similarly examined the language in § 6201(4) and concluded that the amount of any deficiency (as defined in § 6211(a)) for a tax year is not reduced by any criminal restitution paid. In that decision, 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."

B. Discovery: Summons and FOIA

C. Litigation Costs

D. StatutoryNotice of Deficiency

E. Statute of Limitations

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

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

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

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

F. Liens and Collections

G. Innocent Spouse

H. Miscellaneous

1. The Tax Court has concluded that "the excess of A over B" can be a negative number when B is larger than A. Galloway v. Commissioner, 149 T.C. No. 19 (10/17/17). The taxpayers, a married couple, claimed in 2011 the American Opportunity Credit provided by § 25A for postsecondary educational expenses with respect to each of three children. They claimed a credit of $2,500 with respect to each child, or a total of $7,500. They determined the amount of their credit on Form 8863, which was attached to their return. However, they mistakenly included on Form 1040 only the $3,000 refundable portion of the credit and omitted the $4,500 nonrefundable portion. Their return showed tax liability of $6,984 reduced by the $3,000 credit, or $3,984. The taxpayers also had $8,287 withheld from their wages, which meant that they claimed a refund of $4,303. In the course of processing the return, the IRS adjusted their tax liability to take into account the $4,500 nonrefundable portion of the credit. The IRS calculated their tax liability as $6,984 - $4,500 nonrefundable credit, or $2,484, reduced by both the $3,000 refundable portion of the educational credit and their withholding of $8,287, which resulted in the IRS issuing a refund to the taxpayers of

$8,803. The IRS later disallowed the educational credits, determined a deficiency of $7,500, and imposed an accuracy-related penalty of $1,500. The taxpayers ultimately conceded that they were not entitled to any educational credits. The issue was the amount of the taxpayers' deficiency for 2011. The Tax Court (Judge Halpern) held that their deficiency was $7,500. The term "deficiency" is defined in § 6211(a) as "the amount by which the tax imposed … exceeds the excess of (1) the amount shown as the tax by the taxpayer upon his return … plus the amounts previously assessed (or collected without assessment) as a deficiency, over (2) the amount of rebates … made." Section 6211(b)(4) directs that, in determining the amount of a deficiency, the amount by which certain credits (including the refundable portion of the credit at issue here) exceed the amount of tax shown on the return must be treated as negative amounts of tax. The IRS calculated the taxpayers' deficiency as the amount by which the $6,984 tax imposed exceeded the excess of (1) the $3,984 shown as the tax due on the return over (2) the $4,500 rebate made by the IRS (the nonrefundable portion of the education credits). The IRS's position was that the excess of $3,984 over $4,500 is a negative number (-$516), and therefore the taxpayers' deficiency was the amount by which the $6,984 tax imposed exceeded -$516, which is $7,500. After reviewing its prior decisions in analogous situations and the relevant statutory provisions, the court agreed with the IRS's position. The court rejected the taxpayers' argument that the excess of tax shown due on the return over rebates can be a negative number only when no rebate exists. The court also upheld the IRS's imposition of an accuracy–related penalty under § 6662(a) and (b)(2) for a substantial understatement of income tax. The definition of "understatement" in § 6662(d)(2)(A) is similar to (but not the same as) the definition of "deficiency." The court concluded that the taxpayers had an understatement of $7,500, which was a "substantial" understatement because it exceeded the greater of 10 percent of the $6,984 tax required to be shown on the return or $5,000. Finally, the court rejected the taxpayers' reasonable, cause, good faith defense to the penalty because, according to the court, the taxpayers had already claimed the American Opportunity Credit for each of their children for the first four years of post-secondary education, and the forms and instructions on which they relied clearly provided that the credit is not available for a fifth year.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

B. Self-employment Taxes

C. Excise Taxes

XII. TAX LEGISLATION

A. Enacted

XIII. TRUSTS, ESTATES & GIFTS