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

1. What are a professional sports team's player contracts really worth? Nothing, says the IRS. Rev. Proc. 2019-18, 2019-18 I.R.B. 1077 (4/11/19). In this revenue procedure, the IRS has provided a safe harbor for a professional sports team to treat certain personnel contracts (including those of players, managers, and coaches) and rights to draft players as having a zero value for purposes of determining gain or loss to be recognized for federal income tax purposes from the trade of a personnel contract or a draft pick. The IRS provided this safe harbor in recognition of the fact that the value of professional sports personnel contracts fluctuates and is highly subjective. The safe harbor is designed to "avoid highly subjective, complex, lengthy, and expensive disputes between professional sports teams and the IRS regarding the value of personnel contracts" and the resulting amount of gain or loss from their disposition. The revenue procedure apples to trades after April 10, 2019, but teams can choose to apply the revenue procedure to any open year. To be eligible for the safe harbor, a professional sports team's trade of personnel contracts and draft picks must meet four requirements: **(1)** all parties to the trade that are subject to federal income tax in the U.S. must treat the trade in a manner consistent with the revenue procedure; **(2)** each team that is a party to the trade must trade a personnel contract or a draft pick and no party to the trade may transfer property other than a personnel contract, draft pick, or cash; **(3)** no personnel contract or draft pick traded is an amortizable § 197 intangible; and **(4)** the financial statements of the teams that are parties to the trade do not reflect assets or liabilities resulting from the trade other than cash. If the safe harbor applies to a trade, then the following five principles govern the tax treatment of the trade:

1. *Gain or loss generally not recognized.* Except the extent required by the fifth principle (below), a team making a trade within the safe harbor does not recognize gain or loss from the trade. (As described below, a team must recognize any gain or loss realized if it receives cash in the trade.)
2. *Only cash received is included in a team's amount realized.* A team that receives cash in a trade must include the cash in amount realiz d. Because personnel contracts and draft picks are treated as having a value of zero, a team that receives only these assets has an amount realized of zero.
3. *A team's basis in personnel contracts and draft picks received includes only cash provided.* A team that provides cash in exchange for personnel contracts or draft picks has a basis in the assets acquired equal to the cash provided. A team that provides only personnel contracts or draft picks has a basis in the assets received of zero.
4. *Cash provided must be allocated equally to personnel contracts or draft picks received.* A team that provides cash and receives more than one personnel contract or draft pick must determine its basis in the assets acquired by allocating the cash equally among the assets acquired.
5. *A team determines its gain or loss recognized by comparing its amount realized with the unrecovered basis of any personnel contracts and draft picks provided.* A team making a trade within the safe harbor must recognize gain or loss to the extent its amount realized (as determined under the second principle) exceeds or falls below its unrecovered basis in the personnel contracts and draft picks it provides. The character of any gain or loss recognized is determined under the normal rules, e.g., a team's gain or loss might be a § 1231 gain or loss and any gain a team recognizes might be ordinary under § 1245.

The revenue procedure provides the following four examples:

Example 1—Trade with no cash.

1. In 2018, Team A trades Player Contract 1 to Team B for Player Contract 2. The teams apply the safe harbor in this revenue procedure.
2. Neither Team A nor Team B has an amount realized or gain on the trade because neither team received cash in the trade. Team A has a $0 basis in Player Contract 2, and Team B has a $0 basis in Player Contract 1.

Example 2—One team provides cash in the trade.

1. The facts are the same as in Example 1, except Team A trades Player Contract 1 and $10x to Team B for Player Contract 2.
2. Team A has no amount realized or gain on the trade because Team A did not receive cash in the trade. Team A has a $10x basis in Player Contract 2, the amount of cash Team A provided to Team B in the trade. Team A's $10x basis is recovered through depreciation under Reg. § 1.167(a)-3(a) over the life of Player Contract 2.
3. Team B has a $10x amount realized on the trade because Team B received $10x from Team A in the trade. Team B must recognize $10x of gain, the excess of Team B's $10x amount realized over its $0 basis in the Player Contract 2 it traded. Team B's $10x gain is subject to the rules of §§ 1231 and 1245. Team B has a $0 basis in Player Contract 1 because Team B provided no cash to Team A in the trade.

Example 3—No cash in the trade, one team has unrecovered basis.

1. In 2019, Team C signs Player 3 to a contract (Player Contract 3) for 5 years. Under the terms of Player Contract 3, Team C pays Player 3 a $25x signing bonus in 2019. In each of 2019 and 2020, Team C takes a depreciation deduction under Reg. § 167(a)-3(a) of $5x for the $25x it paid to Player 3. In 2021, Team C trades Player Contract 3 to Team D for Player Contract 4, and the teams apply the safe harbor in this revenue procedure.

2. Neither Team C nor Team D has an amount realized or gain on the trade because neither team received cash in the trade. Because neither team provided cash in the trade, each team has a $0 basis in the contract it received in the trade.

3. Team C may deduct in 2021 a $15x loss under §§ 165 and Reg. § 1.167(a)-8, the excess of its unrecovered basis in Player Contract 3 over its amount realized of $0. Team C's $15x loss is subject to the rules of § 1231.

Example 4— One team provides cash and one team has an unrecovered basis.

1. The facts are the same as in Example 3, except Team D trades Player Contract 4 and $20x to Team C for Player Contract 3.

2. Team C has a $20x amount realized on the trade because Team C received $20x from Team D in the trade. Team C must recognize $5x of gain, the excess of Team C's $20x amount realized over its $15x basis in the Player Contract 3 it traded. Team C's $5x gain is subject to the rules of §§ 1231 and 1245. Team C has a $0 basis in Player Contract 4 because Team C provided no cash to Team D in the trade.

3. Team D has no amount realized or gain on the trade because Team D did not receive cash in the trade. Team D has a $20x basis in Player Contract 3, the amount of cash Team D provided to Team C in the trade. Team D's $20x basis is recovered through depreciation under Reg. § 1.167(a)-3(a) over the life of Player Contract 3.

Example 5—Allocation of basis among multiple contracts.

1. In 2019, Team E trades Player Contract 5 and $30x to Team F for Player Contract 6, Player Contract 7,and Player Contract 8. The teams apply the safe harbor in this revenue procedure.

2. Team E has no amount realized or gain on the trade because Team E did not receive cash in the trade. Under section 4.02(3), Team E has a $30x basis in Player Contract 6, Player Contract 7, and Player Contract 8, collectively. Team E has a basis of $10x in Player Contract 6, $10x in Player Contract 7, and $10x in Player Contract 8 because Team E allocates the $30x cash provided to Team F in the trade by dividing the basis equally among the three player contracts received in the trade. Team E's $10x basis of each player contract is recovered through depreciation under Reg. § 1.167(a)-3(a) over the life of the respective player contract.

3. Team F has a $30x amount realized on the trade because Team F received $30x from Team E in the trade. Team F must recognize $30x of gain, the excess of Team F's $30x amount realized over its $0 basis in the Player Contract 5 it traded. Team F's $30x gain is subject to the rules of §§ 1231 and 1245. Team F has a $0 basis in Player Contract 5 because Team F provided no cash to Team E in the trade.

B. <u>Deductible Expenses versus Capitalization</u>

C. <u>Reasonable Compensation</u>

D. <u>Miscellaneous Deductions</u>

1. The CEO and sole shareholder of a janitorial corporation used cocaine as a chick magnet, but can the corporation deduct the cleanup costs? Held, the price paid for the cocaine overdose death of the boss's girlfriend is not a deductible corporate business expense. Cavanaugh v. Commissioner, T.C. Memo. 2012-324 (11/26/12). James Cavanaugh the CEO and sole shareholder of Jani-King International took a holiday trip to the Cavanaugh's villa in St. Maarten with his 27 year-old girlfriend, a body guard and another female Jani-King employee. Unfortunately the girlfriend died from an overdose of cocaine. The girlfriend's mother sued the individuals and the corporation for wrongful death. The taxpayer's S corporation paid the full amount of the settlement, including a $250,000 reimbursement to Cavanaugh and claimed a business expense deduction. The Tax Court (Judge Holmes) began its opinion in this case as follows:

> Twenty-seven-year-old Colony Anne (Claire) Robinson left Texas in November 2002 for a Thanksgiving vacation in the Caribbean with her boyfriend, his bodyguard, and another employee of the company that he had spent decades building.

> She did not return home alive.
>
> The coroner's report showed a massive amount of illegal drugs in her body and concluded that they were the likely cause of her death. Her mother sued the boyfriend and his company for wrongful death. The parties settled. The company paid most of the $2.3 million settlement directly; the boyfriend contributed $250,000, which the company then reimbursed.

Siding with the IRS, Judge Holmes looked to the origin of the claim, which the court held to be applicable to the corporation's payment in settlement of the wrongful death claim. The court concluded that although the claim related to the conduct of the three corporate employees, the conduct was not related to the corporate business, i.e., its profit-seeking activities. The court also rejected the taxpayer's theory that the bodyguard supplied cocaine in the course of his employment as a bodyguard and enabler for the CEO. Further, the court rejected the taxpayer's argument that reimbursement of the taxpayer's contribution to the settlement was contractually required under a corporate indemnity agreement. In addition, the court found that the payment was not deductible under the theory that it was made to protect the corporation's business reputation because there was no evidence that underlay that theory.

- Judge Holmes distinguished and refused to follow *Kopp's Co. v. United States*, 636 F.2d 59 (4th Cir. 1980), in which the court upheld a corporation's deduction for a payment made to settle pending litigation against the corporation brought by an individual injured by the CEO's son who, while home on military leave and making "personal and permissive use of" a corporate-owned car, had an accident that severely injured the individual.

a. The corporation's deductions are vaporized like freebase on appeal. Cavanaugh v. Commissioner, 766 Fed. Appx. 98 (5th Cir. 3/29/19), *aff'g* T.C. Memo. 2012-324 (11/26/12). In a per curiam opinion, the U.S. Court of Appeals for the Fifth Circuit affirmed the Tax Court's decision. The court agreed with the Tax Court that, under *United States v. Gilmore*, 372 U.S. 39 (1963), the deductibility of the corporation's litigation expenses is determined by the origin and character of the claim against it, and not by the claim's potential consequences. The court rejected the taxpayer's argument that the *Gilmore* analysis does not apply when the corporation itself is named as a defendant in the litigation that is settled. Decisions holding otherwise, the court stated, such as *Kopp's Co. v. United States*, 636 F.2d 59 (4th Cir. 1980), "directly conflict with *Gilmore*, which is binding on this court." In this case, the court reasoned, although the board of directors of Jani-King International approved the settlement on the advice of counsel, the claim arose from the provision of cocaine by employees of Jani-King, a non-business activity, and not from their employment by Jani-King. Accordingly, the court held, the Tax Court properly disallowed the corporation's deduction of the settlement payment. The court also held that the Tax Court properly had disallowed the corporation's deduction of its reimbursement of James Cavanaugh for the $250,000 he had contributed. According to the court, Cavanaugh had waived the argument that the reimbursement was required by the corporation's by-laws, and the payment was a nondeductible voluntary payment by the corporation of another's legal expenses.

2. No, you can't plead the Fifth Amendment to avoid a deficiency assessment under § 280E and, duh, when your company's name is "THC, LLC," the IRS probably is going to figure out that you sell marijuana. Feinberg v. Commissioner, 916 F.3d 1330 (10th Cir. 2/26/19). This case had some weird facts: an LLC aptly but perhaps stupidly named Total Health Concepts, LLC ("THC, LLC") that had elected subchapter S status. And it had some procedural quirks: the Service agreed that the Tax Court's reasoning (failure to substantiate expenses) for upholding the asserted deficiency should be overturned, but the Tenth Circuit (Judge McHugh) nevertheless upheld the Tax Court's ultimate conclusion on the basis of § 280E. Section 280E disallows any deduction or credit otherwise allowable if such amount is paid or incurred in connection with a trade or business "if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances …." The Tax Court had upheld the deficiency based upon the taxpayer's failure to substantiate expenses; however, the Tenth Circuit ruled that this was improper because the notice of deficiency itself did not raise the issue of substantiation. The Tenth Circuit nonetheless upheld the deficiency based upon the Service's argument that § 280E disallowed the taxpayer's deductions because the taxpayers had not met their burden of proving that the Service's determination that THC was unlawfully trafficking in a controlled substance was erroneous. The court rejected the taxpayers' argument that placing the burden of proof on them violated their Fifth Amendment privilege against self-incrimination. The court held that, although the Fifth Amendment provides protection against self-incrimination in criminal proceedings, it does not shift the burden of proof to the IRS in a civil tax matter. As a result, because the deficiency was based upon the Service's disallowance of deductions under § 280E, and because the taxpayer had failed to provide any evidence that it was not in the marijuana business, the Service's position was upheld. Although not mentioned by either court, the authors wonder, "What was the taxpayer thinking? The company's name was 'THC, LLC.' Didn't the taxpayer realize that might attract the Service's attention?"

3. Rats! We knew that we should have been architects or engineers instead of tax advisors. The 2017 Tax Cuts and Jobs Act, § 11011, added § 199A, thereby creating an unprecedented, new deduction for trade or business (and certain other) income earned by sole proprietors, partners of partnerships (including members of LLCs taxed as partnerships or as sole proprietorships), and shareholders of S corporations. The Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, Division T, § 101 ("CAA 2018"), signed by the President on March 23, 2018, amended § 199A principally to address issues related to agricultural or horticultural cooperatives. New § 199A is intended to put owners of flow-through entities (but also including sole 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 or qualified publicly traded partnership income (because these two categories are separate components of the § 199A deduction).

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

6. *Revised rules for cooperatives and their patrons.* The Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, Division T, § 101, signed by the President on March 23, 2018, amended § 199A to fix what was commonly referred to as the "grain glitch." Under 199A as originally enacted, farmers selling goods to agricultural cooperatives were permitted to claim a deduction effectively equal to 20 percent of gross sales, while farmers selling goods to independent

buyers effectively could claim a deduction equal to 20 percent of net income. Some independent buyers argued that this difference created an unintended market preference for producers to sell to agricultural cooperatives. Under the amended version of § 199A, agricultural cooperatives would determine their deduction under rules set forth in § 199A(g) that are similar to those in old (and now repealed) section § 199. The § 199A deduction of an agricultural cooperative is equal to 9 percent of the lesser of (1) the cooperative's qualified production activities income, or (2) taxable income calculated without regard to specified items. The cooperative's § 199A deduction cannot exceed 50 percent of the W-2 wages paid of the cooperative. A cooperative can pass its § 199A deduction through to their farmer patrons. In addition, the legislation modified the original version of § 199A to eliminate the 20-percent deduction for qualified cooperative dividends received by a taxpayer other than a corporation. Instead, under the amended statute, taxpayers are entitled to a deduction equal to the lesser of 20 percent of net income recognized from agricultural and horticultural commodity sales or their overall taxable income, subject to a wage and capital limitation.

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

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

a. Let the games begin! Treasury and the Service have issued final regulations under § 199A. T.D. 9847, Qualified Business Income Deduction, 84 F.R. 2952 (2/8/19). The Treasury Department and the Service have finalized proposed regulations under § 199A (see REG-107892-18, Qualified Business Income, 83 F.R. 40884 (8/16/18)). The regulations address the following six general areas. In addition, Reg. § 1.643(f)-1 provides anti-avoidance rules for multiple trusts.

Operational rules. Reg. § 1.199A-1 provides guidance on the determination of the § 199A deduction. The operational rules define certain key terms, including qualified business income, qualified REIT dividends, qualified publicly traded partnership income, specified service trade or business, and W-2 wages. According to Reg. § 1.199A-1(b)(14), a "trade or business" is "a trade or business that is a trade or business under section 162 (a section 162 trade or business) other than performing services as an employee." In addition, if tangible or intangible property is rented or licensed to a trade or business conducted by the individual or a "relevant passthrough entity" (a partnership or S corporation owned directly or indirectly by at least one individual, estate, or trust) that is commonly controlled (within the meaning of Reg. § 1.199A-1(b)(1)(i)), then the rental or licensing activity is treated as a trade or business for purposes of § 199A even if the rental or licensing activity would not, on its own, rise to the level of a trade or business. The operational rules also provide guidance on computation of the § 199A deduction for those with taxable income below and above the $157,500/$315,000 thresholds mentioned earlier as well as rules for determining the carryover of negative amounts of qualified business income and negative amounts of combined qualified REIT dividends and qualified publicly traded partnership income. The regulations clarify that, if a taxpayer has an overall loss from combined qualified REIT dividends and qualified publicly traded partnership income, the overall loss does not affect the amount of the taxpayer's qualified business income and instead is carried forward separately to offset qualified REIT dividends and qualified publicly traded partnership income in the succeeding year. Reg. § 1.199A-1(c)(2)(i). The operational rules also provide rules that apply in certain special situations, such as Reg. § 1.199A-1(e)(1), which clarifies that the § 199A deduction has no effect on the adjusted basis of a partner's partnership interest or the adjusted basis of an S corporation shareholder's stock basis.

Determination of W-2 Wages and the Unadjusted Basis of Property. Reg. § 1.199A-2 provides rules for determining the amount of W-2 wages and the unadjusted basis immediately after acquisition (UBIA) of qualified property. The amount of W-2 wages and the UBIA of qualified property are relevant to taxpayers whose taxable incomes exceed the $157,500/$315,000 thresholds mentioned earlier. For taxpayers with taxable income in excess of these limits, one component of their § 199A deduction (*Bucket 1* described earlier) is the lesser of (1) 20 percent of the qualified trade or business income with respect to the trade or business, or (2) the greater of (a) 50 percent of the W-2 wages with respect to the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the UBIA of all qualified property. The rules of Reg. § 1.199A-2 regarding W-2 wages generally follow the rules under former § 199 (the now-repealed domestic production activities deduction) but, unlike the rules under former § 199, the W-2 wage limitation in § 199A applies separately for each trade or business. The amount of W-2 wages allocable to each trade or business generally is determined according to the amount of deductions for those wages allocated to each trade or business. Wages must be "properly allocable" to qualified business income to be taken into account for purposes of § 199A, which means that the associated wage expense must be taken into account in determining qualified business income. In the case of partnerships and S corporations, a partner or S corporation shareholder's allocable share of wages must be determined in the same manner as that person's share of wage expenses. The regulations provide special rules for application of the W-2 wage limitation to situations in which a taxpayer acquires or disposes of a trade or business. Simultaneously with the issuance of these regulations, the Service issued Rev. Proc. 2019-11, 2019-9 I.R.B. 742 (1/18/19), which provides guidance on methods for calculating W–2 wages for purposes of § 199A. The regulations also provide guidance on determining the UBIA of qualified property. Reg. § 1.199A-2(c)(1) restates the statutory definition of qualified property, which is depreciable tangible property that is (1) held by, and available for use in, a trade or business at the close of the taxable year, (2) used in the production of qualified business income, and (3) for which the depreciable period has not ended before the close of the taxable year. The regulations clarify that UBIA is determined without regard to both depreciation and amounts that a taxpayer elects to treat as an expense (e.g., pursuant to § 179, 179B, or 179C) and that UBIA is determined as of the date the property is placed in service. Special rules address property transferred with a principal purpose of increasing the § 199A deduction, like-kind exchanges under § 1031, involuntary conversions under § 1033, subsequent improvements to qualified property, and allocation of UBIA among partners and S corporation shareholders.

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

Aggregation Rules. Reg. § 1.199A-4 permits, but does not require, taxpayers to aggregate trades or businesses for purposes of determining the § 199A deduction if the requirements in Reg. § 1.199A-4(b)(1) are satisfied. Treasury and the Service declined to adopt the existing aggregation rules in Reg. § 1.469-4 that apply for purposes of the passive activity loss rules on the basis that those rules, which apply to "activities" rather than trades or businesses and which serve purposes somewhat different from those of § 199A, are inappropriate. Instead, the regulations permit aggregation if the following five requirements are met: (1) the same person, or group of persons, directly or indirectly owns 50 percent or more of each of the businesses to be aggregated, (2) the required level of ownership exists for the majority of the taxable year in which the items attributable to the trade or business are included in income, (3) all of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year (not taking into account short taxable years), (4) none of the aggregated businesses is a specified service trade or business, and (5) the trades or businesses to be aggregated meet at least two of three factors designed to demonstrate that the businesses really are part of a larger, integrated trade or business. The regulations also impose a consistency rule under which an individual who aggregates trades or businesses must consistently report the aggregated trades or businesses in subsequent taxable years. In addition, the regulations require that taxpayers attach to the relevant return a disclosure statement that identifies the trades or businesses that are aggregated.

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

Special Rules for Passthrough Entities, Publicly Traded Partnerships, Trusts, and Estates. Reg. § 1.199-6 provides guidance necessary for passthrough entities, publicly traded partnerships trusts, and estates to determine the § 199A deduction of the entity or its owners. The regulations provide computational steps for passthrough entities and publicly traded partnerships, and special rules for applying § 199A to trusts and decedents' estates.

Effective Dates. The regulations generally apply to taxable years ending after February 8, 2019, the date on which the final regulations were published in the Federal Register. Nevertheless, taxpayers can rely on the final regulations in their entirety, or on the proposed regulations published in the Federal Register on August 16, 2018 (see REG-107892-18, Qualified Business Income, 83 F.R. 40884 (8/16/18)) in their entirety, for taxable years ending in 2018. However, to prevent abuse, certain provisions of the regulations apply to taxable years ending after December 22, 2017, the date of enactment of the 2017 TCJA. In addition, Reg. § 1.643(f)-1, which provides anti-avoidance rules for multiple trusts, applies to taxable years ending after August 16, 2018.

a. The Service has issued a revenue procedure that provides guidance on methods for calculating W-2 wages for purposes of § 199A. Rev. Proc. 2019-11, 2019-9 I.R.B. 742 (1/18/19). This revenue procedure provides three methods for calculating "W-2 wages" as that term is defined in § 199A(b)(4) and Reg. § 1.199A-2. The first method (the unmodified Box method) allows for a simplified calculation while the second and third methods (the modified Box 1 method and the tracking wages method) provide greater accuracy. The methods are substantially similar to the methods provided in Rev. Proc. 2006-47, 2006-2 C.B. 869, which applied for purposes of former Code § 199. The revenue applies to taxable years ending after December 31, 2017.

b. The Service has provided a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of § 199A. Rev. Proc. 2019-38, 2019-42 I.R.B. ___ (9/24/19). Whether a rental real estate activity constitutes a trade or business for federal tax purposes has long been an area of uncertainty, and the significance of this uncertainty has been heightened by Congress's enactment of § 199A. To help mitigate this uncertainty, the Service has issued this revenue procedure to provide a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of § 199A and the regulations issued under that provision. (The revenue procedure is the final version of a proposed revenue procedure set forth in Notice 2019-7, 2019-9 I.R.B. 740 (1/18/19).) If a rental real estate enterprise does not fall within the safe harbor, it can still be treated as a trade or business if it otherwise meets the definition of trade or business in Reg. § 1.199A-1(b)(14). The proposed revenue procedure defines a "rental real estate enterprise" as "an interest in real property held for the production of rents [that] may consist of an interest in a single property or interests in multiple properties." Those relying on the revenue procedure must hold the interest directly or through a diregarded entity and must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents (with certain exceptions) as a single enterprise. Commercial and residential real estate cannot be part of the same enterprise. Taxpayers that choose to treat similar properties as a single enterprise must continue to do so (including with respect to newly acquired similar properties) when the taxpayer continues to rely on the safe harbor, but a taxpayer that treats similar properties as separate enterprises can choose to treat similar properties as a single enterprise in future years. For a rental real estate enterprise to fall within the safe harbor, the following three requirements must be met:

1. Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;

2. For rental real estate enterprises that have been in existence fewer than four years, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental enterprise. For rental real estate enterprises that have been in existence for at least four years, in any three of the five consecutive taxable years that end with the taxable year, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise; and

3. The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. If services with respect to the rental real estate enterprise are performed by employees or independent contractors, the taxpayer may provide a description of the rental services performed by such employee or independent contractor, the amount of time such employee or independent contractor generally spends performing such services for the enterprise, and time, wage, or payment records for such employee or independent contractor. Such records are to be made available for inspection at the request of the IRS. The contemporaneous records requirement does not apply to taxable years beginning prior to January 1, 2020.

4. The taxpayer attaches to a timely filed original return (or an amended return in the case of 2018 only) a statement that describes the properties included in each enterprise, describes rental real estate properties acquired and disposed of during the taxable year, and represents that the requirements of the revenue procedure are satisfied.

The revenue procedure provides a definition of "rental services." The revenue procedure applies to taxable years ending after December 31, 2017. For 2018, taxpayers can rely on the safe harbor in this revenue procedure or the one in the proposed revenue procedure that was set forth in Notice 2019-7, 2019-9 I.R.B. 740 (1/18/19).

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 AND INCOME

A. Gains and Losses

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

1. The IRS gets hoisted by its own petard, and in the process, we get an unusual lesson in "following the money" for purposes of the interest expense deduction limits under IRC § 163. Lipnick v. Commissioner, 153 T.C. No. 1 (8/28/19). Although the facts are a bit convoluted, this Tax Court opinion by Judge Lauber reaffirms the "follow the money" principles for determining deductible interest expense under IRC § 163, including for debt-financed partnership distributions and the aftermath thereof. The taxpayer's father held membership interests in several limited liability companies ("LLCs") classified as partnerships for federal income tax purposes. The LLCs owned and managed very profitable residential rental properties in the Washington, D.C., area. In 2009—*really??? . . . during the great recession??? . . . wow!*—the LLCs made nonrecourse debt-financed distributions to the taxpayer's father totaling approximately $80 million. The taxpayer's father used the proceeds of these debt-financed distributions to purchase investment assets that he held personally. Similarly, in 2012, the taxpayer's father received, directly and indirectly, yet another debt-financed distribution of approximately $1.7 million from a residential rental property limited partnership ("LP") in which he and his family limited partnership ("FLP") were partners. The taxpayer's father also used the proceeds of this debt-financed distribution to purchase investment assets that he held personally. For the years 2009-2012, pursuant to Notice 89-35, 1989-1 C.B. 675, and Temp. Reg. § 1.163-8T(a)(4)(i)(C), the taxpayer's father reported his allocable share of the LLCs' and the LP's interest expense (including the LP's interest expense passed through his FLP) as investment interest for purposes of the IRC § 163(d)(1) limitation on the deductibility of investment interest. (Incidentally, it appears that the taxpayer's father was able to deduct his entire allocable share of the LLCs' and LP's interest expense during the years 2009-2012 because the taxpayer's father had ample investment income during those years.) Midway through 2011, the taxpayer's father gave a portion of his membership interests in the LLCs to his taxpayer-son. Then, in October of 2012, the taxpayer's father died bequeathing his partnership interests in the LP and FLP to his taxpayer-son. The foregoing transfers from the father to the taxpayer-son were treated as part-gift/part-sale transactions because the father's allocable share of the LLCs' and LP's debt (including debt allocated via the FLP) was treated as an amount realized by the father, and an amount paid by the taxpayer-son, under Reg. § 1.752-1(h) and § 1.1001-2(a)(4)(v). In fact, the taxpayer's father had reported taxable capital gains of approximately $23 million from his "gift" of the LLC interests to his taxpayer-son in 2011. (Presumably, no capital gains were realized or recognized upon the taxpayer father's bequest of the LP and FLP interests to his taxpayer-son in 2012 due to the estate's stepped-up basis.) After receiving the foregoing LLC, LP, and FLP interests, the taxpayer-son did not continue to report his allocable share of the LLCs' and LP's interest expense as investment interest. Rather, the taxpayer-son reported his allocable share of the LLCs' and LP's interest expense for the years 2012 and 2013 as properly allocable to the underlying real estate assets and rental income of the LLCs and the LP. Accordingly, the taxpayer-son deducted his allocable shares of the interest expense against his allocable shares of the rental income. The IRS, noticing the change in treatment of the interest, audited the taxpayer-son (because the LLCs and the LP were not subject to TEFRA-partnership audit rules), disallowed the deduction of the interest expense against the rental income of the LLCs and the LP, and proposed deficiencies for 2012 and 2013 totaling approximately $500,000. (Presumably, unlike his father, the taxpayer-son did not have sufficient investment income to be able to fully deduct his allocable share of the interest expense from the LLCs and LP.)

- In support of his position that the interest expense was properly allocable to and deductible against the rental income of the LLCs and the LP (including debt allocated via the FLP), the taxpayer-son relied upon Reg. § 1.752-1(h) and § 1.1001-2(a)(4)(v) cited above as well as the regulations under IRC § 163. Specifically, Temp. Reg. § 1.163-8T(c)(3)(ii)(C) provides that if a taxpayer "takes property subject to debt," and no debt proceeds are disbursed to the taxpayer, the debt is treated as being used to acquire the property. Accordingly, the associated interest expense is allocated to the acquired property for purpose of the deduction limitations of IRC § 163. The taxpayer-son contended that even though his LLC interests were received via "gift," and the LP interest was received via a bequest, the taxpayer-son was allocated a share of LLCs' and the LP's debt, and he thus acquired his interests "subject to debt." Further, the taxpayer-son relied upon Notice 89-35, 1989-1 C.B. 675, which provides in relevant part that "in the case of debt proceeds allocated under [Reg. 1.163-8T] to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and the associated interest expense shall be allocated among all of the assets of the entity using any reasonable method." The IRS argued that taxpayer-son was bound by the father's treatment of the interest as an investment expense because a "once investment interest, always investment interest" rule should apply. Moreover, the IRS argued that Temp. Reg. § 1.163-8T(c)(3)(ii)(C) was not relevant because the taxpayer-son did not actually "take [his LLC and LP interests] subject to a debt" as contemplated by the regulations and Notice 89-35; but rather, the rules of Reg. § 1.752-1(h) and § 1.1001-2(a)(4)(v) use such an approach for purposes of subchapter K, not IRC § 163. The Tax Court (Judge Lauber) disagreed with the IRS, however, citing Temp. Reg. § 1.163-8T(c)(3)(ii)(C) and Notice 89-35, 1989-1 C.B. 675, as noted above. Judge Lauber determined that the IRS's position had no authoritative support and that the taxpayer-son's position was correct. Judge Lauber wrote, "In short, whereas [the taxpayer's father] received a debt-financed distribution, the [taxpayer-son] is treated as having made a debt-financed acquisition of the partnership interests he acquired from [his father]." Therefore, reasoned Judge Lauber, the IRS's own Notice 89-35, 1989-1 C.B. 675, expressly allows the interest expense to be allocated to the real estate assets and income generated by the LLCs and LP (as was done by the taxpayer-son).

D. Section 121

E. Section 1031

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

A. Fringe Benefits

B. Qualified Deferred Compensation Plans

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

D. Individual Retirement Accounts

1. A rollover that was deposited 62 days after withdrawal from an IRA was not taxable because it constituted a bookkeeping error and qualified for a hardship waiver. Burack v. Commissioner, T.C. Memo. 2019-83 (7/9/19). The taxpayer withdrew $524,981 from her IRA to purchase a home while waiting for her former home to sell. She planned to redeposit the funds in her IRA within the 60-day period permitted by § 408(d)(3)(A) for making a tax-free rollover of IRA funds. Pershing, LLC served as custodian of the IRA. The taxpayer's financial adviser was a representative of Capital Guardian, LLC. The relationship between Pershing and Capital Guardian was not entirely clear. Capital Guardian generated statements for the taxpayers IRA and the statements listed both Pershing and Capital Guardian. Pursuant to instructions from Capital Guardian, on Thursday, August 21, 2014, 57 days after the taxpayer's withdrawal, the taxpayer sent a check for $524,981 by overnight delivery to Capital Guardian, which received the check the next day. For reasons that are not clear, the check was not deposited at Pershing in the taxpayer's IRA until Tuesday, August 26, 2014, which was 62 days after the taxpayer's withdrawal. The IRS issued a notice of deficiency in which the IRS asserted that the taxpayer had to include the withdrawn funds in gross income because the taxpayer had not rolled them over within the required 60-day period. The Tax Court (Judge Ruwe) held that the taxpayer was entitled to treat the transaction as a tax-free rollover for two reasons. *First*, the court concluded that the withdrawn funds were not redeposited in a timely manner because of a bookkeeping error by Capital Guardian. "Because the check was received by Capital Guardian during the rollover period but not book-entered by Capital Guardian until after, we find that the late recording is due to a bookkeeping error." The court reasoned that the situation was analogous to that in *Wood v. Commissioner*, 93 T.C. 114 (1989), in which the court reached a similar conclusion when the taxpayer had transferred stock to Merrill Lynch within the 60-day period with instructions that it be deposited in the taxpayer's IRA, but Merrill Lynch deposited the stock in a nonqualified account before transferring it to the IRA after the 60-day period. *Second*, the court held that the taxpayer was eligible for a hardship waiver under § 408(d)(3)(I). As interpreted by Rev. Proc. 2003-16, 2003-1 C.B. 359, an automatic waiver under § 408(d)(3)(I) is granted if, prior to the expiration of the 60-day period, a financial institution receives funds on behalf of a taxpayer, the taxpayer follows all procedures required by the financial institution for depositing the funds into an eligible retirement plan (including giving instructions for deposit of the funds) and, "solely due to an error on the part of the financial institution, the funds are not deposited into an eligible retirement plan within the 60-day rollover period," if two conditions are satisfied: (1) the funds are deposited into an eligible retirement plan within 1 year from the beginning of the 60-day rollover period; and (2) if the financial institution had deposited the funds as instructed, it would have been a valid rollover. The court concluded that all requirements for an automatic hardship waiver were satisfied and that this served as an alternative basis for treating the taxpayer's withdrawal and contribution as a tax-free rollover.

V. PERSONAL INCOME AND DEDUCTIONS

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

1. Thirty years after the Technical and Miscellaneous Revenue Act of 1988, the regulations under § 301 are proposed to be updated to make conforming changes. REG-21694-16, Updating Section 301 Regulations to Reflect Statutory Changes, 84 F.R. 11263 (3/26/19). The Technical and Miscellaneous Revenue Act of 1988 amended § 301(b)(1) and § 301(d), effective as if the amendments had been included in the Tax Reform Act of 1986, to eliminate certain distinctions that previously existed between corporate and non-corporate distributees and certain special rules for distributions to or from foreign corporations. As amended, these statutory provisions state that the amount of a corporate distribution is the amount of money received plus the fair market value of property received (§ 301(b)(1)), and that the basis of property received from a corporation is the fair market value of that property (§ 301(d)). These proposed amendments update Reg. § 1.301-1 to reflect these changes and make certain non-substantive changes including modifying cross-references and reorganizing some provisions. Although the proposed regulations would be effective when published as final regulations, the statutory changes that they reflect are already effective.

2. Treasury and the IRS have withdrawn the 2009 proposed regulations on allocation of consideration and allocation and recovery of basis in transactions involving corporate stock. REG-143686-07, The Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities; Withdrawal, 84 F.R. 11686 (3/28/19). In 2009, Treasury and the IRS published proposed regulations under §§ 301, 302, 304, 351, 354, 356, 358, 368, 861, 1001, and 1016 regarding the recovery of stock basis in (1) § 301 distributions and transactions that are treated as § 301 distributions, and (2) sale and exchange transactions to which § 302(a) applies (including certain aspects of reorganization exchanges). The proposed regulations also provided the method for determining gain realized under § 356 and made a number of clarifying, but nonsubstantive, modifications to the rules for determining stock basis under § 358 resulting from a reorganization. The core principal underlying the rules was that each share of stock is a separate unit of property that can be sold or exchanged and the results of a transaction should be determined with respect to the consideration received in regard to each share. After considering comments submitted on the proposed regulations, Treasury and the IRS "determined that it is unlikely that approach of the 2009 Proposed Regulations can be implemented in comprehensive final regulations without significant modifications." Accordingly, Treasury and the IRS have withdrawn the 2009 proposed regulations and will continue to study the issues addressed in them "with a particular focus on issues surrounding sections 301(c)(2) and 304, and [Reg.] § 1.302-2(c)." The notice of withdrawal published in the Federal Register reiterates the belief of Treasury and the IRS in the core principle underlying the 2009 proposed regulations:

> The Treasury Department and the IRS continue to believe that under current law, the results of a section 301 distribution should derive from the consideration received by a shareholder in respect of each share of stock, notwithstanding designations otherwise. See *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971). The Treasury Department and the IRS also continue to believe that, under current law, with respect to redemptions governed by section 302(d), any unrecovered basis in the redeemed stock of a shareholder may be shifted to other stock only if such an adjustment is a proper adjustment within the meaning of [Reg.] § 1.302-2(c). Not all shifts of a redeemed shareholder's unrecovered basis result in proper adjustments, and certain basis adjustments can lead to inappropriate results. See, e.g., Notice 2001-45, 2001-33 I.R.B. 129.

C. Liquidations

D. S Corporations

1. 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.

a. Final regulations address the treatment of ESBTs that are S corporation shareholders and have nonresident aliens as beneficiaries. T.D. 9868, Electing Small Business Trusts With Nonresident Aliens as Potential Current Beneficiaries, 84 F.R. 28214 (6/18/19). The Treasury Department and the IRS have finalized without change proposed regulations (REG-117062-18, Electing Small Business Trusts With Nonresident Aliens as Potential Current Beneficiaries, 84 F.R. 16415 (4/19/19)) addressing the treatment of electing small business trusts that are S corporation shareholders and have nonresident aliens as beneficiaries. The preamble to the proposed regulations noted the apparent assumption in the legislative history of the 2017 Tax Cuts and Jobs Act that an ESBT is subject to tax and therefore would be subject to tax on the ESBT's share of the S corporation's income. That preamble notes, however, that ESBTs can be grantor trusts for federal tax purposes with the result that the beneficiaries of the ESBT, not the ESBT itself, are subject to tax on the S corporation's income. If a nonresident alien is a beneficiary of an ESBT, this could lead to the S corporation's income not being subject to U.S. taxation (e.g., if the income is foreign-source). Therefore, according to the premable to the proposed regulations, the regulations generally

> would modify the allocation rules under § 1.641(c)-1 to require that the S corporation income of the ESBT be included in the S portion of the ESBT if that income otherwise would have been allocated to an NRA deemed owner under the grantor trust rules. Accordingly, such income would be taxed to the domestic ESBT by providing that, if the deemed owner is an NRA, the grantor portion of net income must be reallocated from the grantor portion of the ESBT to the ESBT's S portion.

The final regulations apply to all ESBTs after December 31, 2017.

E. Mergers, Acquisitions and Reorganizations

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

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

a. Taxpayers have sufficient guidance on continuity of interest and the proposed regulations issued in 2011 are withdrawn. REG-124627-11, Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest, 84 F.R. 12169 (4/1/19). As indicated earlier, since 2011, final regulations under § 368 generally have permitted the determination of whether the continutity of interest (COI) requirement is satisfied to be based on the actual trading value of a publicly traded acquiring corporation's stock on either the closing date (as defined) or the signing date (as defined). *See* Reg. § 1.368-(e)(2). Proposed regulations promulgated in 2011 under § 368 provide in part that, under specified circumstances, certain average trading price determinations of value (rather than actual trading value on a specific date) are allowed for determining whether the COI requirement is satisfied. See Prop. Reg. § 1.368-1(e)(2)(vi)(A). Treasury and the IRS have concluded that current law generally provides sufficient guidance to taxpayers with respect to the COI requirement. Accordingly, the proposed regulations issued in 2011 have been withdrawn. However, because the IRS also has concluded that taxpayers in certain cirtcumstances should be able to rely on average stock valuation methods for purposes of measuring COI, the IRS issued Rev. Proc. 2018-12, discussed above, which specifies the circumstances in which the IRS will not challenge the use of certain average stock valuation methods in determining whether the COI requirement is satisfied.

2. Proposed regulations address the items of income and deduction that are included in the calculation of built-in gains and built-in losses under § 382(h). REG-125710-18, Regulations Under Section 382(h) Related to Built-In Gain and Loss, 84 F.R. 47455 (9/10/19). In an effort to minimize tax-motivated tax-free acquisitions, Congress has enacted various provisions that limit an acquiring corporation's ability to make use of an acquired corporation's tax attributes, such as its net operating losses and tax credits. One such provision, § 382, in very simplified terms, limits an acquiring corporation's ability to use an acquired corporation's pre-acquisition net operating losses. Somewhat more accurately, § 382 limits the ability of a ''loss corporation'' to offset its taxable income in periods subsequent to an ''ownership change'' with losses attributable to periods prior to that ownership change. The § 382 limitation imposed on a loss corporation's use of pre-change losses for each year subsequent to an ownership change generally is equal to the fair market value of the loss corporation immediately before the ownership change, multiplied by the applicable long-term tax-exempt rate as defined in § 382(f). A loss corporation's built-in gains and built-in losses affect its § 382 limitation. Section 382(h) provides rules relating to the determination of a loss corporation's built-in gains and losses as of the date of the ownership change. Generally, built-in gains recognized during the five-year period beginning on the date of the ownership change allow a loss corporation to increase its § 382 limitation, and built-in losses recognized during this same period are subject to the loss corporation's § 382 limitation. These proposed regulations address the items of income and deduction that are included in the calculation of built-in gains and losses under § 382 and reflect numerous changes made by the 2017 Tax Cuts and Jobs Act, which generated significant uncertainty regarding the application of § 382. The preamble to the proposed regulations indicates that Treasury and the IRS propose to withdraw the following IRS notices and incorporate their subject matter into the proposed regulations: Notice 87-79, Notice 90-27, Notice 2003-65, and Notice 2018-30. The proposed withdrawal of the prior IRS notices would be effective on the day after the proposed regulations are published as final regulations in the Federal Register. The proposed regulations generally would be effective for ownership changes occurring after the date on which they are published as final regulations in the Federal Register. However, taxpayers and their related parties (within the meaning of §§ 267(b) and 707(b)(1)) may apply the proposed regulations to any ownership change occurring during a taxable year with respect to which the period described in § 6511(a) (the limitations period on refund claims) has not expired, as long as the taxpayers and all of their related parties consistently apply the rules of these proposed regulations to such ownership change and all subsequent ownership changes that occur before the effective date of final regulations.

F. Corporate Divisions

2. The IRS has suspended two old revenue rulings on the active trade or business requirement of §§ 355(a)(1)(C) and (b). Rev. Rul. 2019-9, 2019-14 I.R.B. 925 (3/21/19). If certain requirements are met, § 355(a)(1) permits a corporation to distribute stock and securities of a controlled corporation to its shareholders and security holders without recognizing gain or loss and without income to the recipients. One of those requirements is that the distributing corporation and the controlled corporation must be engaged in an active trade or business immediately after the distribution. I.R.C. §§ 355(a)(1)(C), 355(b); Reg. § 1.355-3(a)(1)(i). To qualify, each trade or business must have been actively conducted throughout the five-year period ending on the date of the distribution. I.R.C. § 355(b)(2)(B); Reg. § 1.355-3(b)(3). Under Reg. § 1.355-3(b)(2)(ii), a "trade or business" is "a specific group of activities … being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit." The same regulation further provides that "[s]uch group of activities ordinarily must include the collection of income and the payment of expenses." In Rev. Rul. 57-464, 1957-2 C.B. 244, and Rev. Rul. 57-492, 1957-2 C.B. 247, the IRS concluded that certain activities conducted by a corporation did not meet the active trade or business requirement largely because the activities had failed to generate income. The IRS has suspended these rulings pending the completion of a study by the Treasury Department and the IRS. The study, which was previously announced in a statement on the IRS website dated September 25, 2018, concerns

> [possible] guidance to address whether a business can qualify as an [active trade or business] if entrepreneurial activities, as opposed to investment or other non-business

> activities, take place with the purpose of earning income in the future, but no income has yet been collected.

Pending completion of this study, the IRS will entertain requests for private letter rulings regarding the qualification as an active trade or business of corporations that have not collected income.

- A subsequent statement on the IRS website dated May 6, 2019, requests information in a number of categories to assist the IRS in identifying entrepreneurial activities that do not generate income but nevertheless should qualify as an active trade or business and explains the rationale for the study as follows:

> In recent years, the IRS has observed a significant increase in entrepreneurial ventures that collect little or no income during lengthy and expensive R&D phases, particularly pharmaceutical and technology ventures. However, these types of ventures often use the R&D phase to develop new products that will generate income in the future but do not collect income during that phase. If a corporation wishes to achieve a corporate-level business purpose by separating one R&D segment from an established business or from another R&D segment, the IRS's historical application of the income collection requirement likely would present a challenge for section 355 qualification.

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

VII. PARTNERSHIPS

A. Formation and Taxable Years

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

C. Distributions and Transactions Between the Partnership and Partners

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

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

Distribution of Corporate Partner's Stock. A distribution of the corporate partner's stock to the corporate partner by the partnership also can trigger gain recognition. In addition to any gain previously recognized under the deemed redemption rule, if stock of a corporate partner is distributed to the corporate partner, the corporate partner must recognize gain to the extent that the partnership's basis in the distributed stock exceeds the corporate partner's basis in its partnership interest (as reduced by any cash distributed in the transaction) immediately before the distribution.

De Minimis Exception. The rules described above do not apply if a de minimis exception is satisfied. The de minimis exception applies if three conditions are met: (1) the corporate partner and any related persons own less than 5 percent of the partnership, (2) the partnership holds stock of the corporate partner worth less than 2 percent of the value of the partnership's gross assets, including stock of the corporate partner, and (3) the partnership has never, at any time, held more than $1 million in stock of the corporate partner or more than 2 percent of any particular class of stock of the corporate partner.

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

a. We thought the final regulations on partnership transactions involving equity interests of partners were already sufficiently complex. Proposed regulations modify certain key definitions. REG-135671-17, Partnership Transactions Involving Equity Interests of a Partner, 84 F.R. 11005 (3/25/19). These proposed regulations modify certain definitions in the final regulations that were issued in June 2018 to address so-called "May Company" transactions. See T.D. 9833, Partnership Transactions Involving Equity Interests of a Partner, 83 F.R. 26580 (6/8/18). The deemed redemption rule in the final regulations is triggered when a corporate partner exchanges an interest in appreciated property for an interest in "Stock of the Corporate Partner" owned, acquired, or distributed by the partnership. The final regulations generally define Stock of a Corporate Partner as stock, or other equity interests, including options, warrants, and similar interests, in the Corporate Partner or a corporation that controls the Corporate Partner within the meaning of § 304(c) (except that § 318(a)(1) and (3) do not apply). The propsod regulations would make four amendments to the final regulations. *First*, the final regulations excluded the attribution rules of § 318(a)(1) and (3) to limit for this purpose the meaning of control as defined in § 304(c) (generally stock possessing 50 percent or more of total combined votong power or value) to entities that own a direct or indirect interest in the corporate partner. Out of concern that excluding the attribution rules of § 318(a)(1) and (3) in determining control would allow taxpayers to structure transactions to eliminate gain on appreciated assets the proporsed regulations eliminate the exclusion of the attribution rules of § 318(a)(1) and (3) in determining control. Instead, according to the preamble, the proposed regulations implement the rationale for the prior exclusion of the attribution rules more directly:

> For the purpose of testing direct or indirect ownership of an interest in the Corporate Partner, ownership of Stock of the Corporate Partner would be attributed to an entity under section 318(a)(2) (except that the 50-percent ownership limitation in section

318(a)(2)(C) would not apply) and under Section 318(a)(4), but otherwise without regard to section 318. Thus, sections 318(a)(1), 318(a)(3), and 318(a)(5) would not apply for determining whether an entity directly or indirectly owns an interest in Stock of the Corporate Partner, but once an entity is found to directly or indirectly own an interest in such stock, then the section 304(c) control definition would apply in its entirety to determine whether the tested entity is a Controlling Corporation.

Second, the proposed regulations would modify the rule in the 2018 final regulations that Stock of a Corporate Partner does not include any stock or equity interest held or acquired by a partnership if all interests in the partnership's capital and profits are held by members of an affiliated group within the meaning of § 1504(a) (the "Affiliated Group Exception")." Out of concern that the Affiliated Group Exception may result in abuse, Treasury and the IRS propose to remove the Affiliated Group Exception from the regulations and have requested comments describing situations in which a more tailored version of it might be appropriate. *Third*, the proposed regulations would make certain modifications to the rule in the 2018 final regulations that Stock of the Corporate Partner includes interests in any entity to the extent that the value of the interest is attributable to Stock of the Corporate Partner (the so-called value rule). *Finally*, the proposed regulations would make certain conforming changes to the exception for certain dispositions of stock in Reg. § 1.337(d)–3(f)(2). The proposed regulations would be effective on the date they are published as final regulations in the Federal Register, but taxpayers may rely on them for transactions occurring on or after June 12, 2015, provided that the taxpayer consistently applies all of the proposed regulations to such transactions.

D. <u>Sales of Partnership Interests, Liquidations and Mergers</u>

1. The Tax Court gives the Service 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. <u>Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner</u>, 149 T.C. 63 (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 Service 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 Service 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 Service 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 Service 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. Nonetheless, the Service asserted that an exception in § 865(e)(2)(A) applied (the "U.S. office rule"). Under the U.S. office rule, 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 Service's contrary conclusion in Rev. Rul. 91-32, 1991-1 C.B. 107. In that ruling, according to the court, the Service 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.

b. Grecian Magnesite may have won the battle, but the Service 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 Service'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 and the D.C. Circuit's decisions and effectively adopt the Service's position in Rev. Rul. 91-32, 1991-1 C.B. 107. New § 864(c)(8) thus essentially renders the application of the U.S. office rule meaningless with respect to a partnership interest owned by a nonresident alien individual or a foreign corporation in a partnership engaged in a U.S. trade or business.

c. A victory in the DC Circuit for the taxpayer, but merely a pyrrhic victory for future, similarly-situated taxpayers. Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner, 926 F.3d 819 (D.C. Cir. 6/11/19), *aff'g* 149 T.C. 63 (7/13/17). The U.S. Court of Appeals for the District of Columbia Ciruit, in an opinion by Judge Srinivasan, has upheld the Tax Court's decision that the $4 million of disputed gain was not effectively connected income by virtue of the U.S. office rule in § 865(e)(2)(A). (The Service did not appeal the Tax Court's first holding that, pursuant to the general rule of § 865(a), subject to a narrow exception in § 897(g) for U.S. real property interests, income from the sale of a partnership interest by a nonresident is a sale of personal property and therefore foreign-source income.) In reaching its decision affirming the Tax Court, the D.C. Circuit assumed without deciding, as did the Tax Court, that Permier's U.S. office would be attributed to the taxpayer under § 864(c)(5). Further, the D.C. Circuit agreed with the Tax Court that little deference should be given to the Service's position espoused in Rev. Rul. 91-32, 1991-1 C.B. 107, that gain realized by a foreign partner from the disposition of an interest in a U.S. partnership should be analyzed asset by asset. The Service made a technical argument that the Tax Court's decision was incorrect under canons of statutory interpretation, but the D.C. relied upon competing canons of statutory intepretation to side with the taxpayer.

E. Inside Basis Adjustments

F. Partnership Audit Rules

G. Miscellaneous

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. Wait a minute, I thought we had a deal?! The IRS can assess and collect the full amount of restitution ordered in a criminal proceeding if the restitution is due immediately, even if the U.S. District Court that ordered it set a schedule of payments. Carpenter v.

Commissioner, 152 T.C. No. 12 (4/18/19). The taxpayer agreed to plead guilty in U.S. District Court to two counts of willfully making and subscribing to a false federal income tax return in violation of § 7206(1) and was sentenced to 27 months in prison and ordered to pay to the IRS restitution of $507,995. According to the District Court's order, "the restitution was 'due and payable immediately' and … 'if … [petitioner] can't pay' the entire amount of restitution, he must pay $100 per month beginning 60 days after his release from imprisonment … [and] 'continue making payments until the monies are repaid.'" Following his release from prison in May 2016, the taxpayer complied with this payment schedule. Pursuant to § 6201(4), the IRS assessed the full amount of restitution that had been ordered. The assessment occurred in January 2016, apparently while the taxpayer was still in prison. The IRS subsequently sent a final notice of intent to levy, which indicated that he owed approximately $760,000. This represented the restitution assessed plus interest and penalties. The IRS also filed a notice of federal tax lien. In response, the taxpayer requested a collection due process hearing. He initially indicated that Social Security disability benefits were his only source of income and requested collection alternatives. When the IRS informed him that he was ineligible for collection alternatives because he had failed to file returns for 2011 through 2015, he responded that he had mistakenly requested collection alternatives and that the IRS had no authority to collect because it had not issued a notice of deficiency. Following the CDP hearing, the IRS Appeals Division issued notices of determination upholding the collection action and the taxpayer sought review of the notices of determination in the Tax Court. The Tax Court (Judge Cohen) held that IRS Appeals did not abuse its discretion in sustaining the collection action. In reaching this conclusion, the court considered two issues. *First*, the court rejected the taxpayer's argument that § 6201(4) does not authorize the IRS to exercise administrative collection powers without obtaining a further order from the sentencing court. Section 6201(4) provides in part:

> A. The Secretary shall 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.
>
> B. An assessment of an amount of restitution under an order described in subparagraph (A) shall not be made before all appeals of such order are concluded and the right to make all such appeals has expired.

These provisions, the court reasoned, "indicate[] that Congress intended to grant the Secretary collection authority that is independent from title 18 and the underlying criminal procedures." *Second*, the court rejected the taxpayer's argument that the payment schedule set forth by the sentencing court limited the amount that the IRS could collect. The court distinguished between restitution due immediately with a schedule of payments, such as in the taxpayer's case, and restitution that the sentencing court expressly declines to order as due immediately. Only in the latter situation, the court reasoned, would the IRS be precluded from collecting more than the amounts due under the payment schedule. The court concluded that, unless the sentencing court expressly declines to order restitution payable immediately, the court's judgment imposes an immediate obligation on the defendant to pay the restitution. In this case, the court explained, the sentencing court did not decline to order the restitution as payable immediately, and therefore the IRS could assess and collect the entire amount owed despite the schedule of payments established by the sentencing court.

- The IRS conceded and abated the assessed interest and the additions to tax for late payment based on the Tax Court's decision in *Klein v. Commissioner*, 149 T.C. 341 (2017), in which the court held that the language of § 6201(4)(A) makes clear that "[t]he amount of restitution is not a 'tax imposed by' title 26"and that an assessment of restitution therefore does not trigger interest under § 6601(a) or an addition to tax for late payment under § 6651(a)(3).

- 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: Summonses and FOIA