RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

We apologize to our readers. If we had more time, this outline would be much shorter.

By

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

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Note: This outline was prepared jointly with Cassady V. ("Cass") Brewer, Associate Professor of Law, Georgia State University College of Law, Atlanta, GA, and James M. Delaney, Winston S. Howard Distinguished Professor of Law at the University of Wyoming College of Law.

I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

1. 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:

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.

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.

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.

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).

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.

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.

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.

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

a. Let the games begin! Treasury and the IRS have issued final regulations under § 199A. T.D. 9847, Qualified Business Income Deduction, 84 F.R. 2952 (2/8/19). The Treasury Department and the IRS 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 the 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 the 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 IRS 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 IRS declined to adopt the existing aggregation rules in Reg. § 1.469-4 that apply for purposes of the passive activity loss rules on the basis that those rules, which apply to "activities" rather than trades or businesses and which serve purposes somewhat different from those of § 199A, are inappropriate. Instead, the 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.

b. The IRS 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.

c. The IRS 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. 942 (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 IRS 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 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 four 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;
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; and
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).

d. Treasury and IRS have finalized regulations under § 199A regarding previously suspended losses included in QBI and the QBI deduction for taxpayers holding interests in regulated investment companies, split-interest trusts, and charitable remainder trusts. T.D. 9899, Qualified Business Income Deduction, 85 F.R. 38060 (6/25/20). Treasury and the IRS have finalized proposed regulations issued in early 2019 (REG 134652–18, Qualified Business Income Deduction, 84 F.R. 3015 (2/8/19)) that provide guidance on the treatment of previosuly suspended losses included in qualified business income and on the determination of the § 199A deduction for taxpayers that hold interests in regulated investment companies, split-interest trusts, and chraitable remainder trusts. The final regulations are substantially the same as the proposed regulations and provide clarifying changes, particularly to Reg. § 199A-3(b)(1)(iv) (previously disallowed losses or deductions) and Reg. § 1.199A-6(d)(3)(iii) (trusts or estates). Only two of the clarifying changes are summarized here. *First*, taxpayers and practitioners questioned whether the exclusion of § 461(*l*) (regarding excess business losses) from the list of loss disallowance and suspension provisions in Reg. § 1.199A-3(b)(1)(iv) meant that losses disallowed under section 461(*l*) are not considered QBI in the year the losses are taken into account in determining taxable income. The final regulations clarify that the list of loss disallowance and suspension provisions in Reg. § 1.199A-3(b)(1)(iv) is not exhaustive. If a loss or deduction that would otherwise be included in QBI under the rules of Reg. § 1.199A-3 is disallowed or suspended under any provision of the Code, such loss or deduction is generally taken into account for purposes of computing QBI in the year it is taken into account in determining taxable income. *Second*, taxpayers and practitioners also questioned how the phase-in rules apply when a taxpayer has a suspended or disallowed loss or deduction from a Specified Service Trade or Business (SSTB). Whether an individual has taxable income at or below the threshold amount, within the phase-in range, or in excess of the phase-in range, the determination of whether a suspended or disallowed loss or deduction attributable to an SSTB is from a qualified trade or business is made in the year the loss or deduction is incurred. If the individual's taxable income is at or below the threshold amount in the year the loss or deduction is incurred, and such loss would otherwise be QBI, the entire disallowed loss or deduction is treated as QBI from a separate trade or business in the subsequent taxable year in which the loss is allowed. If the individual's taxable income is within the phase-in range, then only the applicable percentage of the disallowed loss or deduction is taken into account in the subsequent taxable year. If the individual's taxable income exceeds the phase-in range, none of the disallowed loss or deduction will be taken into account in the subsequent taxable year. The final regulations provide other clarifications not summarized here regarding (i) regulated investment company income and the QBI deduction and (ii) application of § 199A to trusts and estates. Affected taxpayers and practitioners should consult the final regulations for details. The final regulations apply to taxable years beginning after August 24, 2020, but taxpayers can elect to apply the final regulations beginning on or before that date. Alternatively, taxpayers who relied on the proposed regulations issued in February 2019 for taxable years beginning before August 24, 2020, can continue to do so for those years.

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

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

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

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

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

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

> **Example 3:** The client of a self-employed attorney spends the day in the attorney's office to review strategy for an upcoming IRS Appeals conference. They take a break for lunch at a restaurant down the street. During lunch, they continue their discussion.

The attorney pays for the meal. Is the meal nondeductible "entertainment"? Or is it (at least in part) a deductible business expense subject to the 50 percent limitation of § 274(n)(1)?

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

Example 1.

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

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

Example 2.

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

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

Example 3.

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

2. As in Example 2, the basketball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expense and is not deductible by C. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets, is not an entertainment expense and is not subject to

the § 274(a)(1) disallowance. Therefore, C may deduct 50 percent of the expenses associated with the food and beverages provided at the game.

b. Final regulations issued. T.D.9925, Meals and Entertainment Expenses Under Section 274, 85 F.R. ___ (10/9/20). Treasury and the IRS have finalized proposed regulations (REG-100814-19, Meals and Entertainment Expenses Under Section 274, 85 F.R. 11020 (2/26/20)) to implement the changes made to § 274(a) by § 13304 of the 2017 Tax Cuts and Jobs Act. Specifically, new Reg. § 1.274-11 sets forth the rules for entertainment expenses. New Reg. § 1.274-12 sets forth the separate rules for business meals, travel meals, and employer-provided meals. The regulations affect taxpayers who pay or incur expenses for meals or entertainment in taxable years beginning after December 31, 2017, and apply to those taxpayers for taxable years that begin on or after October 9, 2020. For prior periods, taxpayers may rely upon the proposed regulations for the proper treatment of entertainment expenditures and food or beverage expenses, as applicable, paid or incurred after December 31, 2017. In addition, taxpayers may rely upon the guidance in Notice 2018-76 for periods prior to the effective date of the final regulations. Set forth below is a high-level summary of the proposed regulations, but affected taxpayers and their advisors should study the new guidance carefully rather than rely upon this summary.

Entertainment expenses. With respect to § 274(a) *entertainment expenses*, Reg. § 1.274-11(a) restates the new deduction-disallowance rule under § 274(a), including the application of the disallowance rule to dues or fees relating to any social, athletic, or sporting club or organization. Section 1.274-2(b)(1)(i) of the regulations substantially incorporates the definition of "entertainment" that appeared in the prior regulations, with minor modifications to remove outdated language. Section 1.274-11(c) of the regulations confirms that the nine exceptions to § 274(a), which are set forth in § 274(e) (e.g., entertainment costs or club dues reported as employee-compensation, recreational expenses for employees, employee or stockholder business meeting expenses, etc.) continue to apply to entertainment expenses. Importantly, like Notice 2018-76, the regulations clarify that *food or beverage expenses* are not considered entertainment expenses subject to disallowance under § 274(a) and that food or beverages provided during or at an entertainment activity (such as meals purchased at a sporting event) similarly are not considered entertainment expenses provided that the food or beverages are purchased separately from the entertainment or the cost of the food or beverages is stated separately from the cost of the entertainment on one more invoices, bills, or receipts. Reg. § 1.274-11(b)(1)(ii). The rule that separately-stated food or beverages are not considered entertainment applies only if the separately-stated cost reflects the venue's usual selling cost for those items if they were to be purchased separately from the entertainment or approximates the reasonable value of those items. Examples 1 through 4 in Reg. § 1.274-11(d) illustrate the rules for meals purchased during or at an entertainment activity.

Business meal expenses. Section 274(k) provides that no deduction is allowed for the cost of food or beverages unless the expense is not lavish or extravagant and the taxpayer, or an employee of the taxpayer is present at the furnishing of the food or beverages. Reg. § 1.274-12(a)(1)-(3) reflects and expands upon these statutory requirements and provides that business meals are deductible (subject to the normal 50 percent limit) as a business expense provided that the expense is not lavish or extravagant under the circumstances, the taxpayer or an employee of the taxpayer is present for the meal, and the food or beverages are provided to a "business associate," defined in Reg. § 1.274-12(b)(3) as "a person with whom the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer's trade or business such as the taxpayer's customer, client, supplier, employee, agent, partner, or professional adviser, whether established or prospective."

Further guidance. In addition, new Reg. § 1.274-12 goes beyond Notice 2018-76 in several respects. ***One***, even though the rules for travel expenses were not amended by the 2017 Tax Cuts and Jobs Act, new Reg. § 1.274-12(a)(4) provides that food or beverages purchased while away from home in pursuit of a trade or business generally are subject to the requirements of § 274(k) discussed above, the 50-percent limitation of § 274(n), the substantiation requirements of § 274(d), and certain special rules in § 274(m) (cruise expenses, education travel expenses, and spouse and dependent travel expenses). ***Two***, new Reg. § 1.274-12(b)(1) clarifies the treatment of food or beverages provided to employees as *de minimis* fringe benefits excludable by employees under § 132(e). Under Reg. § 1.132-

7, employee meals provided on a nondiscriminatory basis by an employer qualify as *de minimis* fringe benefits under § 132(e) if (1) the eating facility is owned or leased by the employer; (2) the facility is operated by the employer; (3) the facility is located on or near the business premises of the employer; (4) the meals furnished at the facility are provided during, or immediately before or after, the employee's workday; and (5) the annual revenue derived from the facility normally equals or exceeds the direct operating costs of the facility. Such employer-provided meals previously were fully deductible by the employer and fully excludable by employee; however, the 2017 Tax Cuts and Jobs Act, § 13304, amended Code § 274(n) to limit the employer's deduction to 50 percent of the cost of employee meals provided at an employer-operated eating facility (unless, as discussed immediately below, an exception applies). Beginning in 2026, the costs of such employer-provided meals will be *entirely disallowed* as deductions pursuant to new Code § 274(o). ***Three***, new Reg. § 1.274-12(c) addresses the six exceptions to the § 274(n)(1) 50-percent limitation on the deduction of food or beverage expenses set forth in § 274(n)(2) (e.g., food or beverage expenses treated as compensation to employee, recreational expenses for employees, etc.). ***Four***, in response to practitioner concerns, Reg. § 1.274-12(c) also addresses by way of examples several common scenarios, including the deductibility of expenses for (i) food or beverages provided to food service workers who consume the food or beverages while working in a restaurant or catering business; (ii) snacks available to employees in a pantry, break room, or copy room; (iii) refreshments provided by a real estate agent at an open house; (iv) food or beverages provided by a seasonal camp to camp counselors; (v) food or beverages provided to employees at a company cafeteria; and (vi) food or beverages provided at company holiday parties and picnics.

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

1. The discharge of nonrecourse debt is not income from cancellation of indebtedness under Oregon's anti-deficiency statute and must be included in amount realized on sale of the property, says the Tax Court. Duffy v. Commissioner, T.C. Memo. 2020-108 (7/13/20). This memorandum decision is lengthy and addresses a number of time-worn issues not worth reviewing here. Of interest, however, is the Tax Court's analysis of whether the taxpayers were required to include in gross income the discharge of indebtedness that secured property they ultimately sold. The taxpayers, a married couple, bought a second residence in Oregon (the Gearhart property) for an agreed price of $2 million. During some of the years in question, the taxpayers occasionaly rented the Gearhart property. Consistent with the purchase contract, the taxpayers paid $430,500 to the sellers but were unable to pay the remaining balance at that time. Subsequently, the taxpayers borrowed $1.4 million from J.P. Morgan Chase (JPMC) and used the proceeds to pay a portion of the remaining amount they owed to the sellers. In 2011, the taxpayers sold the Gearhart property for $800,000 and JPMC agreed to accept $750,841 of the proceeds in full satisfaction of the mortgage on the Gearhart property. On their 2011 income tax return, the taxpayers reported cancellation of indebtedness of $626,046, the remaining principle balance on the JPMC loan. The IRS issued a Notice of Deficiency (NOD) to the taxpayers in relation to their 2011 tax return which, among other things, determined that the taxpayers had additional cancellation of debt (COD) income related to the Gearhart property of $108,661, the amount of unpaid interest that had accrued on the JPMC loan. The Tax Court (Judge Halpern) first concluded that the taxpayers were not entitled to a loss deduction from their sale of the Gearhart property. The taxpayers had rented the Gearhart property and, pursuant to Reg. § 1.165-9(b)(2), their basis for purposes of determining loss was the lower of their cost basis or the fair market value of the property at the time they began renting it. The court concluded that they had not established the fair market value of the property at the time they began renting it and therefore had not established their basis for purposes of determining any loss deduction to which they might be entitled.

Cancellation of Indebtedness Income. In addressing whether the taxpayers were required to report any COD income on the sale of the Gearhart property, the Tax Court reviewed the rules applicable to sales or exchanges under § 1001 and the relevant regulations. Judge Halpern noted that, when a creditor cancels debt that is secured by the property that is sold, the cancellation of the debt can result in either COD income or be included in the amount realized from the sale, thereby increasing the taxpayer's gain or reducing the taxpayer's loss on sale. Under Reg. § 1.1001-2(a)(1), when a taxpayer transfers property and is relieved of a liability, the taxpayer generally must include the liability relief in the amount realized from the disposition of the property. However, under Reg. § 1.1001-2(a)(2), the taxpayer's amount realized from a disposition of property that secures a recourse liability does not include amounts that are income from the discharge of indebtedness under § 61(a)(12). Thus, the cancellation of recourse debt gives rise to COD income to the extent the cancelled debt exceeds the fair market value of the property, and the cancellation of nonrecourse debt does not give rise to COD income and instead is included in the taxpayer's amount realized from the disposition of the property. The taxpayers took the position on their 2011 return that the liabilities were recourse and that any COD income that arose was excluded from income under § 108(a)(1)(B) due to their alleged insolvency. Conceding that the taxpayers did not have COD income on $32,572 of the unpaid interest (because it would otherwise have been deductible), the IRS maintained that the taxpayers realized unreported COD of $76,089 ($108,661 total unpaid interest less $32,572 deductible portion). Judge Halpern deduced from this argument that the IRS viewed the JPMC loan as being a recourse liability. Moreover, the IRS acknowledged that, if the JPMC loan had been nonrecourse (i.e., if the bank's remedies upon default were limited to the Gearhart property alone), the portion of the loan that was cancelled would be included in the taxpayer's amount realized. However, before considering the taxpayers' argument that any COD income arising from the sale of the Gearhart property was excluded due to their alleged insolvency, the court turned to state law to determine whether the debt was recourse or nonrecourse.

Effect of a State Anti-Deficiency Statute. According to the Tax Court's opinion, Oregon law bars a lender from pursuing a borrower for any portion of a debt remaining (i.e., for any deficiency) after a judicial foreclosure of a residential trust deed and after an administrative foreclosure of *any type* of property. *See* Or. Rev. Stat. § 86.770(2) (2011). Although there had been no judicial foreclosure of the Gearhart property, Judge Halpern reasoned that, if the taxpayers sold the Gearhart property in an administrative foreclosure, without the involvement of a court, then the Oregon anti-deficiency statute limited JPMC's remedies against the taxpayers. Judge Halpern then inferred that, because the Gearhart property sale documents did not include any judicial filings by JPMC or references to any judicial proceedings, the sale was part of an administrative as opposed to a judicial foreclosure. Accordingly, Oregon's anti-deficiency statute prevented JPMC from pursuing the Duffy's other assets to satisfy any debt in excess of the proceeds it received from the sale of the Gearhart property, and the JPMC loan was nonrecourse debt. Therefore, the court concluded, the amount of the loan from which the taxpayers had been discharged must be included in their amount realized from the sale of the property and the taxpayers had no COD income under § 61(a)(12).

- *Other cases raising similar issues.* For an example of a case reaching this result, see *Simonsen v. Commissioner*, 150 T.C. 201 (2018), in which the Tax Court held that debt secured by real property sold by the taxpayers in a short sale was nonrecourse debt when California's anti-deficiency statute precluded the lender from pursuing the taxpayers for the balance of the loan that was not satisfied by the short sale. For this reason, the court in *Simonsen* treated the full amount of the mortgage loan as the taxpayers' amount realized in the short sale. In contrast, in *Breland v. Commissioner*, T.C. Memo. 2019-59 (5/29/19), the debt in question was recourse debt and therefore the portion of the debt that exceeded the fair market value of the properties sold at a foreclosure sale was not included in the taxpayers' amount realized.

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

D. Section 121

E. Section 1031

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

A. Fringe Benefits

B. Qualified Deferred Compensation Plans

1. You don't have to CARE about RMDs during 2020. The CARES Act, § 2203, amends Code § 401(a)(9) by adding § 401(a)(9)(I), which waives the requirement to take required minimum distributions for 2020. If a taxpayer turned 70-½ in 2019, he or she was required take their 2019 minimum distribution by April 1, 2020. Such taxpayers, and others who previously had turned 70-½, also must take their 2020 RMD by December 31, 2020. The CARES Act suspends both RMDs that should have been taken by April 1, 2020, and those that normally would be taken by December 31, 2020. One issue that arises is how to treat RMDs that taxpayers took in 2020 before passage of the legislation waiving the requirement to take RMDs. The CARES act does not address this issue. Possibile ways to address this situation include depositing the funds in an eligible returement plan within 60 days and treating the withdrawal and contribution as a tax-free rollover. Another possibility is treating the withdrawal as a coronavirus-related distribution if the applicable requirements are met, reporting the income ratably over three years, and redepositing within three years to treat the withdrawal and contribution as a tax-free withdrawal.

- As discussed earlier in this outline, a provision of the SECURE Act, Division O, Title I, § 114 of the 2020 Further Consolidated Appropriations Act, amended Code § 401(a)(9)(C)(i)(I) to increase the age at which RMDs must begin to 72 for distributions required to be made after December 31, 2019, with respect to individuals who attain age 70-½ after such date.

a. The IRS has issued guidance regarding the waiver of RMDs in 2020. Notice 2020-51, 2020-29 I.R.B. 73 (6/23/20). This notice provides guidance relating to the waiver of 2020 RMDs. The notice permits rollovers of waived RMDs and certain related payments and extends the normal 60-day rollover period for certain distributions to August 31, 2020. The notice also answers several questions in Q&A format related to the waiver of RMDs in 2020. Finally, the notice provides guidance to plan administrators, including a sample plan amendment that, if adopted, would provide participants a choice whether to receive waived RMDs and certain related payments.

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

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

1. Under § 1016, the cost basis of a life insurance contract is not reduced by the cost of insurance, regardless of the purpose for purchasing the contract. Rev. Rul. 2020-5, 2020-9 I.R.B. 454 (2/24/20). This ruling reflects a modification to the determination of a taxpayer's basis in a life insurance contract made by the Tax Cuts and Jobs Act of 2017 (TCJA). Section 13521 of the TCJA added a new subsection "(B)" to § 1016(a)(1) to clarify (and reverse the IRS's position in Rev. Rul. 2009-13, 2009-1 C.B. 1029 (05/01/09)) that basis in an annuity or life insurance contract includes premiums and other costs paid without reduction for mortality expenses or other reasonable charges incurred under the contract (also known as ''cost of insurance''). In general, mortality and expense charges are charges by the insurance company that cover the company's cost of death benefits and expenses related to the costs of providing and administering the insurance contract. Mortality and expense charges together are referred to as the "cost of insurance." Prior to the TCJA amendments to § 1016(a)(1), Rev. Rul. 2009-13 and Rev. Rul. 2009-14 set forth the rules for determining a taxpayer's basis as a component of the calculation of gain or loss on the sale of a life insurance contract. In Rev. Rul. 2009-13, taxpayer A purchased a life insurance contract for protection against economic loss. A later sold the life insurance contract to B, an unrelated third party. In calculating gain, A was required to reduce the basis of the contract by the insurance company's cost of insurance. However, in Rev. Rul. 2009-14, the IRS ruled on the same facts except that B, who enjoyed no insurance protection from the contract, later sold the insurance contract to C solely with a view toward making a profit. Under these circumstances, the IRS ruled that B would not be required to reduce the basis of the insurance contract by the cost of insurance. Applying the TCJA amendment to § 1016(a)(1), Rev. Rul. 2020-5 provides that upon sale of an insurance contract, basis is not reduced by the cost of insurance. This is true regardless of whether the insurance contract is held for insurance protection or purely for investment. Accordingly, as in the first situation above where A holds an insurance contract for protection against loss and sells the contract to B, A is no longer required to reduce the basis in the contact by the cost of insurance. The ruling is effective for transactions entered into on or after August 26, 2009.

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

D. Deductions and Credits for Personal Expenses

E. Divorce Tax Issues

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

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

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

G. Miscellaneous

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

B. Charitable Giving

1. ♫♪♬"We are the champions . . . we are the champions!"♬♪♫ of denseflower knotweed, canoers, and kayakers, says this golf course taxpayer. Champions Retreat Golf Founders, LLC v. Commissioner, 959 F.3d 1033 (11th Cir. 5/13/20), *rev'g and remanding* T.C. Memo 2018-46 (9/10/18). Reversing and remanding the Tax Court, a three-judge panel of the Eleventh Circuit, in an opinion by Judge Hinkle (District Judge sitting by designation), has upheld a golf course conservation easement as meeting the "conservation purpose" requirement of § 170(h). Moreover, the

Eleventh Circuit upheld the conservation easement notwithstanding that the golf course was private property generally inaccessible to most of the public. Essentially, the taxpayer won the case because (i) the easement protected land where a rare plant species, the denseflower knotweed, grew, and (ii) canoers and kayakers floating the Little and Savannah Rivers could view the undeveloped land protected by the easement.

Facts. The taxpayer, an LLC classified as a partnership for federal tax purposes, owned and operated a golf course alongside the Little and Savannah Rivers. In 2009, the golf course struggled financially, so the taxpayer solicited capital contributions from individuals to acquire membership interests. The taxpayer used the capital contributions to strengthen its finances. In 2010, the taxpayer granted a conservation easement over 348 acres of land, including the golf course, to the North American Land Trust. The taxpayer's members thus enjoyed a charitable contribution deduction passed through to them as members (partners) in the taxpayer LLC. Unlike other conservation easement cases, the IRS did not challenge the technical language of the easement deed, but instead argued that the contribution was not made "exclusively for conservation purposes" within the meaning of § 170(h)(4)(A).

Analysis. Section 170(h)(4)(A) defines a "conservation purpose" in part as "the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem" or "the preservation of open space . . . where such preservation is for the scenic enjoyment of the general public." In the Tax Court, the IRS convinced Judge Pugh that the taxpayer had not established the required "conservation purpose." Judge Pugh discounted the testimony of the taxpayer's experts regarding plants and wildlife inhabiting the easement property, and Judge Pugh also held that public access was lacking. Furthermore, Judge Pugh emphasized that chemicals used on the golf course could defeat the "conservation purpose" of the easement. The Eleventh Circuit, however, disagreed with Judge Pugh. Observing that nothing in the Code or Regulations per se prohibits a golf course easement from qualifying for a "conservation purpose," the Eleventh Circuit recounted the numerous species of birds and wildlife inhabiting the conservation easement land. Most significant, the Eleventh Circuit found, was the presence of the denseflower knotweed, a rare plant species growing on one portion of the land covered by the easement. Responding to the IRS's argument that the property was not accessible to the general public, the Eleventh Circuit found that canoers and kayakers floating the Little and Savannah Rivers could enjoy the scenic beauty of the land protected by the easement. They could enjoy the scenic beauty, the Eleventh Circuit found, even if the riverbank partially obscured their view, and they could see only the trees on the golf course. That view, the Eleventh Circuit concluded, was "scenic" as compared to the sight of condominiums and private homes elsewhere on the rivers. Having upheld the "conservation purpose" of the taxpayer's easement, the Eleventh Circuit remanded the case to the Tax Court to determine the proper value of the taxpayer's charitable contribution deduction

2. What does "protected in perpetuity" mean? These cases provide some answers in the contect of conservation easements. It is well known that the IRS is battling syndicated conservation easements. Moreover, after recent victories, the IRS has announced a time-limited settlement offer to certain taxpayers with pending Tax Court cases involving syndicated conservation easements. *See* IR 2020-130 (6/25/20). Other than challenging valuations, the IRS's most successful strategy in combating syndicated conservation easements generally has centered around the "protected in perpetuity" requirement of § 170(h)(2)(C) and (h)(5)(A). The IRS has argued successfully in the Tax Court that the "protected in perpetuity" requirement is not met where the taxpayer's easement deed fails to meet the strict requirements of the "extinguishment regulation." *See* Reg. § 1.170A-14(g)(6)(ii). The extinguishment regulation ensures that conservation easement property is protected in perpetuity because, upon destruction or condemnation of the property and collection of any proceeds therefrom, the charitable donee must proportionately benefit. According to the IRS's and Tax Court's reading of the extinguishment regulation, the charitable donee's proportionate benefit must be determined by a fraction determined at the time of the gift as follows: the value of the conservation easement as compared to the total value of the property subject to the conservation easement (hereinafter the "proportionate benefit fraction"). *See* Coal Property Holdings, LLC v. Commissioner, 153 T.C. 126 (10/28/19). Thus, upon extinguishment of a conservation easement due to an unforeseen event such as condemnation, the charitable donee must be entitled to receive an amount equal to the product of the proportionate benefit fraction multiplied by the proceeds realized from the disposition of the property. As part of its litigation strategy against syndicated conservation easements, the IRS pounces upon any technical flaws in the deed's extinguishment clause/proportionate benefit fraction language. In fact, the IRS recently has been successful in challenging extinguishment clause/proportionate benefit fraction language that either (i) would allow the donor to reclaim from the charitable donee property subject to a conservation easement by conveying to the donee substitute property in exchange therefor or (ii) would reduce the charitable donee's benefit upon extinguishment of the conservation easement by the fair market value of post-contribution improvements made to the subject property after the date of the taxpayer-donor's deductible gift. *See, e.g.*, Pine Mountain Preserve, LLLP v. Commissioner, 151 T.C. No. 247 (12/27/18), including its companion case, Pine Mountain Preserve, LLLP v. Commissioner, T.C. Memo. 2018-214 (12/27/18) (deed allowed substituted property); and PBBM Rose Hill, Ltd. v. Commissioner, 900 F.3d 193 (5th Cir. 9/14/18) (deed reduced charitable donee's benefit for subsequent improvements made by taxpayer donor). The latter argument by the IRS—that a properly-drafted extinguishment clause/proportionate benefit fraction cannot give the donor credit for post-contribution improvements to the conservation easement property—is particularly potent. This argument by the IRS is the subject of the two Tax Court companion opinions rendered in *Oakbrook Land Holdings, LLC v. Commissioner*, as discussed below. Reportedly, many conservation easement deeds have such language, especially syndicated conservation easement deeds originating in the southeastern U.S. Hence, the Tax Court's opinions in *Oakbrook Land Holdings, LLC v. Commissioner* are very important to the conservation easement industry. For a discussion of other IRS and Tax Court developments relating to conservation easements, see the Agricultural Law and Taxation Blog post of July 8, 2020, avaialble here.

a. Duh, forty-five days is not perpetuity. Hoffman Properties II, LP v. Commissioner, 956 F.3d 832 (6th Cir. 4/14/20), aff'g, . And here's yet one more case in which a court strikes down a conservation easement deduction. Instead of "extinguishment clause" language, though, this case turns on another provision in the easement deed that the Tax Court and the Sixth Circuit found problematic under the "protected in perpetuity" requirement of § 170(h)(2)(C) and (h)(5)(A).

Facts. The taxpayer, a limited partnership owning the historic Tremaine Building in Cleveland, Ohio, donated a $15 million façade easement and certain airspace restrictions to the American Association of Historic Preservation ("AAHP"). One paragraph in the easement deed provided for certain conditional actions that the taxpayer could take with respect to the building so long as the charitable donee, AAHP, agreed. For instance, with AAHP's consent, the taxpayer could "[a]lter, reconstruct or change the appearance" of the building's façade or "[a]lter or change the appearance" of the building's airspace. Rather than leaving any such proposed changes entirely up to AAHP, however, the easement deed further provided that AAHP's consent was deemed granted if AAHP failed to either approve or reject any proposed changes "within forty-five (45) days of receipt" of a request from the taxpayer. In an unpublished order granting summary judgment to the IRS, the Tax Court, Judge Nega, had held that the easement deed failed to meet multiple aspects of IRC § 170(h). *See* Order dated March 14, 2018, in *Hoffman Properties LP v. Commissioner*, Docket No. 14130-15. The Sixth Circuit, though, focused upon the 45-day provision mentioned above as violative of the "protected in perpetuity" requirement of § 170(h)(2)(C) and (h)(5)(A).

Analysis. In an opinion by Judge Thapar, a three-judge panel of the Sixth Circuit upheld the Tax Court's decision granting summary judgment to the IRS. With respect to the 45-day deemed approval language in the easement deed, Judge Thapar wrote, "It almost goes without saying that this provision violates the 'perpetuity' requirement. After all, there's a world of difference between restrictions that are enforceable 'in perpetuity' and those that are enforceable for only 45 days." The Sixth Circuit rejected numerous arguments made by the taxpayer, including (i) that the Tax Court had raised the 45-day provision *sua sponte* (on its own accord); (ii) that other language in the easement deed appropriately limited the 45-day provision; (iii) that the 45-day provision was similar to language in a "model" conservation easement deed; (iv) that a previously executed but unrecorded amendment remedied any deficiency in the original easement deed; and (v) that the application of the 45-day provision was so remote as to be "negligible" within the meaning of Reg. § 1.170A-14(g)(3).

b. A crack in the IRS's armor with respect to syndicated conservation easements? Or, a death knell for taxpayers? You be the judge. Oakbrook Land Holdings LLC v. Commissioner, 154 T.C. No. 10 (5/12/20), including the companion memorandum opinion Oakbrook Land Holdings LLC v. Commissioner, T.C. Memo 2020-54 (5/12/20). In these companion opinions totaling 172 pages, the Tax Court disallowed a taxpayer-donor's charitable contribution deduction because the language in the conservation easement deed was found to be defective under either of two theories argued by the IRS and supported by the Tax Court's reading of Reg. § 1.170A-14(g)(6)(ii). See below for further discussion. The taxpayer-donor's counter arguments, that the conservation easement deed's language was correct and that Reg. § 1.170A-14(g)(6)(ii) is invalid, failed to persuade the Tax Court. Just to keep us on our toes, perhaps, the Tax Court's decision resulted in two lengthy opinions. Judge Lauber wrote the majority opinion for the Tax Court's reviewed decision regarding one theory of the case, while Judge Holmes wrote a memorandum decision based upon another theory of the case. Interestingly, *Oakbrook Land Holdings* did not arise out of a syndicated conservation easement; however, it is very informative as to the IRS's litigation strategy with respect to syndicated conservation easements as well as the Tax Court's view of the law applicable to conservation easements generally.

Facts. The facts of *Oakbrook Land Holdings* are typical of recent conservation easement cases litigated in the Tax Court. The taxpayer-donor, Oakbrook Holdings LLC, acquired a 143-acre parcel of property near Chattanooga, Tennessee in 2007 for $1.7 million. The plan was to develop the property for "higher-end, single family residences." In late 2008 Oakbrook Holdings LLC transferred approximately 37 acres of the property to related entities to allow a portion of the property to be developed without restrictions relating to the remainder of the property. The remaining 106 acres of the property then was subjected to a conservation easement in favor of Southeast Regional Land Conservancy (the "Conservancy"), a § 501(c)(3) organization. The taxpayer-donor, Oakbrook Holdings LLC, claimed a charitable contribution deduction of over $9.5 million for the donated conservation easement even though the contribution occurred only a little over a year after Oakbrook Holdings LLC had acquired the property for $1.7 million.

Oakbrook Holdings LLC, the taxpayer-donor, largely relied upon the charitable donee, the Conservancy, and its attorneys to draft the conservation easement deed. The Conservancy in turn relied upon language found in similar conservation easement deeds that have been executed and approved by numerous taxpayers and their attorneys. The deed provided as follows in relevant part:

> This Conservation Easement gives rise to a real property right and interest immediately vested in [the Conservancy]. For purposes of this Conservation Easement, the fair market value of [the Conservancy]'s right and interest shall be equal to the difference between (a) the fair market value of the Conservation Area as if not burdened by this Conservation Easement and (b) the fair market value of the Conservation Area burdened by this Conservation Easement, as such values are determined as of the date of this Conservation Easement, (c) less amounts for improvements made by O[akbrook] in the Conservation Area subsequent to the date of this Conservation Easement, the amount of which will be determined by the value specified for these improvements in a condemnation award in the event all or part of the Conservation Area is taken in exercise of eminent domain as further described in this Article VI, Section B(3) below. If a change in conditions makes impossible or impractical any continued protection of the Conservation Area for conservation purposes, the restrictions contained herein may only be extinguished by judicial proceeding. Upon such proceeding, [the Conservancy], upon a subsequent sale, exchange or involuntary conversion of the Conservation Area, shall be entitled to a portion of the proceeds equal to the fair market value of the Conservation Easement as provided above. [The Conservancy] shall use its share of the proceeds in a manner consistent with the conservation purposes set forth in the Recitals herein.

Article VI, Section B(3) of the deed further stated:

> Whenever all or part of the Conservation Area is taken in exercise of eminent domain * * * so as to abrogate the restrictions imposed by this Conservation Easement, * * * [the] proceeds shall be divided in accordance with the proportionate value of [the Conservancy]'s and O[akbrook]'s interests as specified above; all expenses including attorneys fees incurred by O[akbrook] and [the Conservancy] in this action shall be paid out of the recovered proceeds to the extent not paid by the condemning authority.

First argument of the IRS and taxpayer's response. The IRS's first argument to disallow the taxpayer-donor's charitable contribution deduction was that the above-quoted language of the conservation easement deed only entitled the charitable donee, the Conservancy, to a fixed (not proportionate) benefit (i.e., historical value of the conservation easement at the time of the gift) upon the destruction or condemnation of the subject property. According to the IRS, Reg. § 1.170A-14(g)(6)(ii) requires that the charitable donee be entitled to a *proportionate* (i.e., fractional) benefit upon extinguishment of a conservation easement. Further, the IRS's position is that the amount of the benefit must be determined by applying the proportionate benefit fraction against the fair market value of the subject property at the time of the extinguishment. Put differently, the IRS contends that Reg. § 1.170A-14(g)(6)(ii) does not merely establish a baseline amount equal to the value of the conservation easement as the amount of the benefit to be received by the charitable donee upon extinguishment of a conservation easement. Rather, upon extinguishment of the easement, if the subject property has appreciated in value the charitable donee must be entitled to receive more than the claimed charitable contribution value of the conservation easement. (It is not entirely clear what the IRS's position would be under Reg. § 1.170A-14(g)(6)(ii) if upon extinguishment of the easement the subject property has decreased in value after the taxpayer-donor's gift, although consistency would argue that the charitable donee should receive less than the claimed charitable contribution value.)

On the other hand, the taxpayer-donor argued, of course, that the above-quoted language in the deed complied with Reg. § 1.170A-14(g)(6)(ii) because the regulation should be read to require only a fixed (not fractional) amount that must be received by the charitable-donee upon extinguishment of a conservation easement. In other words, the taxpayer-donor believed that Reg. § 1.170A-14(g)(6)(ii) was meant to protect the chartable donee's downside risk: i.e., that the event extinguishing the conservation easement would result in proceeds much less than the taxpayer-donor's claimed charitable contribution deduction. The taxpayer-donor's reading of Reg. § 1.170A-14(g)(6)(ii) was that the extinguishment clause in a conservation easement deed must entitle the charitable donee to an amount equal to the previously claimed charitable contribution deduction (or, if less, all of the proceeds from the disposition of the property).

Memorandum Opinion of Judge Holmes. In Oakbrook Land Holdings LLC v. Commissioner, T.C. Memo 2020-54 (5/12/20), Judge Holmes, citing the Tax Court's prior decision in Coal Property Holdings, LLC v. Commissioner, 153 T.C. 126 (10/28/19), agreed with the IRS's position regarding Reg. § 1.170A-14(g)(6)(ii) and the conservation easement language at issue, thereby disallowing the taxpayer-donor's more than $9.7 million charitable contribution deduction. Judge Holmes reasoned that the language in the deed did not grant a fractional proportionate benefit to the Conservancy. It granted only a minimum benefit equal to the amount of the taxpayer-donor's claimed charitable contribution deduction. Judge Holmes agreed with the IRS that Reg. § 1.170A-14(g)(6)(ii) requires a fractional benefit, not a fixed amount. Other cases also have interpreted Reg. § 1.170A-14(g)(6) to require a fractional, not fixed, benefit in favor of the charitable donee. *See, e.g.*, *PBBM Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 9/14/18). This aspect of the Tax Court's decision in *Oakbrook Land Holdings* is not novel, and presumably this lack of novelty is the reason for this memorandum decision written separately from the Tax Court's reviewed opinion written by Judge Lauber.

Second argument of the IRS and taxpayer's response. Alternatively, the IRS argued that the above-quoted language in the conservation easement deed was flawed in another respect. Specifically, the IRS contended that the deed's extinguishment language, which required that the charitable-donee's benefit upon destruction or condemnation of the property be reduced by the value of improvements to the property made by the taxpayer-donor after the contribution, was not allowed by the strict requirements of Reg. § 1.170A-14(g)(6)(ii). This position of the IRS is not explicitly supported by Reg. § 1.170A-14(g)(6)(ii) and is a novel argument by the IRS. The taxpayer-donor responded that to the extent Reg. § 1.170A-14(g)(6)(ii) is read to disallow such a reduction in the charitable-donee's benefit upon extinguishment of a conservation easement, the extinguishment regulation violates either the procedural or substantive requirements of the Administrative Procedures Act ("APA") and is invalid. This alternative argument by the IRS, and the taxpayer-donor's response, was the subject of the Tax Court's reviewed opinion by Judge Lauber, discussed below.

Reviewed opinion of Judge Lauber. In Oakbrook Land Holdings LLC v. Commissioner, 154 T.C. No. 10 (5/12/20), a reviewed opinion (12-4-1) by Judge Lauber, the Tax Court agreed with the IRS's position concerning Reg. § 1.170A-14(g)(6)(ii) and post-contribution improvements to conservation easement property by a taxpayer-donor. We will spare the reader pages and pages of arguments and counter-arguments regarding the requirements of the APA. Suffice it to say that a majority of the Tax Court held that Reg. § 1.170A-14(g)(6)(ii) reflects a reasonable interpretation of the "protected in perpetuity" requirement of § 170(h)(2)(C) and (h)(5)(A). The majority also agreed with the IRS's position that Reg. § 1.170A-14(g)(6)(ii) does not permit the extinguishment clause of a conservation easement deed to reduce the charitable donee's proportionate benefit by the fair market value of post-contribution improvements to the subject property made by the donor. Hence, the majority disallowed the taxpayer-donor's claimed $9.7 million plus charitable contribution deduction based upon the IRS's alternative argument (in addition to the grounds expressed in Judge Holmes's separate memorandum opinion).

Concurring opinion of Judge Toro. In a concurring opinion, Judge Toro, joined by Judge Urda and in part by Judges Gustafson and Jones, wrote that, although the majority reached the correct result for the reasons expressed in Judge Holmes's memorandum decision, the majority was mistaken concerning whether Reg. § 1.170A-14(g)(6)(ii) violates the APA and whether the IRS's interpretation of the extinguishment regulation (regarding post-contribution improvements made by a taxpayer-donor) was permissible.

Dissenting opinion of Judge Holmes. In an interesting twist, Judge Holmes (who held in favor of the IRS in his memorandum opinion) dissented from the Tax Court's reviewed opinion. Judge Holmes wrote: "Our decision today will likely deny any charitable deduction to hundreds or thousands of taxpayers who donated the conservation easements that protect perhaps millions of acres." And Judge Holmes made his views clear regarding the IRS's interpretation of Reg. § 1.170A-14(g)(6)(ii) to prohibit reduction of a charitable donee's extinguishment benefit for the value of improvements made by a taxpayer-donor and Treasury's compliance with the APA: "[I]f the majority is right, the Treasury Department can get by with the administrative-state equivalent of a quiet shrug, a knowing wink, and a silent fleeting glance from across a crowded room."

X. TAX PROCEDURE

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

1. Taxpayer again escapes penalties where supervisory approval to impose penalties is not obtained until after imposition of the penalties. Kroner v. Commissioner, T.C. Memo. 2020-73 (6/1/20). The taxpayer, Mr. Kroner, had an incredibly successful relationship with a benefactor, Mr. Haring, with whom he had worked for years. Notwithstanding that Mr. Kroner submitted into evidence a letter purportedly from Mr. Haring indicating that more than $24 million in transfers over several years to Mr. Kroner were gifts, the transfers were held not to qualify as excludable from gross income under § 102(a) as gifts. Instead, the Tax Court (Judge Marvel) applied the U.S. Supreme Court's analysis in *Commissioner v. Duberstein*, 363 U.S. 278 (1960), and held that the transfers were included in Mr. Kroner's income because he had failed to prove that the transfers were made with detached, disinterested generosity. In short, despite the court's strong recommendation during trial, Mr. Kroner failed to offer any testimony from Mr. Haring that he had anything more than a business relationship with Mr. Haring. The court found the taxpayer's story concerning the transfers and the testimony of the taxpayer, his attorney, and a third witness not to be credible.

Accuracy-Related Penalties Under § 6662. The more significant aspect of this decision relates to Judge Marvel's denial of the IRS's imposition of accuracy-related penalties under § 6662 based on substantial understatement of income. The issue before the court was whether the IRS had complied with the requirement of § 6751(b)(1) that the initial determination of the assessment of a penalty be "personally approved (in writing) by the immediate supervisor of the individual making such determination." In *Graev v. Commissioner*, 149 T.C. 485 (2017), the Tax Court held that compliance with § 6751(b)(1) is properly a part of the IRS's burden of production under I.R.C. § 7491(c). Further, in *Chai v. Commissioner,* 851 F.3d 190 (2d Cir. 2017), the U.S. Court of Appeals for the Second Circuit held that "the written approval requirement of § 6751(b)(1) is appropriately viewed as an element of a penalty claim, and therefore part of the IRS's prima facie case." The Tax Court has held the initial determination of a penalty occurs in the document through which the IRS Examination Division notifies the taxpayer in writing that the examination is complete and it has made a decision to assert penalties. *See Belair Woods, LLC v. Commissioner*, 154 T.C. No. 1 (1/6/20). Here, the IRS supervisor approved the agent's penalty determination on a Civil Penalty Approval Form dated October 31, 2012. The IRS had sent the taxpayer two letters. The first, dated August 6, 2012, was Letter 915 accompanied by Form 4549 (Income Tax Examination Changes), which proposed the penalties and provided petitioner with an opportunity to protest the proposed adjustments with the IRS Appeals Office. The second, dated October 31, 2012, was Letter 950 accompanied by Form 4549-A (Income Tax Discrepancy Adjustments), which also offered the taxpayer an opportunity to file a protest with the IRS Appeals Office. According to the court, if Letter 915 was the initial determination to assert accuracy-related penalties, then the IRS could not meet its burden to show the required supervisory approval because Letter 915 predated the date on which the Civil Penalty Approval Form was signed. The IRS argued that Letter 915 was not the initial determination of the penalties because Letter 915 was not the so-called "30-day letter" giving the taxpayer 30 days within which to file a protest with IRS Appeals and instead was meant only to invite the taxpayer to submit additional information "at a time when it was understood that petitioner would not yet pursue an administrative appeal." The court rejected this argument. The court reasoned that, in *Clay v. Commissioner*, 152 T.C. 223 (2019), the court had held that a letter offering the taxpayer a right to pursue an administrative appeal and enclosing a revenue agent's report that proposed a § 6662 penalty was the initial determination within the meaning of § 6751(b), and Letter 915 in this case did just that. The court made clear that the content of the document sent to the taxpayer is the relevant inquiry and not the IRS's subjective intent in mailing the document. The court concluded that the IRS made its initial determination of the assessment of penalties no later than August 6, 2012, when Letter 915 was delivered to the taxpayer. Because the initial determination to assert penalties occurred before the Civil Penalty Approval Form was signed on October 31, 2012, the IRS had failed to satisfy its burden of production under § 6751(b) and the taxpayer, therefore, was not liable for the § 6662(a) accuracy related penalties.

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

F. Liens and Collections

1. Following a CDP hearing, the Tax Court held that it had jurisdiction to consider the taxpayer's underlying tax liabilities because the taxpayer did not have a prior opportunity to contest them. Amanda Iris Gluck Irrevocable Trust v. Commissioner, 154 T.C. No. 11 (5/6/20). The taxpayer, the Amanda Iris Gluck Trust (the Trust), was a direct and indirect partner in partnerships subject to the TEFRA audit procedures. The taxpayer allegedly omitted from its income $48.6 million of its distributive share of partnership income on its 2012 federal income tax return. Because this income allegedly was reflected on the Schedule K-1 received by the taxpayer and the taxpayer did not notify the IRS of its inconsistent reporting of income by filing Form 8082 (Notice of Inconsistent Treatment or Administrative Audit Request), the IRS was permitted to make a "computational adjustment" to the Trust's 2012 income tax return to include the omitted income without issuing a notice of deficiency. The adjustment had the effect of eliminating the net operating loss (NOL) the Trust had reported for 2012, which also eliminatined the NOL carryforwards the Trust had claimed in 2013-2015. The IRS sent letters (Letter 4735) to the Trust indicating that it would have to pay the resulting liabilities and file for a refund. Upon the Trust's failure to pay, the IRS assessed liabilities for 2013-2015 and issued a notice of intent to levy. The Trust timely requested a collection due process (CDP) hearing for 2012-2015, even though the notice of levy related only to 2013-2015. In the hearing, the IRS Settlement Officer (SO) confirmed that the 2013-2015 tax liabilities had been properly assessed but that the 2012 liability was not a subject of the levy notice. The SO therefore concluded he had no jurisdiction over the Trust's 2012 year. The SO did not address the Trust's underlying challenge of the liabilities imposed in relation to 2013-2015 in the hearing. Following the CDP hearing, the IRS issued a notice of determination sustaining the levy. The notice explained that, because the taxpayer could have paid the underlying tax liabilities and filed a claim for refund, it had neglected to take advantage of a prior opportunity to dispute its 2013-2015 liabilities and therefore was precluded from contesting the underlying liabilities in the CDP hearing. In response to the notice of determination, the taxpayer filed a petition in the Tax Court. The IRS moved to dismiss as to 2012 and 2013 on the basis that 2012 was not properly before the court and the 2013 liability had been fully satisfied by tax credits applied from other years. The Tax Court (Judge Lauber) initially held that it lacked jurisdiction to consider any challenge for 2012 because the IRS had not issued a notice of determination in relation to that year. Further, because the Trust conceded that the 2013 tax liability was satisfied and there no longer existed any liability upon which collection action could be based for 2013, the court concluded that any proceeding in relation to 2013 was moot. Accordingly, the court granted the IRS's motion to dismiss as to 2012 for lack of jurisdiction and as to 2013 on grounds of mootness. The remaining two years, 2014 and 2015, remained at issue for the court to decide whether the IRS's motion for summary judgement should be granted. Section 6330(c)(2)(B) permits a taxpayer to challenge the existence or amount of the taxpayer's underlying tax liability in a CDP hearing only "if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability." The SO concluded that the taxpayer had such a prior opportunity because it could have paid the underlying tax liabilities and filed a claim for refund. The IRS conceded that the SO's reason for not considering the Trust's underlying tax liabilities for 2014 and 2015 was erroneous. Because the Trust did not have a prior opportunity to dispute its 2014 and 2015 liabilities, the court held that it had jurisdiction to review the liabilities for those years. The court noted that, although it generally lacks jurisdiction to review computational adjustments in deficiency cases, it does not have a similar lack of jurisdiction in CDP cases. The court referrred to prior decisions in which it similarly had concluded that it had jurisdiction to review liabilities in CDP cases despite the fact that it would have no jurisdiction to review them in deficiency proceedings. *See, e.g., McNeill v. Commissioner*, 148 T.C. 481 (2017) (concluding that Tax Court has jurisdiction to review underlying liabilities arising from adjustments to partnership items of TEFRA partnerships even though it could not review such liabilities in deficiency cases). The court concluded that the Trust had properly raised its underlying tax liabilities for 2014-2015 during the CDP hearing and that these liabilities were properly before the court. The taxpayer raised several arguments as to why it was entitled to the NOL carryforward deductions for 2014 and 2015. Because these arguments and the IRS's reponses raised genuine issues of material fact, the court denied the IRS's motion for summary judgement.

G. Innocent Spouse

H. Miscellaneous

1. Sixth Circuit reverses District Court holding that the government was barred by the doctrine of judicial estoppel from challenging the taxpayer's method of calculating its R&D credit. Audio Technica U.S., Inc. v. United States, 963 F.3d 569 (6th Cir. 6/26/20). The main issue in this case was whether a U.S. District Court had erred in holding that the IRS was judicially estopped from challenging the fixed-base percentage that Audio Technica used in calculating its research and development credit ("R&D credit") under § 41. In general, under § 41(a)(1), the R&D credit is equal to 20 percent of the excess of the taxpayer's annual qualified research expenses over the "base amount." The base amount is generally equal to the taxpayer's average gross receipts over the previous four years multiplied by a "fixed-base percentage." This percentage is arrived at by adding up the total qualified research expenses for the relevant five-year period and then dividing that amount by aggregate gross receipts for the same period. The lower the fixed-base percentage, the higher is the R&D credit. Audio Technica claimed an R&D credit for several years prior to the years in issue. With respect to those previous years, the IRS twice agreed to stipulated settlements of litigation in the U.S. Tax Court in which Audio Technica used a fixed-base percentage of 0.92 percent. For the later tax years at issue in this case, Audio Technica reported R&D credits again using a fixed-base percentage of 0.92 percent. However, the IRS disallowed the credits for these years. Audio Technica paid the tax that the IRS asserted was due, filed a claim for refund, and ultimatley brought a refund action in a U.S. Disctirct Court. At trial, Audio Technica asserted that, because the IRS had twice agreed with the 0.92 percent fixed base percentage in previous years, the doctrine of judicial estoppel applied to estop or prevent the IRS from challenging the fixed-base percentage used by Audio Technica in the years at issue. The trial court agreed with Audio Technica on the basis that the Tax Court had approved the previous settlement agreements in which the parties had stipulated that a fixed-base percentage of 0.92 percent applied. In an opinion by Judge Clay, the U.S. Court of Appeals for the Sixth Circuit disagreed and held that the Tax Court's orders memorializing the settlement agreements did not constitute judicial acceptance of the facts to which the parties had stipulated in the settlement agreements. In general, the doctrine of judicial estoppel prevents a litigant from asserting a legal position that is contrary to a legal position that the same litigant asserted under oath in a prior proceeding and that was accepted by the court. *See, e.g., Teledyne Indus., Inc. v. NLRB*, 911 F.2d 1214, 1218 (6th Cir. 1990). Applying this principle, the Sixth Circuit held that the doctrine of judicial estoppel did not bar the government from challenging Audio Technica's fixed-base percentage because the previous litigation in the Tax Court had been resolved through settlements in which there had been no judicial acceptance of the IRS's position. The court emphasized that a settlement agreement, even in the form of an agreed order, does not constitute judicial acceptance of the terms contained in the agreement. *See Teledyne*, 911 F.2d at 1219. The court also declined to accept Audio Technica's additional argument that judicial estoppel should apply pursuant to the court's the 0.92 percent fixed-base percentage.prior holding in *Reynolds v. Commissioner*, 861 F.2d 469 (6th Cir. 1988), in which the court had applied the doctrine when the parties previously had entered into a settlement agreement approved by the Bankruptcy Court. The court rejected this argument on the basis of the unique nature of bankruptcy settlements. In bankruptcy proceedings (as opposed to an ordinary civil proceeding) a compromise between a debtor and his or her creditors must be carefully examined by the bankruptcy court to protect the interests of third parties and must be determined to be fair and equitable before the bankruptcy court will approve it. The bankruptcy court has an affirmative obligation to apprise itself of the underlying facts before it can approve a compromise. Here, the court reasoned, the Tax Court did not have the same obligation and, because the Tax Court proceedings ended with a settlement between the IRS and Audio Technica that did not require the Tax Court to accept the parties' litigating positions, judicial estoppel did not apply. Finally, the court noted that, even if judicial estoppel could apply, the Tax Court never relied on or approved the 0.92 percent fixed-base percentage. The stipulated decisions entered in the prior proeceedings referred only to total dollar amounts and did not refer to the 0.92 percent fixed-base percentage. Based on this reasoning, the Sixth Circuit held that the IRS was not judicially estopped from redetermining Audio Technica's fixed base percentage for the years at issue.

2. The IRS has announced that individuals can e-file amended returns on Form 1040-X for 2019. IR-2020-182 (8/17/20). Individuals who wish to amend a federal income tax return by filing Form 1040-X historically have had to mail the form to the IRS. The IRS has announced that individuals now can e-file Form 1040-X using available software products to amend Forms 1040 or 1040-SR for 2019. Whether the ability to e-file amended returns will be expanded to other years is not entirely clear. The announcement states that "[a]dditional improvements are planned for the future." Taxpayers still will have the option to mail a paper version of Form 1040-X.

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

A. <u>Enacted</u>