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TAX SECTION
STATE BAR OF TEXAS

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Dear Fellow Tax Section Members,

With the Astros having won the American League Division Series for 2018 and having put up a gallant fight for a 2018 World Series spot in the playoffs, and the Texans improving their chances for a playoff spot this fall, I am honored to deliver the following report for our fall edition of the *Texas Tax Lawyer*. I would also like to thank our Editor, **Michelle Spiegel**, for her continued commitment and hard work in delivering an outstanding *Texas Tax Lawyer* publication 3 times every year.

Overview of Our Busy Summer

The new officers met over the weekend of July 13, 14 and 15 2018 to begin planning for the upcoming year. This was preceded by our Council Retreat which was held in conjunction with the Annual Meeting on Thursday, June 21, 2018. In addition, the Tax Section held its first meeting of the Chairs, Vice Chairs and Council on Friday, August 24, 2018 at the Houston offices of Norton Rose Fulbright.

As a result of these meetings, below are a few documents that have been approved:

1. The Calendar for the 2018-2019 Fiscal Year;

2. The List of Chairs and Vice Chairs for the committees; and

3. The Statement of Direction.

The **2018 Annual Meeting** was held in Houston, Texas and we give a special thanks to the Annual Meeting chair, **John Strohmeyer**, together with a planning committee including the CLE Committee chairs and a number of Tax Section leaders, including past Tax Section Chair and current Council member **Alyson Outenreath**, for having put together a great program.

Continuing This Year

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

Leadership Academy

The Leadership Academy, chaired by **Rob Morris**, is a program developed to guide the next generation of Texas tax lawyers in taking ownership of their careers and leading the Tax Section. The class meets four times over a year, which each session held in a different city and focusing on a particular aspect of tax law. The deadline for applications for the 2019-2020 Leadership Academy class is January 11, 2019.

Committee on Governmental Submissions

The Committee on Governmental Submissions, co-chaired by **Henry Talavera**, **Jeffry Blair**, **Ira Lipstet,** and **Jason Freeman**, and the substantive committees of the Tax Section have been extremely busy this year providing comments to the Texas Comptroller of Public Accounts and the Internal Revenue Service.

On October 1, 2018, comments were submitted to the Internal Revenue Service. The principal drafters were **Professor Bruce McGovern**, Chair of the General Tax Committee, **Chris M. Goodrich**, Vice Chair of the General Tax Committee, **Nathan Smithson**, Chair of the Partnership and Real Estate Tax Committee, **Will Becker**, **Argyrios Saccopoulos** and **Vu Khoa**, each a Member of the Partnership and Real Estate Tax Committee, **Carol G. Warley**, **Laurel Stephenson**, and **Celeste C. Lawton**, each a Co-Chair of the Estate and Gift Tax Committee, **Corey Junk**, Vice Chair of the Estate and Gift Tax Committee, **Jeffry M. Blair**, Chair of the Corporate Tax Committee, and **Kelly Rubin**, Vice Chair of the Corporate Tax Committee.

The comments are a magnificent scholarly collaboration of the above committees, and addresses the government's request for assistance with the Proposed Regulations providing guidance on the application of Section 199A of the Tax Cuts and Jobs Act of 2017. The comments suggest two operational rules: (1) how qualified property contributed to a partnership or S Corporation should be its pre-contribution unadjusted basis immediately after acquisition ("UBIA"); and (2) that certain basis adjustments under Sections 734 and 743 should be qualified property for purposes of determining UBIA. The comments also address how the proposed regulations excluding qualified business income ("QBI") for 707(a) payments received for services may unfairly impact partners who would otherwise have QBI from a valid trade or business and suggests that guaranteed payments under Section 707(c) for the use of capital should not be excluded from QBI. The comments also:

- request assistance from the Treasury for additional elaboration on the "performance of services in the field of health" and additional regulatory clarification in determining QBI under code section 864(c)(8) upon the sale of a partnership interest;
- request clarification from the Treasury on the definition of a primary beneficiary for lifetime and testamentary trust planning and provide additional guidance on how the IRS will assess whether trusts have "substantially the same primary beneficiary or beneficiaries";
- request clarity regarding the 199A proposed regulations and the net investment income tax and distribution standards under a trust;
- suggest that "if a trust or estate has a QBI net loss that the loss carryover be retained at the entity level"; and
- suggest that charitable remainder trusts, charitable lead trusts and their beneficiaries should be eligible for the Section 199A deduction because the legislative history indicates it was enacted to provide a deduction for taxpayers other than a corporation based on QBI.

Pro Bono Dockets

The Pro Bono Committee, co-chaired by **Juan Vasquez** and **Rachael Rubenstein,** assisted taxpayers at the Lubbock Regular and Small Tax Case docket on September 17, 2018, the Dallas

Regular Case docket and San Antonio Regular and Small Tax Case docket on October 1, 2018, and the Houston Regular Tax Case docket October 15, 2018. Similar events are scheduled throughout the state of Texas for the remainder of the calendar year at various locations including Dallas, El Paso, Houston, Lubbock, and San Antonio. The Texas Tax Court Pro Bono Program was established by past Chair and now sitting Tax Court Judge Elizabeth A. Copeland. The Texas Pro Bono Program is now used as a model for other state bars.

Meeting with the Texas Comptroller's Office

Our annual meeting with the Texas Comptroller of Public Accounts office is scheduled for Thursday**, November 13, 2018 in Austin, Texas**. Presentations from speakers from the Texas Comptroller's Office, the Counsel on State Tax, the Texas Taxpayers and Research Association and the Multi State Tax Commission will be sprinkled throughout the day. The speakers will include **Fred Nicely** who is Legislative Counsel with the Counsel on State Tax, **Dale Cramer**, who used to be with the Comptroller's Office and is now with Texas Taxpayers and Research Association, **Chris Barber** of the Multi State Tax Commission along with the Texas Comptroller **Glenn Hegar** and his staff. Portions of this program should soon be available on the Tax Section's 24/7 Free Online CLE Library. Many thanks to the Texas Comptroller of Public Accounts, **Glenn Hegar,** his staff and the State and Local Tax Committee, co-chaired by **Sam Megally** and **Stephen Long** for their hard work and efforts to plan this program and make it available to members of the Tax Section.

Law School Outreach Program

The Tax Section's efforts at reaching out to law school students are well underway. The Tax Section met with students at Texas Tech on September 17, 2018 Southern Methodist University Dedman School of Law on October 30, 2018. Other law school programs are in the process of being scheduled. Welcome to our **new IRS Liaison Audrey Morris** who is heading up the Law School Outreach for the Tax Section. Special thanks to **Abbey Garber**, who is vice chairing the Law School Outreach Committee with Audrey and for his continued stewardship and support in connection with the Law School Outreach Program.

Law School Student Scholarships

The application period for law school scholarships is scheduled to open in January of 2019. Applications will be available on our website, so law students and professors will want to be on the lookout for the application! Thanks to **Stephen Long** for continuing to spearhead the law school scholarship program this year.

The 24/7 Free Online CLE Library

Almost three years ago, the Tax Section launched a newly updated 24/7 Free Online Library thanks to **Michael Threet**, Co-Chair of the CLE Committee and **Alyson Outenreath**, Council member and former Chair of the Tax Section. It continues to be free to members of the Tax Section. It includes over 100 audio and video programs, along with PowerPoint presentations and outlines. And it continues to grow.

Nominations Committee

As directed under the Bylaws, I have recently appointed members of the Nominations Committee. These members include:

- **Stephanie M. Schroepfer** (Immediate Past Chair);
- **Mary McNulty** (2011-2012 Chair); and
- **Tina Green** (2012-2013 Chair)

As the current Chair, I will serve on the Nominations Committee as an Ex-Officio member.

I would like to extend a special thanks to our past chairs for their continued willingness to serve and support the Tax Section of the State Bar; their time and interest is greatly appreciated.

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

The deadline for submitting articles and other items for the winter edition of the *Texas Tax Lawyer* is January 25, 2019. Any members interested in submitting articles or other items should contact **Michelle Spiegel** at Michelle.Spiegel@nortonrosefulbright.com.

Upcoming Events

Tax Law in a Day is scheduled for Friday, **January 25, 2019 in Dallas, Texas** at the **Belo Mansion**. This year the CLE will be sponsored by the Tax Section and the Solo and Small Firm Section of the Dallas Bar. The topics will focus on the Basics of the Tax Cuts and Jobs Act of 2017. Tax Law in a Day is an annual all-day survey of tax law basics given under the stewardship of **Lora Davis**. This year she is our Treasurer and is graciously training and grooming her CLE Committee Members, **Renesha Fountain**, **David Gair**, and **Tiffany Hamil**, to accept the baton in the near future.

The annual Property Tax continuing legal education program will be held in March in Austin. The Property Tax CLE is always a wonderful success and we congratulate the Property Tax Committee on having discovered the key to the CLE magic. More details will soon follow. The Property Tax Committee is chaired by **Rick Duncan** and vice chaired by **Daniel Richard Smith**.

Advanced Tax CLE a Deep Dive - The Tax Section is working on yet another Advanced Tax continuing legal education program and this year's topic will be South Dakota v. Wayfair. The program is scheduled for **March 22, 2019** at the **Belo Mansion in Dallas, Texas**. We are engaging the best and the brightest from all over the United States to discuss Wayfair and it promises to be a fantastic day. The program is being spearheaded by Co-Chair of the CLE Committee, **Dan Baucum** and the State and Local Committee**,** co-chaired by **Sam Megally** and **Stephen Long** and assisted by Chair-Elect **Charolette Noel** and Secretary **Christi Mondrik.** More details to come. We are extremely grateful for **Dan Baucum's** involvement and for being such a wonderful supporter of the Tax Section.

The **2019 Annual Meeting** will be held in **Austin, Texas** on **June 13th and 14th** at the **JW Marriott.** The Annual Meeting CLE is being planned by a number of the Tax Section leaders including past Tax Section Chair **Bill Elliott,** Chair-Elect **Charolette Noel**, **Professor Bruce McGovern**, Co-Chair of the CLE Committee **Dan Baucum** and myself.

Hurricane Harvey Task Force

Houston is rebuilding after Hurricane Harvey left its footprint on the city. In response to Hurricane Harvey, a large number of concerned Tax Section leaders (including **Brett Wells**, **Bruce McGovern**, **Alyson Outenreath**, **Juan Vasquez**, **Elizabeth Copeland**, **Rob Morris**, **Jeffry Blair**, **Bob Probasco**, **Dan Baucum**, **Chris Goodrich, Richard Hunn**, and the officers, to name a few) formed an unofficial Hurricane Harvey task force. The Tax Section created a Hurricane Harvey corner on its website for the general population. The Tax Section will leave the Hurricane Harvey corner on its website for the foreseeable future to aid anyone who may be in need of its information. A heart felt and special thanks to all of those who spent their time creating the Hurricane Harvey corner for the Tax Section website.

Join a Committee

We have an active set of committees, both substantive and procedural as in previous years. Our substantive committees include: Corporate Tax, Employee Benefits, Energy and Natural Resources, Estate and Gift Tax, General Tax Issues, International Tax, Partnership and Real Estate, Property Tax, Solo and Small Firm, State and Local Tax, Tax Controversy, Tax-Exempt Finance, and Tax-Exempt Organizations. In addition, our facilitator committees include: the Committee on Governmental Submissions, Annual Meeting Planning Committee, Continuing Legal Education Committee, Newsletter Committee, and Tax Law in a Day Committee. Any members interested in joining a committee can do so by visiting our web site at www.texastaxsection.org. Your tax family will grow if you join a committee and it is a lot of fun.

Sponsorships

We are very grateful to our many sponsors of the Tax Section and our events. If your organization would like to become a sponsor, please contact **Jim Roberts**, Sponsorship Chair, **Chris Goodrich**, or **Crawford Moorefield**, respectively at jvroberts@gpm-law.com, cgoodrich@cjmlaw.com, crawford.moorefield@clarkhillstrasburger.com.

Special Welcome

Please welcome **James D. Arbogast** as an Ex Officio Council Member of the Tax Section. James is Chief Counsel for Hearings and Tax Litigation for the Texas Comptroller of Public Accounts and has joined our merry band. We thank him for his time.

Contact Information

I look forward to future communications with our members! In the meantime, below is my contact information as well as the contact information for our Tax Section Administrator, Anne Schwartz, if you would like additional information:

Catherine C. Scheid
Law Offices of
Catherine C. Scheid
4301 Yoakum Blvd.
Houston, Texas
ccs@scheidlaw.com

Anne Schwartz
Tax Section Administrator
annehschwartz@gmail.com

2019-2020 Leadership Academy

Application Form

Eligibility Requirements:

- Must have three to six years' experience regardless of age.
- Must be a member of the State Bar of Texas in good standing.
- Must be a member of the Tax Section of the State Bar of Texas (if not a member, must join prior to the commencement of the Leadership Academy).
- Must be willing to attend all four sessions.
- ***Note: Only one candidate per firm office may be accepted from firms with more than one office.***

Tentative Meeting Dates and Cities:

- Dallas Session – March 21-22, 2019
- Austin Session (w/annual meeting) – June 12-14, 2019
- Houston Session – September 19-20, 2019
- San Antonio Session (graduation) – January 23-24, 2020

Note: The sessions begin at approximately 5:00 p.m. on the first day.

Cost and Payment:

- The admission fee for the SBOT Tax Section Leadership Academy is $850.00.
- Payment will be requested for each applicant upon notification of acceptance to the program.
- Scholarships are available, on a limited basis, for qualified applicants to cover the admission fee.
- Each participant is responsible for their travel and hotel expenses.

Application Process: **DEADLINE: JANUARY 11, 2019**

To apply for the SBOT Tax Section Leadership Academy either:

- Complete and scan the application and email with any attachments to:
  - Robert C. Morris, robert.morris@nortonrosefulbright.com
- Complete the application and mail with attachments to:

  Robert C. Morris
  Norton Rose Fulbright US LLP
  1301 McKinney, Suite 5100
  Houston, Texas 77010

- The Leadership Academy committee will consider and respond in writing to all applications received.

Application Form

Section I – Personal Information

____

First Name Middle Initial Last Name

____

Firm

____

Firm Mailing Address

____

City State Zip Code

____

Work Telephone Number Mobile Number

____

Email Address

____

State Bar Number

Gender: ☐ Male ☐ Female

Section II – Work Experience

Number of years working as an attorney: ________

Areas of expertise ____

____

Include a summary of your work experience or attach a copy of your resume. _________

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____

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____

Section III – Recommendation

Attach a letter of recommendation from your Supervisor, Manager or Partner/Shareholder or other attorney with prior approval from the Leadership Development Committee. To obtain approval for a letter of recommendation from someone other than a Supervisor, Manager or Partner/Shareholder, please contact Robert C. Morris (robert.morris@nortonrosefulbright.com or 713-651-8404).

Section IV – Personal Statement

Why are you interested in participating in the Tax Section of the State Bar of Texas Leadership Academy? (Attach additional pages, if necessary.) ______________________

____

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____

____

Section V – Participant Commitment

I commit to actively participate in the Tax Section of the State Bar of Texas Leadership Academy and attend each session.

____

Applicant's Signature

______________________________________ ____________________

Print Name Date

Judge Elizabeth Ann Copeland

Elizabeth Ann Copeland was confirmed by the Senate to be a Judge on the U. S. Tax Court by voice vote on August 28, 2018. Judge Copeland will serve a 15 year term on the Court. Elizabeth was nominated by both President Obama and President Trump to be a Tax Court Judge.

The first thing you notice about Elizabeth is her beautiful smile that she gives to everyone she meets. The trait that makes Elizabeth such a special lawyer is the caring and passion that she brings to the clients she represents and the people with whom she works. Elizabeth has always been able to successfully manage her time and follow through on her projects. Elizabeth's passion for people gave her wings to the Tax Court bench.

Elizabeth has been not only a wonderful friend and mentor to innumerable tax attorneys throughout Texas but also a great leader of the State Bar of Texas Tax Section. She is a past Chair of the Tax Section and was influential in working on many key committees over the years. Although Elizabeth had several important achievements on behalf of the Tax Section, perhaps the most notable was establishing our Tax Court Pro Bono Program. This program, which provides volunteer tax attorneys to help unrepresented taxpayers with their Tax Court cases, was the first statewide program of its kind in the nation and is now used as a model for other state bars. In recognition of her outstanding pro bono contributions, Elizabeth was awarded the Janet Spragens Pro Bono Award by the American Bar Association Section of Taxation in 2009.

Elizabeth is a partner with Clark Hill PLC with offices in San Antonio, Texas and Washington, D. C. She received her undergraduate degree from the University of Texas with Honors and her J. D. from the University of Texas. Elizabeth is Board Certified in Tax Law by the Texas Board of Legal Specialization. She is also a Certified Public Accountant and served as Attorney Advisor to the United States Tax Court after graduating from law school. She has over 20 years of experience resolving complex tax issues such as offshore voluntary disclosure matters, employment tax disputes, tax collection matters, innocent spouse representations, IRS

Appeals and tax litigation. Elizabeth has earned numerous professional accolades. She was named San Antonio Tax Lawyer of the Year for the past three years by Best Lawyers and one of ten Tax Persons of the Year in 2013 by Tax Analysts, a leading provider of tax news and analysis.

The Officers, Council members, and Committee Chairs and Co-Chairs of the State Bar of Texas Tax Section enthusiastically join Elizabeth's many other friends in congratulating her on her confirmation. She will be an outstanding judge on the Tax Court!

Catherine C. Scheid, Chair
State Bar of Texas, Tax Section

Additional Information about Elizabeth's career:

Presentations

- Moderator. Estate Planning Power Panel, Strasburger's Tax Symposium (November 2017)
- Centralized Partnership Audit Regime, Strasburger's Tax Symposium (November 2017)
- Hot Topics in Tax Controversy, Strasburger's Tax Symposium (November 2017)
- Centralized Partnership Audit Regime, Strasburger's Tax Symposium (November 2017)
- Breaking Bad - Dealing with the Partnership Audit Rules and Partnership Agreement Drafting Considerations, ABA Section of Taxation Webinar (July 2017)
- Federal Tax Controversy Hot Topics, Advanced Tax Law Course 2016 (October 2016)
- Handling IRS-targeted Audits, Voluntary Disclosures and Reporting Foreign Assets, Strasburger's Tax Symposium (September 2015)
- Current Developments in Civil and Criminal Controversies, Strasburger's Tax Symposium (August 2014)
- Don't get an 'F'!! The Latest on FATCA and FBAR Compliance, Rio Grande Valley Chapter of CPAs (October 2014)
- Current Developments in Civil and Criminal Controversies, Strasburger's Tax Symposium (August 2014)
- Try a Case in the United States Tax Court (September 2009)
- Dealing with IRS Collections (August 2009)
- Honey! You Shrunk Our Assets! A Discussion of Tax Issues in Divorce (1998-2014)

Publications

- HOT: "H"ealth Care and "O"ther "T"ax Acts, (May 2011)
- Life After UBS: Defending Against the Internal Revenue Service's Efforts to Find and Prosecute Those With Undisclosed Foreign Bank and Financial Accounts (November 2009)

- Dealing with IRS Collections (August 2009)

Awards/Achievements

- Named San Antonio Tax Lawyer of the Year by Best Lawyers (2017, 2018, 2019)
- Recognized as one of the Best Lawyers in America - Litigation and Controversy-Tax and Tax Law by Best Lawyers (2007-2019)
- Named Texas Super Lawyer by Thomson Reuters (2003-2017)
- Named among the Best Tax Law Attorneys by San Antonio Scene Magazine (2004-2017)
- Named one of ten Tax Persons of the Year by Tax Analysts (January 2013)
- Honored as the Belva Lockwood Outstanding Lawyer by the Bexar County Women's Bar Foundation (2010)
- Recipient of the Janet Spragens Pro Bono Award as presented by the American Bar Association Section of Taxation (2009)
- Recipient of the Balance Award as presented by the American Society of Women Accountants (2007)
- Recipient of the Belva Lockwood Outstanding Young Lawyer award as presented by the Bexar County Women's Bar Foundation (1998)

Business Consolidations: Special Considerations under the Texas Unemployment Compensation Act

Scott C. Thompson[i]
Dallas, Texas

As companies continue to seek improved efficiency, cost control, and sustainability in their operations, a frequent strategy to achieve such improved performance has been through consolidation, whether through mergers, acquisitions, and other partnership arrangements among unrelated entities or through the consolidation of a group of related entities. This article discusses certain issues employers who have undergone or are contemplating undergoing a business consolidation should consider vis-à-vis their obligations under the Texas Unemployment Compensation Act (the "***Unemployment Act***") and whether the Texas Workforce Commission ("***TWC***") will treat the new consolidated entity/employer as the successor employer of the consolidated employee group or as an entity acting as a common paymaster (commonly referred to as payrolling) for the now consolidated entities. While this article provides a general overview of the Unemployment Act and employers' obligations thereunder, it assumes that the reader is somewhat familiar with the Unemployment Act, including, without limitation, employers' general obligations thereunder and its predecessor-successor employer rules, and thus, does not provide an in-depth discussion of all of the requirements of the Unemployment Act that are discussed herein.

THIS ARTICLE MAY ANSWER GENERAL QUESTIONS THAT MAY ARISE IN CONNECTION WITH A CONSOLIDATION OF EMPLOYERS UNDER THE UNEMPLOYMENT ACT, BUT IT IS ONLY INTENDED TO BE A GENERAL SUMMARY OF AN EMPLOYER'S OBLIGATIONS UNDER THE UNEMPLOYMENT ACT AND IS NOT INTENDED TO BE COMPREHENSIVE OR COMPLETE. NOTHING CONTAINED HEREIN SHOULD BE CONSTRUED AS PROVIDING LEGAL OR TAX ADVICE.

Introduction

Ongoing regulatory changes, information technology advancements, and financial pressures have caused many companies to strive for improved efficiency, cost control, and sustainability. A frequent strategy to achieve such improved performance has been through consolidation, whether through mergers, acquisitions, and other partnership arrangements among unrelated entities or through the consolidation of a group of related entities. With the latter, the consolidation of a group of related entities will typically result in either (i) the rolling up of the related entities and their operations into a single entity or (ii) if some or all of the entities will continue to operate separately, consolidating all employees at a single employer and then leasing back employees to their original employers for cost allocation purposes. A key issue practitioners and their clients should consider during either type of related-employer consolidations is whether TWC will treat the new consolidated entity/employer as the successor employer of the consolidated employee group or will TWC challenge the new corporate structure, arguing that the consolidated entity/employer is not the successor employer but is merely acting as a common paymaster (commonly referred to as payrolling) for the now consolidated entities. TWC's view of the newly consolidated entity will be important because if TWC does not treat the new consolidated entity/employer as the successor employer, each entity would continue to be viewed by TWC as a separate employer that is individually responsible for the unemployment taxes and reporting obligations related to its employees. In many cases, TWC's default approach will be that, unless the related entities' separate corporate existences are terminated and their employees and operations are truly rolled up into a single entity, each entity remains individually responsible for its unemployment taxes and reporting obligations and the consolidation of employees at a single employer (or just a few related employers) is merely a payrolling arrangement that is only permissible by a Texas-state licensed professional employer organization ("***PEO***").

The Texas Unemployment Compensation Act

Unemployment taxes and benefits are governed by the Unemployment Act found in Title 4, Subtitle A of the Texas Labor Code. Unemployment benefits are funded primarily by employer taxes that are assessed as a percentage of their employees' first $9,000 in wages each year. TEX. LAB. CODE ANN. § 201.082. New employers are assessed a pre-determined, or default, tax rate equal to their North American Industry Classification System (NAICS) industry average or 2.70%, whichever is higher, for the first four quarters that they are required to file quarterly wage reports with and pay taxes to TWC. *Id.* at § 204.006. Thereafter, an employer's unemployment tax rate will be determined pursuant to the following formula:[ii]

general tax rate

+

replenishment tax rate

+

obligation assessment rate

+

deficit tax rate

+

employment and training investment assessment.

General Tax Rate[iii]

An employer's general tax rate is determined based on the amount of unemployment benefits that have been paid to the employer's former employees and is commonly referred to as the employer's "experience rating". The general tax rate is calculated by multiplying an employer's "benefit ratio" by the "replenishment ratio" for the then current calendar year. An employer's benefit ratio is calculated by dividing the aggregate amount of benefits paid to the employer's former employees for the most recent three years by the aggregate amount of taxable wages paid to the employer's employees. The replenishment ratio is a percentage set by TWC each year that is intended to recoup half of the unemployment benefits paid to eligible individuals that were not charged back to any specific employer. The replenishment ratio for 2018 is 1.36%.

Replenishment Tax Rate[iv]

The replenishment tax rate is a flat tax paid by all employers in Texas that is intended to replenish the Unemployment Compensation Trust Fund (which holds the employer contributions and other funds used to payout unemployment benefits to eligible individuals) for the other half of the benefits paid to eligible individuals that were not charged back to any specific employer. TWC calculates the replenishment tax rate annually using the following formula:

50% of all benefits paid to eligible individuals
but not charged to any specific employer

÷

the aggregate amount of taxable wages for the then current calendar year.

The replenishment tax rate for 2018 is 0.36%.

Obligation Assessment Rate[v]

The obligation assessment rate is intended to collect amounts needed to pay certain bond obligations and to collect interest due on loans made by the federal government to Texas, the proceeds of which will be used to pay unemployment benefits to Texas workers. The obligation assessment rate is the sum of the "bond obligation assessment rate" and the "interest tax rate".

The bond obligation assessment rate is determined by the following formula:

prior year rate x obligation assessment ratio

x

yield margin percentage.

The prior year rate is the sum of an employer's general tax for the prior calendar year, the replenishment tax, and the deficit tax (discussed below). TWC sets the obligation assessment ratio and the yield margin percentage, which are the same for all employers in Texas. The obligation assessment ratio and the yield margin for 2018 are each 0.00%. Accordingly, there is no obligation assessment rate for 2018.

TWC also sets the interest tax rate based on the interest owed on outstanding loans, if any, made by the federal government to Texas to fund state unemployment benefits. The interest tax rate is the same for all employers and was 0.00% for 2018.

Deficit Tax Rate[vi]

The deficit tax rate is added if the funds held in the Unemployment Compensation Trust Fund do not equal an established minimum funding level. The maximum deficit tax rate is 2.00%, and the deficit tax rate for 2018 is 0.00%.

Employment and Training Investment Assessment[vii]

The employment and training investment assessment equals 0.10% percent of the wages paid by a covered employer in a given tax year and is deposited into the Employment and Training Investment Holding Fund, which funds are used to finance worker training and skills development programs.

Based on an employer's experience rating, its effective unemployment tax rate could be substantially different from the default rate initially assessed on the employer. Currently, the average effective unemployment tax rate is 1.37%, the minimum rate is 0.46%, and the maximum rate is 6.46%.[viii]

Following a corporate transaction, the successor employer customarily may rely on the predecessor employer's experience rating for unemployment tax and reporting purposes, rather than being assessed the initial default tax rate that would otherwise apply to a new employer. *See* TEX. LAB. CODE ANN., Ch. 204, Subchapter E. A predecessor employer's experience rating may be transferred to a successor employer when the predecessor employer "transfers, through any means, all or part of the organization, trade, or business, to the successor employer." *Id*. at §§ 204.083–204.084. Transfer of a predecessor employer's experience rating to a successor employer can either be mandatory or permissive depending on whether "there is substantially common management or control or substantially common ownership of the entities" following the corporate transaction. *Id.* If there is substantially common management, control, or ownership, the transfer of the predecessor employer's experience rating to a successor employer is mandatory. *Id.* at § 204.084. In which case, the successor employer should file a Submission for Partial Transfer of Compensation Experience with Common Ownership Form C-82M and a Wage Distribution Information for Partial Transfer of Compensation Experience Form C-83 with TWC. If there is not substantially common management, control, or ownership, the experience rating transfer is permissive and may be requested by the employers filing a Joint Application for Partial Transfer of Compensation Experience with Common Ownership Form C-82J and a Wage Distribution Information for Partial Transfer of Compensation Experience Form C-83 with TWC.

Substantially common management or control exists if:

> after the acquisition of the organization, trade, or business of an employing unit, the predecessor employing unit continues to: (A) own or manage the organization that conducts the organization, trade, or business; (B) own or manage the assets necessary to conduct the organization, trade, or business; (C) control through security or lease arrangements the assets necessary to conduct the organization, trade, or business; or (D) direct the internal affairs or conduct of the organization, trade, or business.

Id. at § 204.081(a)(3). Substantially common ownership exists if:

> on the date of an acquisition of the organization, trade, or business of an employing unit, a shareholder, officer, or other owner of a legal or equitable interest in the predecessor employing unit, or the spouse or a person within the first degree of consanguinity or affinity, as determined under Chapter 573, Government Code, of the shareholder, officer, or other owner: (A) is a shareholder, officer, or other owner of a legal or equitable interest in the successor employing unit; or (B) holds an option to purchase a legal or equitable interest in the successor employing unit.

Id. at § 204.081(a)(4). A transfer of a trade or business includes:

> the transfer of part or all of an employer's workforce to another employer if, as the result of the transfer, the transferring employer no longer performs trade or business with respect to the transferred workforce and the employer to whom the workforce is transferred performs trade or business with respect to the workforce.

Id. at § 204.081(a)(5).

Professional Employer Organizations

Prior to September 1, 2013, PEOs were known as staff leasing arrangements. Senate Bill 1286, which was passed in the 83rd Legislative Session, set out the statutory requirements and obligations that apply to PEOs, which include, among other things, applying for and receiving a license from the State of Texas and meeting certain working capital requirements. *See Id.* at Ch. 91. To qualify as a PEO, the entity must offer "professional employer services." *Id.* at § 91.001(14). Professional employer services means

> services provided through coemployment relationships in which all or a majority of the employees providing services to a client or to a division or work unit of a client are covered employees. The term does not include: (A) temporary help; (B) an independent contractor; (C) the provision of services that otherwise meet the definition of 'professional employer services' by one person solely to other persons who are related to the service provider by common ownership; or (D) a temporary common worker employer as defined by Chapter 92.

Id. at § 91.001(14). A coemployment relationship exists when there is a "contractual relationship between a client and a [PEO] that involves the sharing of employment responsibilities with or allocation of employment responsibilities to covered employees in accordance with the professional employer services agreement and [Chapter 91 of the Texas Labor Code]." *Id*. at § 91.001(3-b). Common ownership is defined as a "direct or indirect ownership interest in excess of 33-1/3 percent. The term includes ownership through subsidiaries or affiliates." *Id.* § 91.001(6). Accordingly, if a group of related entities share common ownership of more than 33-1/3%, then no single entity could qualify as a PEO as to any of the other related entities under current Texas law.

Business Consolidation or Employee Leasing/Payrolling Arrangement?

As discussed in the Introduction section above, when two unrelated employers combine in a corporate transaction or when one employer acquires the assets and employees of another unrelated employer, the successor employer's ability to rely on the predecessor employer's experience rating is less likely to be challenged by TWC. However, where a group of related employers undergo a business consolidation, TWC may challenge the new, consolidated entity's status as the successor employer by arguing that the resulting entity is merely payrolling for the various employers; therefore, those entities continue to be individually responsible for the tax and reporting requirements of the Unemployment Act.

A key question that must be answered to determine whether the consolidated entity will be viewed by TWC as the successor employer of the now consolidated employee group is determining who is the "employer" or "employing unit" of the relevant employees. An employing unit is "a person who, after January 1, 1936, has employed an individual to perform services for a person in this State." *Id.* at § 201.011. According to the TWC's Tax Law Manual (the "***Manual***"), an employing unit can qualify as an employer in any one or more of the following nine ways:

i. employs one or more individuals for 20 weeks during a calendar year or pays wages of $1,500 or more in a calendar quarter;
ii. is a successor to an employer;
iii. is a nonprofit employer as described in Section 501(c)(3) of the Internal Revenue Code of 1986, as amended, and employs four or more employees for 20 weeks in a calendar year,
iv. has filed a TWC approved election of coverage form;
v. is liable for payment of taxes under the Federal Unemployment Tax Act;
vi. is not otherwise covered under the Unemployment Act but is required to be so by the Federal Unemployment Tax Act;
vii. is a state or political subdivision thereof;
viii. employs domestic employees and pays $1,000.00 in a calendar quarter; or

ix. employs as many as 10 farm or ranch employees for 20 weeks or pays as much as $20,000.00 in wages in a calendar quarter.

Section 3.1 of the Manual. Employer can also mean an individual or employing unit that acquires, through any means, the organization, trade, or business of another, or substantially all of the assets thereof, that was an employer subject to the Unemployment Act at the time of the acquisition. TEX. LAB. CODE ANN. § 201.022; Section 3.3 of the Manual.

For purposes of the Unemployment Act, an acquisition is not limited to a transaction in which one party acquires all rights and title from another party. Section 3.3.1 of the Manual. An acquisition, at its most basic level under the Unemployment Act, simply requires the right to possess and use the assets of another. *Id*. Assets include physical assets and intangible assets such as accounts receivable. Section 3.3.6 of the Manual. Evidence that all or substantially all of the employees who worked in an acquired entity continue to work in the same or substantially similar positions that they had prior to a purported acquisition strengthens a successor employer's argument that an acquisition has occurred and that it is the successor employer of such employees. Evidence supporting an acquisition can include any written document relating to the transfer, and does not necessarily need to be a bill of sale or closing documents. *See* Sections 3.3.5 and 3.3.11.4 of the Manual.

Under the Unemployment Act, "employment" means "a service, including service in interstate commerce, performed by an individual for wages or under an express or implied contract of hire, unless it is shown to the satisfaction of the commission that the individual's performance of the service has been and will continue to be free from control or direction under the contract and in fact." TEX. LAB. CODE ANN. § 201.041; Section 2.1.6 of the Manual. The Manual lays out the three essential elements of employment: services, wages, and direction and control. Section 2.1.2 of the Manual.

Steps to Mitigate a TWC Challenge of a Consolidated Entity's Status as a Successor Employer

One way to limit the likelihood that TWC will challenge a consolidated entity's status as a successor employer is to time the consummation of the corporate transaction or consolidation to occur immediately following the end of a tax year. Consequently, both the predecessor and successor employers will file quarterly wage reports with TWC for a complete tax year under their respective TWC account numbers. Filing quarterly wage reports in a given tax year for the same employee group under more than one TWC account number can inadvertently raise red flags at TWC and potentially trigger an audit into the relationship between the purported predecessor and successor employers.

In addition, it is important that transactions necessary to complete a business consolidation are properly documented and all corporate formalities followed. Although no specific type of documentation is technically required to evidence the corporate transaction, an agent or auditor may question whether a business consolidation has actually occurred when it is not memorialized in a formal purchase or merger agreement. *See* Sections 3.3.5 and 3.3.11.4 of the Manual.

Another way to reduce the likelihood of a challenge by TWC of a consolidated entity's status as a successor employer is to clearly delineate who (i) the employees are providing services to, (ii) is responsible for paying the wages attributable to those services, and (iii) directs and controls the employees. *See* Section 2.1.2 of the Manual. This could be accomplished by entering into new employment agreements with employees or issuing employment offer letters outlining the employees' roles in the new, consolidated entity. Doing so could resolve questions around who the employer actually is. Notwithstanding the foregoing, the more attenuated the service, direction, and control relationships are between the new, consolidated entity and the employees, the more likely TWC could view the relationship to be a payrolling/employee leasing one, rather than as a predecessor-successor employer relationship. And if, as discussed above, the consolidated entity shares at least 33-1/3% common ownership with the various entities, the consolidated entity could not qualify as a PEO in Texas. Consquently, TWC could ignore the new corporate structure (viewing it as an attempt to engage in a payrolling arrangement that, due to the percentage of common ownership, cannot satisfy the PEO statutory requirements) and treat each of the entities as an employer with respect to the employees who are providing services to it, with each entity remaining individually responsible for the unemployment taxes and reporting obligations related to those employees.

Appealing an Adverse TWC Tax Determination

If TWC does challenge a consolidated business structure, there is a process to appeal that decision. The first notice an employer may receive that TWC does not recognize a consolidated entity's successor employer status is the receipt of an Employer Liability Notice. The notice will state that the predecessor employer has not filed a quarterly wage report or paid unemployment taxes for a given quarter. Similarly, TWC could send the consolidated entity a Tax Rate Notice showing the effective unemployment tax rate (the predecessor's) TWC believes the consolidated entity should have used to calculate its unemployment tax obligations. TWC could also file a tax lien against the consolidated entity and the various predecessor employers if TWC claims unemployment taxes or penalties remain unpaid.

Meeting with a TWC agent to explain the business consolidation and new organizational structure may help resolve any predecessor-successor employer issues. If it does not, you can file a request for a "Rule 13 Hearing" with TWC. Rule 13 Hearing requests must be filed with TWC in writing and describe the adverse tax determination being appealed and the reason for the appeal. A response by TWC to an employer's Rule 13 Hearing request can take some time, ranging from several weeks to months. The actual Rule 13 Hearing will be conducted telephonically with both sides able to submit evidence and witnesses. An adverse ruling from a Rule 13 Hearing can been appealed to TWC. TEX. LAB. CODE ANN. §§ 212.151–212.153. And an adverse decision from TWC can be appealed to any court of competent jurisdiction. *Id.* at §§ 212.201–212.210.

Conclusion

There are many reasons that may justify an employer's consolidation with other employers, whether related or unrelated. When those employers are related, it is especially important to consider how TWC will view the new entity post-consolidation. Will TWC view it as the successor employer or as acting as a PEO or payrolling agent. To mitigate the risk that TWC might challenge a consolidated entity's status as a successor employer, the consolidation could be timed to occur immediately following the end of a tax year so that wages will be reported for the employee group under a single TWC account number (whether the predecessor's or the successor's) for an entire tax year, rather than under more than one account number, which may inadvertently raise red flags with, or trigger an inquiry or audit by, TWC. In addition, the consolidation should be memorialized in a way that clearly demonstrates that an exchange of assets, stock, or other ownership interests has occurred, such as through a formal merger or purchase agreement and other ancillary transaction documents. Finally, clearly delineating who the employees are providing services to and who directs, controls, and pays them may also help defend against a challenge by TWC of the employers' predecessor-successor relationship.

Overview of Applicable Guidance

- Texas Unemployment Compensation Act, Title 4, Subtitle A of the Texas Labor Code:
    - Chapter 201 (General Provisions): https://statutes.capitol.texas.gov/Docs/LA/htm/LA.201.htm.
    - Chapter 204 (Contributions): https://statutes.capitol.texas.gov/Docs/LA/htm/LA.204.htm.

    - Chapter 212 (Dispute Resolution): https://statutes.capitol.texas.gov/Docs/LA/htm/LA.212.htm.
    - Chapter 213 (Enforcement): https://statutes.capitol.texas.gov/Docs/LA/htm/LA.213.htm.
    - Chapter 214 (Offenses, Penalties, and Sanctions): https://statutes.capitol.texas.gov/Docs/LA/htm/LA.214.htm.
- Professional Employer Organizations, Title 2, Subtitle E of the Texas Labor Code: https://statutes.capitol.texas.gov/Docs/LA/htm/LA.91.htm.
- Texas Workforce Commission, Tax Law Manual: https://twc.texas.gov/businesses/tax-law-manual#taxManual.
- Texas Workforce Commission, Especially for Texas Employers, Appendix B: Tax Audits and Rule 13 Hearings: https://twc.texas.gov/news/efte/appx_b_tax_audits_rule_13s.html.
- Rule 13 Appeal Hearing Officer Handbook: https://twc.texas.gov/appeal-hearing-officer-handbook-table-contents.
- TWC Unemployment Benefits Appeals Policy & Precedent Manual: https://twc.texas.gov/unemployment-benefits-appeals-policy-precedent-manual#precedentDecisions.
    - Chargebacks (details precedents on chargebacks to employers' unemployment tax accounts): https://twc.texas.gov/files/jobseekers/appeals-policy-precedent-manual-chargeback-twc.pdf.
    - Miscellaneous (contains miscellaneous TWC precedents which do not generally fall under any of the other chapter headings): https://twc.texas.gov/files/businesses/appeals-policy-precedent-manual-miscellaneous-chapter-twc.pdf.
    - Procedure (details precedents involving procedural issues related to the administration of unemployment benefits and claim determinations): https://twc.texas.gov/files/businesses/appeals-policy-precedent-manual-procedure-twc.pdf.
    - Appendix (lists court cases interpreting various sections of the Texas Unemployment Act, listed in alphabetical order as well as according to sections of the Unemployment Act): https://twc.texas.gov/files/jobseekers/appeals-policy-precedent-manual-appendix-twc.pdf.

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[ii] TEX. LAB. CODE ANN. § 204.041.
[iii] *Id.* at §§ 204.042–204.046.
[iv] *Id*. at § 204.062.
[v] Texas Workforce Commission, https://twc.texas.gov/businesses/unemployment-insurance-tax-rates (last visited Oct. 13, 2018).
[vi] TEX. LAB. CODE ANN. §§ 204.063–204.064.
[vii] Texas Workforce Commission, https://twc.texas.gov/businesses/unemployment-insurance-tax-rates (last visited Oct. 13, 2018).
[viii] *Id.*

Estate planning subsequent to the enactment of tax reform

INSIGHT ARTICLE | July 24, 2018

The Tax Cuts and Jobs Act (TCJA) increased the lifetime estate, gift, and generation-skipping transfer tax exemption amounts to $11.18 million per taxpayer, in essence a doubling all transfer tax exemption thresholds. Under the new law, however, the doubling of the exemption amounts sunsets at the end of seven years. Nevertheless, if political power shifts, estate, gift, and generation-skipping transfer tax law changes could materialize sooner. The prospect of exemptions decreasing or major income tax changes at a future point in time, means that taxpayers need to consult their tax advisors to develop an estate plan flexible enough to utilize the current larger exemption amounts but is also sufficiently functional regardless of the laws in effect at death.

While the permanency of current exemption amounts and tax rates is subject to the vagaries of the political process, strategies exist to minimize future estate, gift and generation-skipping taxes for estates in excess of the existing exemption. This article explores tips and traps associated with estate planning strategies to consider.

Strategy 1 – Use it or lose it

Tip: The TCJA instructs the Treasury Department to develop regulations as necessary to address any difference in the basic exclusion amount. Without new guidance, it is possible that a prior gift covered by the gift tax exclusion at the time of the gift could theoretically result in tax, if the basic exclusion was decreased by the time of the donor's death. This concept is often called 'clawback.' A similar phenomenon could also occur with the deceased spouse unused exclusion (DSUE) amount, that is 'ported' from the first deceased spouse to the surviving spouse.

Differences in exclusion amounts could be problematic. Most commentators are taking Treasury at its word and assuming that the requisite adjustments will be made at death so that no clawback occurs. Even without the threat of decreasing exemption amounts, taxpayers with taxable estates should take advantage of the increased exemptions and consider making gifts of appreciating assets now. Taxpayers reluctant to part completely with assets can use so-called estate freezes to transfer the appreciation of assets to trusts for the benefit of their heirs. Well known estate freeze techniques include sales to defective trusts and grantor retained annuity trusts (GRATs). Net gifts where the donee pays the gift tax should be considered for large gifts. Defined-value clauses, which shift the tax burden if values are changed on audit, should also be evaluated by donors.

Trap: With large gifts, whether taxable or designed to match the donor's current remaining exemption amount, two concerns should be reviewed:

1. The first issue is the appropriate discounts for gifts of closely held business assets. Some estate and gift attorneys are reporting increased IRS challenges to discounts. It may be that having lost its battle to police discounts with the Section 2704(b) proposed regulations, which were withdrawn last year by Treasury, the IRS is looking more closely at the business valuations submitted and taking exception to the discounts claimed for lack of control and lack of marketability.

2. The other issue in play for some taxpayers is the three-year rule. Under the three-year rule, certain gift tax paid within three years of the donor's death is included in the donor's gross estate.

Strategy 2 — Business succession planning that minimizes estate taxes

Tip: Optimal estate planning for taxpayers who own business assets involves transferring non-controlling interests in those assets to trusts for family members, allowing the appreciation and sale proceeds to be received outside of the taxpayers' taxable estate. Ideally, these transfers precede the sale or significant growth by years. GRATs, sales to defective grantor trusts and restructuring of businesses to create voting and non-voting shares are strategies with proven track records of minimizing estate taxes on heirs and transferring ownership of business assets to children and grandchildren working in the family business. Timing is everything. TCJA has been a windfall for many companies actively looking for acquisitions. The private equity and hedge fund markets are also very lively.

Trap: Failing to plan for payment of capital gains taxes. Whether the client opts to use a GRAT or a sale to a defective grantor trust to transfer business assets to heirs, the income tax profile is the same. The trustor is deemed to own the transferred assets for income tax purposes and would owe the capital gain taxes if the business is sold either during the GRAT term or while the grantor trust is in existence. Planning ahead to ensure that the grantor has sufficient liquidity to pay the capital gain taxes should be a key component of the business succession planning and strategy.

Strategy 3 — Situs planning for irrevocable trusts

Tip: Taxpayers should consider relocating irrevocable family trusts to states without an income tax or with lower income tax rates than their resident state. Each state has a different definition of a resident trust. Some state laws allow grantors to relocate trusts easily. Avoiding tax under other state laws is complicated or in some cases, forbidden. Recent taxpayer victories in Pennsylvania, New Jersey, Illinois, North Carolina and Ohio are encouraging other taxpayers to consider relocating family trusts. Taxpayers in these cases successfully argued that the state taxation scheme violated the U.S. Constitution.

Relocating trusts can be accomplished through decanting or trust merger or in some cases simply by having the trustee declare the trust has been moved. In some instances, this planning can be combined with planning designed to ensure a state income tax deduction for the irrevocable trust.

Trap: Some states, such as California and New York, have aggressively pursued taxpayers who relocated family trusts to avoid state taxation. While the new case law is helpful, taxpayers seeking to challenge the status quo will need to be prepared for a fight with the state taxing authority.

Strategy 4 — Marital planning with formula clauses and utilizing portability

Tip: Estate planning documents drafted prior to 2011 should be reviewed to account for portability as well as the higher exemption amounts ushered in by TCJA. Portability is the ability of the first deceased spouse to transfer his or her DSUE to his or her surviving spouse. One complexity of estate planning in 2018 is deciding how to make optimal use of portability. The primary advantages of portability are simplicity and the ability of the surviving spouse's estate to get a second basis step-up on estate assets. In considering how and whether to use portability, there are a number of factors to consider, including the surviving spouse's age and life expectancy, the classes and location of assets, whether assets will likely be sold by the surviving spouse or held long-term, state estate taxes, the family's comfort with trust planning, and the income tax brackets of the spouse's heirs. Another approach involves blending trust planning with outright spousal bequests. One such example is planning that transfers all assets to the surviving spouse but then has the survivor use some or all of the DSUE to make gifts to children and grandchildren, typically in trust.

Trap: Married couples residing in a state with a separate estate tax should consider using a by-pass trust or a disclaimer trust to create a trust at the first death, using the amount that can be excluded from state estate taxes to fund the trust, thereby ensuring that the state exemption amount of the first spouse to die is not lost. Married couples may prefer a structure where outright transfers of the personal residence and retirement plan assets are made to the survivor in combination with a two-trust plan that

1. Funds a by-pass trust with the amount necessary to eliminate all state estate taxes on the first death

2. Funds a marital trust with the balance of assets.

Formula clauses must be revisited to ensure the intent of the trustor is consistent with the language in the documents. For example, a married taxpayer with a $10 million estate could end up not providing for his or her spouse if the will instructs the executor to fund a marital trust with the amount necessary to eliminate federal estate taxes while leaving the balance to children. Since a marital trust would not be needed to eliminate federal estate taxes on the first death, (presuming the taxpayer had made no lifetime gifts) the $10 million could end up passing outright to children from a first marriage and disinheriting the surviving spouse. These clauses should also be reviewed from an income tax perspective. If, during a period of estate administration, assets appreciate and are then used to fund a pecuniary gift, the estate will owe capital gains taxes as the funding is treated as a sale.

Strategy 5 — Expanded 529 planning

Tip: TCJA modifies Code Section 529 to include expenses and tuition for K-12 education. This means that 529 accounts can now be used to pay for private or religious high school, middle school and elementary school. The payments are limited to $10,000 per student during any taxable year. Earnings in 529 plans grow tax free and are not taxed when funds are withdrawn to pay tuition and certain expenses set forth in the statute.

Trap: Not all states with state income taxes offer a full or partial tax deduction or credit for 529 plan contributions. Donors are permitted to fund a 529 plan with up to five years of contributions in one year. Since the annual exclusion has now increased to $15,000 per donee, married donors can now gift $150,000 ($15,000 per year over five years from each spouse) to a 529 account for a beneficiary without incurring gift tax. To make the five-year election, the donor must complete and file a gift tax return. During that five-year period, the donor cannot make additional annual exclusion gifts to that beneficiary without using their lifetime exemption.

Strategy 6 — Qualified personal residence trusts

Tip: Qualified personal residence trusts (QPRTs) allow taxpayers to transfer ultimate ownership of a residence to their heirs (or into a trust for their heirs) at a discounted gift tax value. Under this strategy, the taxpayer(s) contribute their residence to a trust for a term of years (typically seven to 15) and pay gift tax (or apply their applicable exemption amount) only on the value of the remainder interest in the trust. The value of the remainder is based on the taxpayer's age and the interest rate used by the IRS to calculate present value. During the term, the residence is administered as usual. The taxpayer pays the property taxes and maintenance expenses and continues to reside in the residence. If the taxpayer dies during the term of the QPRT, the residence reverts to the taxpayer's estate.

Trap: If the taxpayer survives the term, he or she must pay fair market value rent to either the remainder trust or directly to the heirs, depending on how the QPRT was designed. The best-constructed QPRT documents include a sample lease to ensure this significant QPRT feature is not overlooked or forgotten. The impact of a divorce should also be considered.

Strategy 7 – Incapacity planning

Tip: While working on funding and designing your revocable trust, be sure to plan for incapacity. If a revocable trust holds business assets and the settlor of the revocable trust becomes disabled, the successor trustee could then step in, manage the business assets, and use the trust funds to pay for the settlor's care as well as the maintenance and support of any dependents.

Trap: If business assets are held outside of a trust, a power of attorney should be executed that makes specific provision for the management of business assets by empowering an agent to run your business if you become incapacitated.

Strategy 8 – Controlling the family limited partnership

Tip: Family limited partnerships (FLPs) and family limited liability companies (FLLCs) offer the opportunity to reduce estate taxes by making gifts or bequests of limited partnership interests (or membership interests) that are discounted to reflect their inherent lack of marketability and lack of control. Family partnerships, moreover, offer families the opportunity to create a single entity and consolidate ownership of various investments, including interests in other partnerships, alternative investments, real estate and marketable securities. FLPS are also good choices for holding voting blocks in publicly traded securities. FLPS allow centralized management and powerful creditor protection for family assets.

Trap: The issue of whether the taxpayer can retain control over the general partner and still avoid estate tax inclusion is murky under the case law. The Supreme Court decision in *U.S. versus Byrum*, stands for the proposition that control" in a fiduciary capacity does not cause inclusion under the retained rights or retained interest prohibitions in the Code. But a string of bad facts cases has muddied the water, beginning with *Estate of Strangi*, which involved four decisions, two in the Tax Court and two in the Fifth Circuit and continuing up to the recent *en* banc decision in *Estate of Powell*.

One example of this case law is *Turner v. Commissioner*. In *Turner*, the decedent and his wife transferred marketable securities and investment assets to a family limited partnership and remained the general partner. The Tax Court ruled that there was an express and implied agreement for retained enjoyment of the transferred assets under section 2036(a)(1). Even though the court had already found inclusion under section 2036(a)(1), the court still went ahead and found that section 2036(a)(2) was applicable. The court viewed the decedent as effectively being the sole general partner and having

1. The sole and absolute discretion to make distributions of partnership income,
2. The ability to make distributions in kind and

3. The ability to amend the partnership agreement without the consent of the limited partners.

These powers caused the decedent's partnership interest to be included in his estate. Turner has been positively cited by seven courts.

Strategy 9 — Basis adjustment planning

Tip: Congressional staffers advising federal tax committees have long understood the tremendous benefit for taxpayers of the so-called 'step-up' under IRC section 1014. Under current law, the basis of appreciated assets owned by the decedent is stepped-up to fair market value at death, eliminating built-in gains. Even taxpayers who don't have taxable estates receive this benefit. With higher exemption amounts, planning to optimize the use of the step-up is more important than ever. For donors contemplating gifts this year, selecting which assets to gift is critical. Assets gifted away don't get a stepped-up basis at death because they are no longer owned by the decedent. This includes assets that are sold to defective grantor trusts.

Trap: Traditional estate planning creates two trusts at the death of a married taxpayer. The so-called by-pass or credit shelter trust holds that amount that can be excluded from federal and state estate taxes at death and the other trust, the marital trust, which is typically the residuary trust. An exemption trust established at the first spouse's passing prevents a second step-up of basis at the surviving spouse's passing. Utilizing portability could allow for a second step-up in basis and should be examined in detail to assess the trade-offs.

Strategy 10 — Planning for estate taxes

Tip: The higher TCJA exemption thresholds will help many taxpayers avoid federal estate taxes. But given the uncertainty regarding future exemption amounts as well as the separate state estate tax regimes in seventeen states, many taxpayers, especially business owners and investors, must continue to plan for owing estate taxes at death. Estate taxes are due nine months from date of death, and the best estate plans have considered payment strategies well in advance.

Two options allow for financing estate taxes.

1. The first is a so-called Graegin loan arrangement. A Graegin loan provides an opportunity to use an outside lender instead of the IRS to fund the estate tax loan. The lender can be an external bank or a related party (family limited partnership or irrevocable gift trust) as long as the loan is bona fide. A Graegin loan has three requirements:

- The estate must be illiquid,
- The loan must be at a fixed rate and

- The loan must prohibit prepayment.

Because the terms of the loan are fixed, the amount of the interest to be paid on the loan is ascertainable from the date of death, allowing the full amount of the interest to be paid to be permitted as a deduction rather than the discounted present value. This can create a sizeable favorable deduction for the estate.

2. Section 6166 provides a second option for financing estate taxes and allows for considerable deferral of estate taxes at a very reasonable interest rate. The section 6166 election is restricted to an estate with so-called 'qualified business interests'. Essentially, the deceased taxpayer must have been an active business owner with a business interest that accounts for at least 35 percent of his or her adjusted gross estate. The election allows the deferral of the first payment of estate tax for five years and nine months from the decedent's date of death. Thereafter, each successive payment is made annually for the next nine years until the debt has been paid off. This election is essentially a loan from the IRS at favorable low interest rates. Interest is payable annually. The deferral can be lost if the estate is delinquent in making its installment payments or the business is sold during the installment term.

Trap: Although the filing date for the estate tax return can be extended for an additional six months, the obligation to pay the estate taxes cannot be extended. If illiquidity is an issue for your estate, make sure that you have a financing plan in place. We recommend specifically authorizing your executor to enter into a Graegin loan arrangement and/or make a section 6166 election. The IRS has scrutinized related party Graegin loans.

Strategy 11 — Generation-skipping transfer tax exemption allocations

Tip: While the increased gift and estate tax exemption allows for additional transfers to the second generation, the increase in the generation-skipping transfer tax exemption (GSTT) allows for additional gifting to more distant generations. An automatic GSTT exemption allocation typically occurs when a transfer is made either as a direct skip to a person more than one generation younger than the donor or as an indirect skip to a trust in which there is a potential beneficiary that is more than one generation younger than the donor. If GSTT exemption allocations are not made to these trusts with potential skip beneficiaries, there may be a taxable event upon the death of the last primary, non-skip beneficiary. To protect against a taxable termination event, a late allocation of GSTT exemption to trusts with potential skip beneficiaries may be desired.

Trap: Late allocations of GSTT exemption require the trust to be valued at the current fair market value, not historical value, so it may require significantly more GSTT exemption to cover assets than it would have when the original gifting occurred. Late allocations are effective when the Form 709 is filed, so valuations of trust assets cannot occur any earlier than the first of the month in which the return is filed. This can create some logistical issues when a trust owns assets that require formal valuation reports.

The decision to either affirmatively allocate or not allocate GSTT exemption should be made on a gift tax return rather than relying on automatic allocation rules due to the complexity of those rules. Also, the decision to allocate or not to allocate should be discussed with the client's attorney and the client to determine the intent. For example, a trust may be drafted as a dynasty trust but the intent is for the children to spend all of the trust assets. In this case, affirmatively electing out of GSTT exemption allocation might be the intent despite the fact the trust was drafted as a dynasty trust.

Conclusion

Your tax advisors can provide further insight on these strategies and assist you in developing a unique estate plan tailored to your assets and your goals. If your estate is close to, or exceeds, the taxable threshold, you should meet regularly with your tax advisor to ensure that your planning is updated and that your documents are current.

Divorce and Tax

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STATE BAR OF TEXAS

2018

Houston, Texas

Federal Tax Issues In Divorce

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I. TAX TREATMENT OF PROPERTY TRANSFERS INCIDENT TO DIVORCE.

Though there is usually no tax to be paid when marital property is divided and distributed pursuant to a divorce, the property received by the spouses is almost always encumbered with latent tax characteristics that often affect its true value to the recipient at some time in the future. This paper will analyze several potential matters for the practitioner to consider in assessing exactly what his or her client is really getting in the way of true value. Primary emphasis will be given to considerations of the impact tax basis has on valuation (including the special rules pertaining to businesses and capital assets) and in the mechanics and side effects of getting assets out of closely held corporations and other businesses for the benefit of the spouses.

A. What May A Trial Court Consider Regarding Taxes In Dividing The Parties' Property?

The issue often arises as to whether the trial court may properly consider the tax consequences of certain assets in its overall division of the parties' property. Issues presented in this consideration primarily include those of basis. For example, a spouse who takes 100 shares of Exxon stock, valued at $80 per share takes $8,000 in value. But, if the basis of that stock is only $10 per share, there is a potentially hidden encumbrance associated with that stock ─ the specter of capital gain taxes. It can certainly be argued from an economic point of view that the trial court ought to consider this in dividing the parties property. For, to give one spouse $8,000 cash; and to give the other the Exxon stock described above is not giving each the same economic value.

Since September 1, 2005, a Texas trial court *may* (but need not) consider taxes in the division of property. The statute is set out below:

> Sec. 7.008. CONSIDERATION OF TAXES. In ordering the division of the estate of the parties to a suit for dissolution of a marriage, the court *may* consider:
> (1) whether a specific asset will be subject to taxation; and
> (2) if the asset will be subject to taxation, when the tax will be required to be paid.

This is the only section of the Texas Family Code that addresses the issue of taxes in Texas. As described in the previous sections of this paper, some states legislate the consideration of income tax obligations and others, through case law, have determined it is a mandatory consideration for the courts.

In *Kimsey v. Kimsey*, 965 S.W.2d 690, 703 (Tex.App.–El Paso 1998, pet. denied), the Court stated that:

> The trial court correctly found that income tax liability is a matter of federal law and controlled by the Internal Revenue Code. State law, however, controls whether income is separate or community property. United States v. Mitchell, 403 U.S. 190, 91 S.Ct. 1763, 29 L.Ed.2d 406 (1971); Hopkins v. Bacon, 282 U.S. 122, 51 S.Ct. 62, 75 L.Ed. 249 (1930). The general rule is that any income that is characterized by Texas law as community income is taxed one-half to each spouse; that is, the community income of both spouses is combined and half the total is included in each spouse's gross income, along with any separate income of that spouse. Section 66 of the Internal Revenue Code provides that effective for tax years beginning after 1980, the requirement that each spouse report one-half of the other's income is eliminated if certain conditions are met, one of which is that no portion of the earned income was transferred between the spouses. Here, the trial court specifically made a finding of fact that both parties had the benefit of the income by reason of the expenses, child support, and spousal support paid by Husband during the pendency of the divorce. Wife does not challenge this finding on appeal.
>
> While the trial court can determine whether the parties will file a joint return or as married filing separately for years preceding the divorce, the court cannot alter the means of reporting income. It does have the discretion to apportion the payment of taxes as between the parties. A joint return must include all income, exemptions, and deductions of both spouses. Generally, both spouses are jointly and severally liable for the tax due on a joint return. Treas. Reg. § 1,6013–4(b). Thus, a spouse may be liable for the entire tax liability although the income was totally earned by the other spouse. If a husband and wife file as married filing separately, each is liable only for the tax due on his or her own return. See Edith Stokby v. C.I.R., 26 T.C. 912, 1956 WL 725(A)(1956).

From Autumn Kraus and J. Kermit Hill, *Trial Court Discretion to Compel to Parties to Sign and File Tax Returns & Other Tax Issues in Divorce*, 2016 TXCLE Advanced Fam. L. 25.3 (Copyright © 2016 State Bar of Texas 2016):

> In Brooks v. Brooks, 515 S.W.2d 730 (Tex. Civ. App. - Eastland 1974, writ ref'd n.r.e), the appellate court denied wife's request that the husband should be liable for her tax obligations for the year of divorce as a result of the trial court's order that husband was liable for all "community debts." In this case, there was no specific outstanding tax obligation or liability presented to the trial court. The appellate court held that the term "community debt" does not include a potential tax obligation relying on cases that have held "a tax is not a debt in the ordinary sense; although it is a liability or obligation." (See Highland Park Independent School Dist. v. Republic Ins. Co., 162 S.W.2d 1056 (Tex. Civ. App. - Dallas 1942) rev'd on other grounds, 171 S.W.2d 342 (1943)).
>
> Applying TFC §3.63, the predecessor to TFC §7.001, the trial judge in Cole v. Cole stated as a threshold matter, that he did not regard taxes as a community debt and he did

not think the court should act as a collector for the Internal Revenue Service. He therefore would not consider income tax liability as a factor in dividing the property and would let each party be responsible for his or her own outstanding tax obligations. Cole v. Cole, 532 S.W.2d 102 (Tex. Civ. App. - Dallas 1975).

However, in dividing the property on divorce, the court may take the tax liability into consideration and may even require one party to assume the other's liability for taxes or require reimbursement for taxes paid. Gaulding v. Gaulding, 256 S.W.2d 684 (Tex. Civ. App. -Dallas 1953, no writ). See also Benedict v. Benedict, 542 S.W.2d 692 (Tex. Civ. App. - Fort Worth 1976, writ dism'd) which held that the trial court has the authority and discretion to impose the entire tax liability of the parties on one spouse.

The language for a just and right division does not mandate an equal division when the circumstances of the parties are unequal. Rather, it suggests that the division should be made in consideration of the parties' differing circumstances. In numerous cases the courts have held that the future needs of one spouse and their lack of earning capacity are proper factors to be considered in dividing the community property, two of the factors for disproportionate division as identified in Murff v. Murff, 615 S.W.2d 696 (Tex. 1981).

Based on the facts of Cole, the trial judge should have considered the probable tax liability and the wife's lack of resources to discharge it. Because the disparity in earning capacity was so great (husband had been earning over $100,000 annually as a salesman and wife had not been employed for several years and was only earning $8,000 annually when she had worked), the division of the estate left the wife with substantial liabilities and insufficient income to discharge her debt, whereas the husband had not been put in a comparable position. Consequently, the trial court should have considered the tax liability and awarded the community estate in a manner that took those factors into account.

Similarly, in McCartney v. McCartney, 548 S.W.2d 435 (Tex. Civ. App. - Houston 1976), the court refused to determine the tax liability of the parties despite a request by both parties to do so, as well as additional requests by the wife through written motions and requests to properly dispose of all issues. Based upon the facts of the case wherein the wife was in a severely disadvantaged financial position (wife suffered from physical disabilities that prevented her from obtaining full time work, lacked a formal education beyond 9th grade, and had only a limited amount of work history outside the home) from that of the husband (a successful doctor with an established practice), the appellate court ruled that the trial court's refusal to make a determination of the parties' income tax liability was reversible error.

While the general rule in Texas is that the court may consider tax consequences on assets being divided, it appears there is an additional rule that the court must consider tax liabilities/obligations when they are material to the final property division.

B. Fundamentals Of Taxation On The Distribution of Marital Property.

A brief understanding of the general rules of divorce taxation is helpful in a discussion pertaining to tax basis considerations.

1. <u>Taxability Of Property Transfers In A Divorce.</u>

The taxability of property transfers in a divorce changed drastically in 1984 with the Domestic Relations Tax Reform Act, which repealed the then leading case of *Davis v. United States*, 370 U.S. 65 (1962), and made most all property divisions non-taxable events.

a. General Rule.

The general rule is that there is no recognition of gain or loss on a transfer of property from one spouse to another spouse if such transfer is made incident to a divorce. Internal Revenue Code (hereinafter "I.R.C.") Sec. 1041(a)(2); Treas. Reg. § 1.1041-1T(d).

b. Application Of The General Rule.

This rule applies regardless of whether the transfer pertains to separate property or community property and whether the division is equal or unequal. H. Rept. No. 98-432, Part 2 (P.L. 98-369) p. 1492. The requirement that the transfer be "incident to the divorce" is met if it occurs within one year after the date on which the marriage ceases, or is related to the cessation of the marriage. I.R.C. § 1041(c); Treas. Reg. § 1.1041- 1T(b). A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce settlement agreement and the transfer occurs not more than six years after the date on which the marriage terminates. *Id*. Transfers after six years are treated as a rebuttable presumption that the transfer was not incident to the divorce. *Id*. Section 1041 applies to any transfer of property between spouses regardless whether the transfer is a gift or is a sale or exchange between spouses acting at arms length, including a transfer in exchange for the relinquishment of property or marital rights, or an exchange otherwise governed by another non-recognition provision of the Code. Further, Section 1041 is not limited to transfers of property incident to a divorce; a divorce or legal separation need not be contemplated between the spouses at the time of the transfer nor must a divorce or legal separation ever occur. Treas. Reg. § 1.1041-1T A-2.

c. Exceptions.

There are two exceptions to the non-recognition provisions of Sec. 1041.

(1) Transfers In Trust Of Property With Liabilities In Excess of Adjusted Basis.

A transfer in trust of property which has liabilities in excess of the adjusted basis of the property results in the transferor recognizing gain to the extent of the excess. I.R.C. §. 1041(e).

(2) Transfers To Nonresident Alien Spouse.

If the transferee spouse (or a former spouse) is a nonresident alien, there is recognition of gain. I.R.C. § 1041(d).

(3) Section 1041 Not Applicable to Transfer Between Entity and Spouse, or Former Spouse.

Section 1041 does not apply to a transfer between an entity owned by a spouse to that spouse. This is not a sale between spouses that is subject to the rules of Section 1041.

(4) Income Producing Property.

While § 1041 renders sales of property between spouses or between ex-spouses pursuant to a divorce nonrecognition events, payments from one spouse to another as compensation for rent of property used in or for services rendered to the payor in the course of the payor's trade or business are income to the payee and deductible (or subject to capitalization) by the payor. *See Cox v. Commissioner*, 121 F.3d 390 (8th Cir. 1997), aff'g, 66 T.C.M. (CCH) 192 (husband lawyer was allowed to deduct on his Schedule C $8,000 of $16,000 paid to himself and his wife for his occupancy of an office building they owned as tenants by the entirety, and wife's $8,000 share of rent was properly reportable by her on Schedule E).

(5) Accrued But Unpaid Income.

Section 1041 does not apply to a mere right to collect accrued but unpaid income. See Rev. Rul. 87-112, 1987-2 C.B. 207 (interest accrued on U.S. savings bonds taxed to transferor notwithstanding § 1041); *Kochansky v. Commissioner*, 92 F.3d 957 (9th Cir. 1996) (husband-attorney taxed under assignment of income principles when former wife collected contingent fee on case husband continued to litigate, which he assigned to her pursuant to divorce; no discussion of § 1041). *See also Berger v. Commissioner*, 71 T.C.M. (CCH) 2160 (1996) (in a case in which an interest in a sole proprietorship is transferred pursuant to a divorce, § 1041 does not preclude the application of § 446(b) to require the transferor to include previously received but unaccrued income items). Thus, for example, if the right to collect accounts received from one spouse's business is awarded to the other spouse by a divorce instrument, § 1041 does not apply, and the earner spouse will be taxed under assignment of income principles. *Kochansky*, 92 F.3d 957. Similarly, if one former spouse transfers to the other former spouse incident to the divorce a debt obligation bearing an original-issue discount, the interest accrued up to the date of the transfer but not previously reportable by the transferor will nevertheless be taxable to the transferor and not to the transferee. See Rev. Rul. 87-112, 1987-2 C.B. 207 (interest accrued on U.S. savings bonds).

(a) Installment Obligation Subject to § 453.

Pursuant to I.R.C. § 453B(g), however, this rule does not apply to the transfer of an installment obligation subject to § 453 if § 1041 would otherwise apply. Thus, if one spouse transfers an installment note to the other, the deferred realized but unrecognized gain will be includable by the transferee as payments are received.

(b) IRA's.

I.R.C. § 408(d)(6) applies a similar rule to transfers of IRA accounts between spouses incident to a divorce. *See also Harris v. Commissioner*, 62 T.C.M. (CCH) 406 (1991) (§ 408(d)(6) does not apply where taxpayer retains IRA in divorce but withdraws funds to discharge obligation to make cash payment to former spouse).

2. <u>Basis Of Property After The Divorce.</u>

Most always, the original basis of property is its cost to the owner. I.R.C. § 1012.

Exceptions are carry-over basis on a gift under Sec. 1015, and fair market value basis on property acquired from a decedent under Sec. 1014. Basis can be increased by capital improvements and decreased by depreciation, depletion, amortization and the like. I.R.C. §§ 1011 and 1016. *See e.g., Farid-es-Sultaneh v. Commissioner*, 160 F.2d 812 (2d Cir. 1947) (transferee of antenuptial settlement has purchase basis under § 1012; transfer is not a gift).

a. Carry-over Basis.

When property is distributed pursuant to a divorce, the recipient spouse will have the same basis in the property as was in existence immediately prior to the divorce. I.R.C. § 1041(b)(2). This is called carry-over basis.

b. Application.

Carry over basis rules apply:

(1) Regardless whether the adjusted basis of the property is less than, equal to, or greater than its fair market value at the time of the divorce;

(2) For determining losses as well as gains on subsequent dispositions; and

(3) Even when the property distributed is subject to liabilities in excess of the adjusted basis of the property (unless the distribution is made to a trust). Treas. Reg. § 1.1041-1T(d).

3. <u>Depreciation Recapture Not Triggered.</u>

A transfer of property subject to § 1041 does not trigger depreciation recapture. Treas. Reg. § 1.1041-1T(d), Q&A 13. On the other hand, the transferee will be subject to recapture on the sale, transfer, or other premature disposition of the property. For example, if a husband transfers to his wife a car used in his business, the transfer does not automatically require that the husband recapture under I.R.C. § 1245 the depreciation taken on the car. When the wife sells the car, however, any gain recognized may be recharacterized as ordinary income to the extent it does not exceed the depreciation deductions claimed by the husband, even though the wife did not depreciate the vehicle. See I.R.C. § 1245(a); Treas. Reg. § 1.1245-2(a)(4). Because of this potential liability, the transferor must provide the transferee with records sufficient to determine not only the adjusted basis of the property, See Temp. Reg. § 1.1041-1T(e), Q&A-14, but also any potential recapture liability.

4. <u>Note Obligations Set Up In The Divorce Between Spouses – Is The Interest Portion Deductible And Includible?</u>

Large cash settlements at divorce are frequently payable in installments, with interest, over a period of time. The tax treatment of the interest was before the Tax Court in both *Gibbs v. Commissioner*, T.C. Memo 1997-196 (to the payee), and *Seymour v. Commissioner*, 109 T.C. Memo 279 (1997)(to the payor).

a. In *Gibbs*, the taxpayer-payee argued that she received the interest portion of the payment, together with the principal portion, in exchange for property she transferred to her former husband incident to divorce and, therefore, the interest, as well as the principal, was excludible from income under I.R.C. § 1041. The Tax Court rejected this argument. Observing that any interest and any nontaxable gain that the taxpayer may have realized "are two distinct items that give rise to separate federal income tax consequences," the Court held that I.R.C. § 1041 has no application to the interest portion of the payments, which must be included in the taxpayer's gross income in the year received.

b. In *Seymour*, the deductibility of the interest portion of installment payments was at issue. In exchange for his wife's interest in the marital home, securities, and other marital property, the taxpayer-payor gave his wife a promissory note payable over a 10-year period, with interest, and secured by the home. The taxpayer deducted the full amount of interest paid on the note, which the I.R.S. disallowed, claiming that I.R.C. § 1041 requires that the interest expense be characterized as nondeductible personal interest under I.R.C. § 163(h). The Court disagreed with the I.R.S.'s analysis, finding it inconsistent with the legislative history of I.R.C. § 163(h) and I.R.C. § 1041, and held that the interest portion of each payment was deductible if and to the extent that it could be allocated to a deductible expense (*e.g.*, qualified residence interest, investment interest, or passive activity interest, to be determined in accordance with Treas. Reg. § 1.163-8T (tracing rules) and Notice 88-74, 1988-2 C.B. 385.

5. <u>Tacking.</u>

One who takes property with a carry-over basis under Section 1041 is treated as having owned the property as long as the transferor did. I.R.C. § 1223(2). The tax term of art for this is "tacking."

a. Definition of Transfer "Incident to the Divorce."

A transfer of property is "incident to the divorce" in either of the following two circumstances: (a) the transfer occurs not more than one year after the date on which the marriage ceases; or (b) the transfer is related to the cessation of the marriage. Section 1041(c). Specifically, a transfer of property occurring not more than one year after the date on which the marriage ceases need not be related to the cessation of the marriage to qualify for Section 1041 treatment. Treas. Reg. § 1.1041-1T A-6.

b. Definition of Transfer "Related to the Cessation of the Marriage."

A transfer of property is treated as related to the cessation of the marriage if the transfer is: (a) pursuant to a divorce or separation instrument; and (b) the transfer occurs not more than six years after the date on which the marriage ceases. Treas. Reg. § 1.1041-1T A-7. Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than six years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. Treas. Reg. § 1.1041-1T A-7. The temporary Treasury regulations provide that the presumption may be rebutted by showing that: (1) the transfer was not made within the one and six-year period because of factors that hampered an earlier transfer of the property, such as legal or business impediments to transfer, or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (2) the transfer is affected promptly after the impediment to transfer is removed. Treas. Reg. § 1.1041-1T A-7.

6. Record Keeping Requirements.

The Internal Revenue Service has issued Temporary Regulations under Section 1041 which require spouses to keep certain records after a divorce.

a. Transferor's Required Record-Keeping.

The transferor (which could be either spouse or both spouses, depending on the circumstances) must give the transferee (the recipient of the property) records pertaining to the adjusted basis of the property, the holding period and investment tax credit recapture. Treas. Reg. § 1.1041-1T(e), QA-14.

b. Transferee's Required Record-Keeping.

The recipient of the property in a divorce must keep the records and make them accessible to the Internal Revenue Service. *Id*. This is no different from any taxpayer who owns property. Treas. Reg. § 31.6001-1(e). Even without these Regulations, a taxpayer is well-advised to always keep records pertaining to basis, as if one cannot be established, the basis is presumed to be zero.

7. Capital Assets.

All property received pursuant to a divorce has some tax basis, even though such basis may be zero or negative. To the extent the basis of the property is lower than the price at which the property is sold or exchanged at some future date, there is gain to be recognized at that time. The tax that has to be paid on such sale or exchange effectively lowers the net value of the asset, and, as such, must be taken into consideration in determining its true value upon the distribution of the marital assets. Loss recognition is a little different; for, if the asset sold at a loss is a personal asset, there cannot be recognition of any loss.

a. Capital Gain And Loss Taxation.

(1) If capital gains for the year exceed capital losses, and the excess is a:

(a) Net short-term gain (i.e., the excess of short term capital gain over short-term capital losses), include it in gross income. I.R.C. §§ 1222(9) and 61(a)(3).

(b) Net long-term gain (i.e., the excess of long-term capital gains over long-term capital losses), include it in gross income, but the maximum tax rate thereon may not exceed 28%. I.R.C. § l(j).

(c) Combination of a net short-term gain plus a net long-term gain, the excess short-term gain is treated as in a(i), immediately above, and the excess net long-term gain is treated as in a(ii), immediately above.

(2) If the capital losses for the year exceed the capital gains and the excess is a:

(a) Net short-term capital loss (i.e., the excess of short term capital losses over short-term capital gains), offset the excess net loss against other income up to $3,000.00 and carry-over the excess, if any, to subsequent years as a short-term capital loss. I.R.C. § 1211(b).

(b) Net long-term capital loss (i.e., the excess of long-term capital losses over long-term capital gains), offset the excess not loss against other income up to $3,000 and carry-aver the excess, if any, to subsequent years as a long-term capital loss. *Id*.

(c) Combination of a net short-term loss plus a net long-term loss, use the same treatments as in b(i) and (ii) .

b. Gains and Losses.

Generally the entire amount of gain realized from a sale or exchange is recognized and is taxable. I.R.C. § 1001(c). Exceptions are like-kind exchanges, involuntary conversions and the sale of a personal residence. Realized losses are also recognized and, therefore, deductible, except that losses of individuals are deductible only if they are incurred in their business, in a transaction entered into for profit, or as a result of a casualty or theft. I.R.C. § 165(c). Thus, losses in personal transactions are generally nondeductible.

c. Amount of Gain or Loss.

Taxpayers are taxed to the extent the amount realized from a sale or exchange exceeds their adjusted basis. If the adjusted basis of the property disposed of exceeds the amount realized, the difference is a loss. I.R.C. § 1001(a). The amount realized on a sale or other disposition is the amount of money plus the fair market value of any property received by the seller. I.R.C. § 1001(b). A cash basis taxpayer reports gain on a sale or exchange in the year the sales proceeds are received, actually or constructively. A loss is reported in the year the transaction is completed by a fixed, identifiable event. When an asset is sold, there may also be a necessity of recapturing depreciation.

(1) Personal Property.

Under the depreciation recapture rules for personal property, the seller has ordinary income to the extent of a specified amount of the depreciation that is recaptured on the sale. I.R.C. § 1245(a)(1). Generally, the amount of the gain to be recaptured is equal to all depreciation or amortization allowed or allowable with respect to the property taken in 1962 and afterwards. I.R.C. §§ 1245(a)(2)(A) & 1245(a)(3)(A). A sale of tangible personal property may also produce an investment credit recapture. I.R.C. § 47(a)(1).

(2) Real Property.

Generally, depreciable real property is subject to recapture on a sale when the actual depreciation or ACRS deductions exceed the straight line method. I.R.C. § 1250(d)(11).

(3) Other Recapture Property.

There are other recapture sections of the code dealing with specific types of property.

(a) Farm Property. I.R.C. §§ 1251(c) and 1252.
(b) Mining Property. I.R.C. § 617(d).
(c) Oil, Gas Or Geothermal Property. I.R.C. § 1254.

d. Special Types of Capital Assets.

(1) Insurance.
The distribution of an insurance policy in a divorce is a non-taxable event under Sec. 1041. The recipient takes a carry-over basis in the policy. I.R.C. § 1041. The basis is the sum of the premiums paid for the policy.

(2) Annuities.
Annuities are treated like any other asset distributed in a divorce. The basis in the hands of the recipient is the initial investment in the purchase of the annuity plus any premiums paid afterwards. Treas. Reg. § 1.72-10(a).

(3) Oil And Gas Property.
Though there is no taxable event upon the distribution of property in the divorce, when ultimately sold, depletion deductions are not subject to recapture, except for intangible drilling costs incurred in 1986 and afterwards. I.R.C. § 1254. On the sale or exchange of post-1986 acquired property, any gain is treated as ordinary income to the extent of all intangible drilling costs and depletion that reduced adjusted basis.

(4) Farm And Ranch Property.
Farm and ranch property is also covered by the non-recognition, carry-over basis rules of Sec. 1041. A possible extra encumbrance, however, is that when farm or ranch land is sold, some of the post-1969 deductions for soil and water conservation expenditures taken pursuant to I.R.C. § 182 may be recaptured as ordinary income. I.R.C. § 1252. If the land is held for five years or less, 100 percent of the deductions are recaptured. That reduces to 80 percent in the sixth year, and an additional 20 percent for each of the next three years. When the land is held for 10 years or more, there is no recapture. I.R.C. § 1252(a)(3).

(5) Patents (Sec. 197 Property).
Patents represent a kind of intangible property having a determinable useful life that are, therefore, subject to treatment as depreciable property used in a trade or business, subject to capital gain and loss treatment upon disposition.

(6) Copyrights.
Copyrights are not generally considered capital assets or Sec. 1231 property. *See* I.R.C. § 1221(3). Disposition thereof, accordingly, results in ordinary gain or loss.

(7) Franchises, Trademarks, And Trade Names.

Generally, franchises, trademarks, and trade names are intangible personal property which, if sold, produce capital gain or loss. The Code, however, disallows capital gains treatment when the transferor retains any significant power, right, or continuing interest with respect to the asset. I.R.C. § 1253(a).

(8) Assets Encumbered With Ordinary Income.

Some assets, when disposed of, result in the recognition of ordinary gain.

e. Inventory.

Property held primarily for sale to customers in the ordinary course of business is neither a capital asset nor Sec. 1231 property. I.R.C. § 1231. *See* I.R.C. § 1221(1) for a definition of this kind of property. *See also Annotation*, 46 A.L.R.2d 615 (Property As Held Primarily For Sale To Customers In Ordinary Course Of Business). A sale of inventory in bulk, therefore, results in ordinary income or loss.

f. Accounts Receivable.

Accounts and notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of inventory or stock in trade are not capital assets or Sec. 1231 property. I.R.C. § 1221(4); Treas. Reg. § 1.1221-1(d). Like inventory, a sale of receivables results in ordinary income or loss.

8. <u>Retirement Accounts.</u>

a. Individual Retirement Accounts.

Transfers of an Individual Retirement Account in a divorce case are tax-free events under Sections 1041 and 408(d)(6). Literally, a Sec. 1041 transfer can be consummated during the marriage (but may be subject to taxation under I.R.C. § 408(d)(1) and the 10 percent penalty for early distributions under I.R.C. § 72(t)), but a Sec. 408(d)(6) transfer is only available after the divorce. I.R.C. §§ 408(d)(6) and 1041.

b. Company-Sponsored Plans (Pension Plans. Profit-Sharing Plans. 401(k) Plans.

Retirement benefits may be used to effectuate a property settlement. Though the distribution of retirement benefits to a spouse, even to the non-employee spouse (with a Qualified Domestic Relations Order) is not a taxable event under I.R.C. § 1041, a withdrawal of benefits, when made, is subject to taxation. Of course, the possibility of withdrawal depends on the terms of the plan as well as the Internal Revenue Code. Unless the distribution qualifies as a lump-sum distribution, a distribution from a retirement plan is taxable to the distributee as ordinary income. I.R.C. §§ 402 & 72. A lump-sum distribution is one that is made as a result of the employee's death, the employee reaching age 59-1/2, or as a result of the employee's separation of service. This special treatment allows the distributee to apply five-year averaging if he or she had been a participant in the plan for five or more tax years. I.R.C. § 402(e)(4)(H).

C. Business Entities And Their Assets.

For tax and other business purposes, spouses often keep their assets in a corporation, a partnership, or just as a sole proprietorship. Upon divorce, it may be desirable for one or both spouses to receive certain assets from the business, or even the entire business. There are several mechanisms available to achieve these results, and, at the same time, minimize the attendant tax implications to the spouses.

1. Corporations.

The corporation is a separate taxable entity. As such, corporate income is taxed to the corporation and distributions qualifying as dividends paid by the corporation are taxable to the shareholders. The catch, of course, is that, though dividends are taxable to the shareholder, they are not deductible by the corporation, thereby resulting in a double taxation of corporate income. Steps should be taken, therefore, to avoid dividend treatment whenever possible. There are, in fact, a number of ways for a shareholder to receive distributions from a corporation other than by dividend. Examples of these are stock redemptions, partial liquidations, preferred stock bailouts and even complete liquidations.

a. The Dividend.

The framework for the taxation of corporate distributions is provided by Internal Revenue I.R.C. §§ 301(a), 301(c) and 316. These sections of the Code require dividend treatment to corporate distributions under I.R.C. §§ 301(c)(1) and 61(a)(7) if and to the extent that it comes out of either earnings and profits of the corporation accumulated after February 28, 1913 or earnings and profits of the taxable year. Though most ordinary dividend-like distributions fall into this category, any such distribution that exceeds these amounts results in a return of capital. And, as will be set out later in this article, a distribution of property other than money, a distribution of the corporation's obligations, and a distribution of the corporation's own stock have special rules of taxation. Due to this "double-taxation" problem, the practitioner should usually never structure a divorce settlement (and always advise the judge not to order a division and distribution of property) in a manner that will result in dividend treatment.

(1) Constructive Dividends.

Since in the overwhelming majority of circumstances, neither party to a divorce will intentionally structure a property division in a manner which will trigger the recognition of a dividend, the focus for the practitioner will be on how to avoid a dividend. The Internal Revenue Service is on a mission to qualify corporate distributions as dividends. The reason is because of the double-taxation stated above. All distributions to shareholders reviewed by the Service will be first viewed to determine whether there can be a classification of the transaction as a dividend. Any distribution at all from a corporation to its shareholder(s) can be a dividend, even though it is informal and non-declared. I.R.C. §. 301. Most cases dealing with these informal distributions come from situations involving informal distributions from closely held corporations. In fact, even disproportionate transfers are potential constructive dividends. *See* e.g. *Lengsfield v. Commissioner of Internal Revenue*, 241 F.2d 508 (5th Cir. 1957).

(a) Salary To Spouse.

One plan for a post-divorce mechanism to get money from a family corporation is to pay a salary to one of the spouses. The corporation may, of course, deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered." I.R.C. § 162(a). But, there is a danger when the employee spouse (or ex-spouse) is not a shareholder and might not be providing a true compensatory quid pro quo for the salary. In such an instance, the excess payments of ostensive compensation may be treated as a disguised distribution to the shareholder, who might just also be the ex-spouse. Factors to which Courts have looked to determine compensation issues are:

i) Employee's qualifications;
ii) Nature, extent and scope of work;
iii) Size and complexities of the business;
iv) Comparison of salaries paid with the gross income and the net income;
v) Prevailing economic conditions;
vi) Salaries for comparable positions;
vii) Salary policy for all employees; and
viii) Amount paid to employee in previous years.

Mayson-Mfg. Co. v. Commissioner of Internal Revenue, 178 F.2d 115, 119 (6th Cir. 1949).

(b) Bargain Sales.

When a corporation sells property to a shareholder, the sale must be for fair market value. When it is not, the amount of the bargain below fair market value is a Sec. 301 "distribution" subject to dividend treatment. Treas. Reg. § 1.301-1(j). These rules also apply to lease and rental transactions.

(c) Corporation's Purchase At Excessive Price.

The corollary is true for sales from an individual to his or her corporation -- that is, the sale must be for fair market value, or there is taxation. *See. e.g. Goldstein v. Commissioner of Internal Revenue*, 298 F.2d 562 (9th Cir. 1962). The same is true for lease and rental payments. *Potter Elec. Signal & Mfg. Co. v. Commissioner of Internal Revenue*, 286 F.2d 200 (8th Cir. 1961).

(2) Dividend Distributions In Kind.

Distributions in kind create additional problems for the practitioner. Not only are they more tempting from a divorce settlement point of view (as there often seems to be more assets than cash in corporations), but questions regarding whether the corporation recognizes gain or loss rise to altogether new levels of complexity when compared to cash distributions. As far as the shareholder-recipient is concerned, the distribution is treated as dividend income at the fair market value of the property distributed. I.R.C. §§ 301(b)(1)(A), 301(c), and 316.

(a) Distribution Of Property At A Loss.

The corporation does not take a loss on distributions of property relating to stock in which such property's fair market value is less than its adjusted basis. I.R.C. § 311(a)(2). This is a codification of the leading case of *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). Note that Sec. 311(a)(2) involves distributions relating to stock. Transactions relating to shareholder/debtor relations, shareholder/creditor relations, shareholder/employee relations and the like are not covered. Treas. Reg. § 1.311-1(e)(1).

(b) Distribution Of Property At A Gain.

Contrary to non-recognition of losses, there is a recognition of gains of a corporation on property distributed in-kind to a shareholder in which Sections 301 through 304 apply (i.e., distributions subject to the dividend rules of Sec. 301, stock redemptions, and partial liquidations). I.R.C. § 311(b)(1). This Section requires the corporation to recognize gain as though it had sold the distributed property to the shareholder at its fair market value. *Id*.

b. Corporate Redemptions.

A redemption occurs whenever a corporation acquires its stock from a shareholder in exchange for corporate property. A redemption can be a useful planning tool in a divorce to divest a spouse of his or her position as a shareholder of a family-owned business. A corporation can choose to redeem its shares with debt obligations rather than with money, thereby allowing ex-spouses a fixed income. If done properly, a redemption can qualify as a capital gain to the shareholder. If not, it could be taxed as a dividend. The Code, in fact, provides that a redemption is treated as a dividend rather than as a sale or exchange of redeemed stock, unless the redemption falls within two safe harbors or, in the final analysis, is "not essentially equivalent to a dividend." I.R.C. §§ 301 and 302(d). In general, the Code distinguishes redemptions that are essentially sales or exchanges of stock from those that are essentially dividend distributions on the basis of the elimination of reduction of the shareholder's interest in the enterprise. Where that interest has been completely terminated (I.R.C. § 302(b)(3)) or has been reduced by at least a specific percentage (I.R.C. § 302(b)(2)), the redemption may safely be treated as a sale or exchange of the redeemed shares. A redemption that fails to qualify under one of the safe harbors may nevertheless qualify for exchange treatment if, on the basis of all the facts and circumstances, there has been a "meaningful reduction" in the redeemed shareholder's ownership interest. See I.R.C. § 302(b)(1) and Treas. Reg. § 1.302-2(b). Unlike the safe harbor provisions, the "meaningful reduction" test is vaguely defined by a body of judicial and administrative principles that are not universally accepted by courts or the Internal Revenue Service and are in key respects unclear. Where the corporations and the shareholders desire exchange treatment, every effort should be made to structure a redemption so that it falls within one of the safe harbors.

(1) Tax Treatment Of The Redeemed Shareholder.

There are three statutorily recognized means through which a redemption can occur with favorable tax treatment. The first two are the so-called "safe harbors."

(a) Complete Termination of Ownership Interest In The Redeeming Corporation.

i) Redeeming all of a shareholder's stock in a corporation guarantees that the redemption will be treated as a distribution in exchange for stock, and hence receive capital gain treatment. I.R.C. § 302(b)(3).

ii) The problem with qualifying a redemption as completely terminating a shareholder's interest in a corporation is that the attribution rules of I.R.C. § 318 attributes ownership of stock between spouses, children, grandchildren and parents. I.R.C. § 318(a)(1). The Code further provides, however, that the family attribution rules of Sec. 318 do not apply to a redemption that results in the complete termination of the redeemed shareholder's interest if three conditions are met.

a) First Requirement.
The first requirement to be met is that immediately after the redemption of all of the stock directly owned by a shareholder, the former shareholder must not have any interest in the corporation except as a creditor. I.R.C. § 302(c)(2)(A)(i).

b) Second Requirement.
The second requirement is that the redeemed shareholder must not acquire any interest in the corporation (other than as a creditor) within 10 years from the date of the redemption. I.R.C. § 302(c)(2)(A)(ii).

c) Third Requirement.
The third requirement is that the redeemed shareholder must file an agreement to notify the District Director within thirty days of any acquisition by him of a disqualifying interest in the corporation. I.R.C. § 302(c)(2)(A)(iii).

(b) Substantially Disproportionate Redemptions.
A partial redemption of a shareholder's ownership interest is treated as a distribution in exchange for stock if it causes a reduction in the shareholder's voting power and equity interest that is substantially disproportionate with respect to non-redeeming shareholders. I.R.C. § 302(b)(2). Because the constructive ownership rules of Section 318 apply without exception to substantially disproportionate distributions, the practitioner must me doubly careful to assure that the precise "safe harbor" rules are met. A redemption is substantially disproportionate when the following four conditions are met.

i) Immediately after the redemption the shareholder must own less than 50 percent of the total combined voting power of all classes of stock entitled to vote. I.R.C. § 302(b)(2)(B);

ii) The percentage of voting stock owned by the shareholder immediately after the redemption must be less than 80 percent of the percentage of voting stock owned by the shareholder immediately before the redemption. I.R.C. § 302(b)(2)(C);

iii) The percentage of common stock of the corporation owned by the shareholder immediately before the redemption must be less than 80 percent of the percentage of common stock owned by the shareholder immediately before the redemption. I.R.C. § 302(b)(2)(C); and

iv) The redemption must not be pursuant to a plan whose purpose or effect is a series of redemptions resulting in a distribution that, in the aggregate, is not substantially disproportionate with respect to the redeemed shareholder. I.R.C. § 302(b)(2)(D).

(c) Redemptions That Are Not Essentially Equivalent To A Dividend.

A redemption of a shareholder's ownership interest that does not qualify as a distribution in exchange for stock under the rules described above still may qualify for exchange treatment if it is not essentially equivalent to a dividend. I.R.C. § 302(b)(1). This rule is intended to provide exchange treatment in cases that cannot satisfy the safe harbor rules, but that nevertheless involve a significant reduction in the shareholder's actual ownership. Each case stands on its own facts, and for planning purposes, this exception should not be relied upon without the advice and written opinion of experienced tax counsel.

(2) Constructive Stock Ownership.

The drafters of the Code, recognizing that control of a corporation can be exercised without formal record ownership, have highlighted a number of suspect relationships where actual control may be exercised even without formal stock ownership. In these instances, the Code attributes ownership of stock from one stockholder to another for application to the safe-harbor rules of Section 302, described above.

(a) Family Attribution.

An individual constructively owns stock that is owned directly or indirectly by a spouse, children, grandchildren, or parents. I.R.C. § 318(a). There is no attribution between siblings, and more importantly for divorce practitioners, there is no attribution between spouses (or ex-spouses) who are legally separated under a decree of divorce or separate maintenance.

(b) Entity Attribution.

Stock is generally attributed from partnerships to partners, from estates and trusts to their beneficiaries, and from corporations to shareholders, in proportion to the individual's ownership interest in the entity. I.R.C. § 318(a).

(3) Tax Treatment Of The Redeeming Corporation.

Generally, a corporation does not recognize gain or loss upon the redemption of its stock for cash (I.R.C. § 311(a)), but may recognize gain (but not loss) if the redemption is for appreciated property (I.R.C. § 311(d)), LIFO inventory (I.R.C. § 311(b)), or property with a liability in excess of basis (I.R.C. § 311(c)).

c. Transfer/Redemptions.

A division of closely held stock between spouses incident to a divorce will be a tax-free transaction pursuant to I.R.C. § 1041. A subsequent complete redemption of one spouse's stock following the property division will ordinarily be governed by the provisions of I.R.C. § 301 and where applicable, § 302. Further, Temp. Treas. Reg. § 1.1041-1T(c), Q&A 9 provides that I.R.C. § 1041 will apply to a transfer of property to a third party on behalf of a spouse (or former spouse) where the transfer is required by a divorce instrument. The Temporary Regulations provide the following:

> Q-9. May transfers of property to third parties on behalf of a spouse (or former spouse) qualify under section 1041?
>
> A-9. Yes. There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. Such consent or ratification must state that the parties intend the transfer to be treated as a transfer to the nontransferring spouse (or former spouse) subject to the rules of section 1041 and must be received by the transferor prior to the date of filing of the transferor's first return of tax for the taxable year in which the transfer was made. In the three situations described above, the transfer of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041.

d. Tax Consequences of Transfers Subject to Section 1041.

(1) Mandatory Redemption.

Based on this, the Service ruled in PLR 9046004 that the mandatory redemption from an ex-wife of stock that had been transferred to her pursuant to the divorce decree would be treated as a § 1041 transfer followed by a taxable redemption from the ex-wife.

(2) Complete Termination of Interest.

In another pronouncement, PLR 9427009 (Apr. 6, 1994), the Service addressed yet another interspousal transfer of stock followed by a corporate redemption from the transferee. The marital settlement agreement involved in the ruling transferred a portion of husband's stock to wife, specified wife would seek to have the stock redeemed, indicated husband had no obligation whatsoever to acquire the stock or cause the corporation to so acquire, provided an escrow for the payment of the wife's income taxes on the gain from redemption, and finally, referenced the nonapplicability of Temp. Treas. Reg. § 1041-1T(c), Q&A 9's "on behalf of" standard to the husband. Even though the stock was redeemed immediately after the execution of the marital settlement agreement, the Service ruled that I.R.C. § 1041 governed the stock transfer from the husband to the wife and that the wife's redemption would be governed by I.R.C. § 302(b)(3), complete termination of interest.

(3) Prior to the enactment of I.R.C. § 1041, however, many cases have hald that where there exists a personal and unconditional obligation on the part of a taxpayer to purchase stock held by another in the taxpayer's corporation and such obligation is discharged in any manner by the corporation, whether by payment of a note the taxpayer has given to the other party or redemption of the shares which the taxpayer is unconditionally obligated to purchase, the taxpayer receives a dividend. *See, e.g., Wall v. United States*, 164 F.2d 462 (4th Cir. 1947); *Louise H. Zipp*, 28 T.C. 314 (1957), *aff'd* 259 F.2d 119 (6th Cir. 1958); *Roy M. Berger*, 33 T.C.M. 737 (1974); *John K. Gordon*, 34 T.C.M. 437 (1975).

(4) Illustrative Cases.

A number of cases have addressed the transfer-redemption transaction. Chief among these are the two *Arnes* decisions: *Joann C. Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992) (*Arnes I*) aff'g 91-1 USTC par. 50,207 (W.D. Wash. 1991), and *John Arnes*, 102 T.C. 522 (1994) (*Arnes II*). Based upon the same facts, the Ninth Circuit in *Arnes I* and the Tax Court in *Arnes II* reached diametrically opposite conclusions. The key issue in the *Arnes'* cases was whether John Arnes had a primary and unconditional obligation to purchase Joann's stock in their closely held corporation. The marital settlement agreement provided that the parties would cause the *corporation* to redeem Joann's stock. In attempting to apply Temp. Treas. Reg. § 1.1041-1T(c), Q&A 9, the District Court held that the stock redemption from Joann was "on behalf of" John, since he received a benefit from the transfer ─ the settlement of all future community claims Joann could have asserted. Consequently, Joann was found to have a tax-free § 1041 transfer.

The Tax Court, on the other hand, in a reviewed decision, held that John did not have a primary and unconditional obligation to acquire Joann's stock. In refusing to express an opinion as to whether the standard "on behalf of" the spouse set forth in Temp. Treas. Reg. § 1.1041-1T(c), Q&A 9, is the same as the primary and unconditional obligation rule, the Court found John did not have a constructive dividend. The large number of concurring opinions and five dissenters, coupled with the above language relating to Q&A 9, make it quite evident that the "on behalf of" standard requires clarification in the Regulations.

In *Gloria Blatt*, 102 T.C. 77 (1994), the Tax Court on facts similar to *Arnes*, found that a redemption satisfied no obligation of the continuing shareholder. Further relief from possible claims under marital distribution laws does not mean a redemption was "on behalf of" the continuing shareholder. A concurring opinion went so far as to indicate that a proper interpretation of the regulations under I.R.C. § 1041 requires that no redemption should be considered "on behalf of" the remaining spouse unless such spouse's primary and conditional obligation to purchase the stock is discharged.

In another case, *Jimmy Hayes*, 101 T.C. 593 (1993), Jimmy was obligated to purchase his ex-wife Ruth's stock in their corporation. Finding that an attempted *nunc pro tunc* order to reform the transaction as a corporate oglibation was invalid under applicable state law, the Court found Jimmy had a constructive dividend since he had the obligation to purchase Ruth's stock. In *Hayes*, the Tax Court did say the redemption was on behalf of Jimmy.

e. Tax-Free Division Of A Corporation.

In some instances, it is advisable to split a closely-held corporation into more than one business to effectuate a division of property on divorce.

(1) Permissible Types.

There are three forms which a tax-free division of a corporation may take.

(a) Spin-Off.

A spin-off involves the distribution of stock of an existing or newly formed subsidiary pro rata to the shareholders of the parent corporation. The result of a spin-off is that after it is effected, the shareholders of the parent corporation own stock in the former subsidiary as well and the parent company no longer controls the subsidiary (which is now controlled by the shareholders of the parent company). Due to the "prohibited device" Proposed Regulations, discussed *infra*, the "spin-offs" usually are not the corporate division of choice in a divorce context.

(b) Split-Off.

The second form of tax-free corporate division, a split-off, is accomplished through a redemption of the parent corporation's own stock in exchange for stock of the subsidiary corporation, which again may be either an existing subsidiary or one formed just prior to the split-off. At the corporate level, a split-off produces the same effects as a spin-off. But, at the shareholder level, the effects of a split-off are quite different from those of a spin-off. In a split-off, usually only a portion of the parent corporation's shareholders participate, and those who do usually tender their entire interest in the parent corporation. The normal effect of the split-off is to create one shareholder (or one shareholder group) that owns the parent corporation and one that owns the former subsidiary. As such, the "split-off" is the most suited corporate division for a divorcing couple.

(c) Split-Up.

The third method by which a tax-free division may be accomplished is where a corporation liquidates and, in the process of liquidation, distributes stock of at least two subsidiaries to its shareholders. In this situation, only the former subsidiaries survive the transaction. A split-up may be either pro rata or disproportionate among the shareholders of the parent corporation, and therefore may produce results identical to either a spin-off or a split-off at the shareholder level.

(2) Statutory Requirements.

Section 355 of the Code sets out several requirements for a corporate division to be tax-free to the corporation and its shareholders.

(a) Two-Business Requirement.

With respect to all three types of tax-free corporate divisions, a requirement exists that after the corporate division, two active businesses exist. I.R.C. § 355(b). There may be, however, a vertical division of a single business. Prop. Treas. Reg. § 1.355- l(a), 1952-2 C.B. 4 (1977); Prop. Treas. Reg. § 1.355-3(c), 1952-2 C.B., Example (10) (1977). Or, a horizontal division, where a corporation that performs several distinct steps in producing and selling a product may incorporate and divide each segment is acceptable. *See* Rev. Rule 75-160, 1975-1 C.B. 112. There is extensive case law on the "two business requirement" which extends well beyond the scope of this article.

(b) Five Year Requirement.

Each of the two or more businesses existing after these tax-free divisions must be at least five years old prior to the time of the distribution. I.R.C. § 355(b)(2)(B). The purpose of the five-year rule is to prevent a corporation from accumulating excess funds, using the funds to purchase a new business, and then distributing stock of this business to shareholders of the corporation, thereby escaping ordinary taxation on the cash accumulation in favor of capital gains taxation on the sale of their stock in the subsidiary corporation.

(c) Business Purpose Requirement.

The regulations provide that these transactions must have a business purpose with respect to the need to separate the one corporation into two, but also the need to distribute the stock of the subsidiary to the shareholder(s) of the parent. Treas. Reg. § 1.355- 2(c). In a divorce context, the question arises as to whether the obvious need for a division of ownership occasioned by the marital discord leading to the divorce is enough to warrant a business purpose under the statute. In this regard, the Regulations proposed under Section 355 provide that "a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them." Prop. Treas. Reg. § 1.355-2(b)(1) (1977). For example, if the shareholders of the parent of a family corporation cannot agree on major decisions affecting their corporation, a division of the corporation is considered motivated by business reasons germane to the corporation. See Prop. Treas. Reg. § 1.355-2(b)(2), Example (2) (1977); and Rev. Rul. 69-460, 1969-2, C.B. 51, Situation (l).

(d) Prohibited Device Requirement.

Corporate divisions are not granted tax-free treatment unless the parent corporation can demonstrate that the transaction is not a "device" for the distribution of earnings and profits. The most important factor used by the Internal Revenue Service in determining whether a principal purpose of the corporate division is the distribution of earnings and profits is if, at the time of the distribution, the shareholders of the parent corporation have a plan or agreement to sell or exchange the shares of either the parent or the former subsidiary. The proposed Regulations provide that if, at the time of the division, a plan or agreement exists to sell or exchange 20 percent or more of the stock of either the parent or subsidiary, the transaction is deemed to be a device for the distribution of earnings and profits. Prop. Treas. Reg. § 1.355- 2(c)(2) (1977). Also, pro rata distributions more closely resemble a distribution of earnings and profits, and are, accordingly, scrutinized with more care. Prop. Treas. Reg. § 1.355-2(c)(1) (1977).

(e) Distribution Of Control Requirement.

The parent corporation must distribute such amount of stock of the controlled corporation to its shareholders so as to place the shareholders in "control" of the former subsidiary corporation. I.R.C. § 355(a)(1)(D). For purposes of this requirement, "control" is defined as ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

(f) Continuity Of Interest Requirement.

The continuity of interest requirement provides that shareholders of the parent corporation must have some continuing proprietary interest in the former subsidiary corporation subsequent to the transaction. Each shareholder of the parent need not have such a continuing proprietary interest, so long as one or more of the parent's shareholders has such an interest. Treas. Reg. § 1.355-2(c).

(3) Effects Of Tax-Free Corporate Division.

(a) Boot.

Section 356 of the Code governs the taxability of the shareholders of the distributing corporation when cash or other property is also distributed (so-called "boot"). This is, in effect, a partial redemption of stock. To this end, the Internal Revenue Service applies a test essentially equivalent to those contained in the stock redemption statutes and Regulations to determine whether there has been a dividend. In this regard, the shareholder's interest in the parent prior to the exchange is compared with the interest he would have retained had he exchanged shares only for the "boot" he received. Rev. Rul. 74-516, 1974-2 C.B. 121. Boot distributions can be sometimes avoided by having the parent transfer the other property to the subsidiary prior to the division. If this is done, no gain is recognized on the distribution. *In Re Albert W. Badanes*, 39 T.C. 410 (1962).

(b) Basis.

Basis calculations in tax-free divisions can become complicated when boot is distributed. But, without boot, the rules are fairly straightforward.

i) Split-Off Or Split-Up.

If no boot is received in a split-off or split-up and the shareholder surrenders all his stock and securities in the parent in exchange for stock in the subsidiary, the basis of the stock received in the exchange is the same as that in the stock surrendered. If no boot is received in the split-off or split-up but the taxpayer does not surrender all his stock in the parent corporation, the basis in the retained stock and the stock received in the transaction is, in aggregate, the same as the basis in the retained and surrendered stock. I.R.C. § 358.

ii) Spin-Off.

If no boot is received in a spin-off, the shareholder's prior basis in his stock is allocated between the retained stock and the stock and received in the distribution. *Id.*

(c) Holding Period.

Where stock or securities of a controlled corporation is received by a taxpayer pursuant to a distribution to which Sec. 355 applies, the period for which the taxpayer has held the stock or securities of the subsidiary includes the period for which the taxpayer held the stock of the parent. Treas. Reg. § 1.1221-1(a). No such "tacking" is permitted, however, with respect to any taxable boot received.

2. Partnerships.

Though partnerships are recognized under the Texas Uniform Partnership act as a separate entity, partnerships pass their taxable income and/or losses directly to the individual partners for taxation, whether or not distributed. I.R.C. §§ 701, 702(a); Treas. Reg. §§ 1.701-1 and 1.702-1(a). Also, because of this separate entity classification, and because Sec. 1041 only applies to spouse-to-spouse transfers, the nonrecognition provisions of Sec. 1041 do not apply to transactions involving the partnership and the spouse. Even if the spouses are the only partners, the partnership is a distinct legal entity separate from the spouses. Treas. Reg. § 1.1041-1T, Q/A-2, Example 3. There are essentially three ways to dispose of partnership interests upon divorce: (l) A sale or exchange of a partnership interest (*i.e.*, awarding the partnership interest to one of the spouses); (2) A distribution of certain partnership property from the partnership to the spouse(s); and (3) A withdrawal of a partner, which results in a distribution of assets upon such withdrawal.

a. Sale Or Exchange Of Partnership Interest.

Unless the transfer meets the requirements of Sec. 1041, any sale or exchange of a partnership interest results in the recognition of gain or loss. I.R.C. § 741. So, in other words, the usual award of the parties' partnership interest to one or both spouses pursuant to a divorce is not a taxable event. It is only when there is a sale of the partnership interest to a third party when taxation rules need be considered.

(1) Partnership Interest Basis.

A partner's initial basis is the sum of the money and the adjusted basis of property contributed to the partnership (plus gain, if any, recognized by the partner on the contribution). If the contributed property is subject to liabilities or if liabilities of the partner are assumed by the partnership, the basis of the partner's interest is reduced by the portion of the indebtedness assumed by the other partners (whose basis in their partnership interests are increased in that amount). I.R.C. § 721. As a general rule, such basis is adjusted by increasing for the partner's distributive share of income and reducing for actual distributions to the partner and for partnership losses. I.R.C. § 705(a).

(2) Sale of Partnership Interest.

The general rule is that a sale of a partnership interest results in a capital gain or loss. I.R.C. § 741. There are exceptions, however, contained in I.R.C. § 751, require a taxpayer to recognize ordinary income on two types of assets that would usually produce ordinary income if sold by the partnership. These are unrealized receivables and substantially appreciated inventory. *Id.*

The amount of ordinary income attributable to this so-called "Section 751" property is the difference between the portion of the total amount realized by the selling partner for the partnership interest that is allocated to the "Section 751" property and the portion of the selling partner's basis for his entire partnership interest that is allocated to such property. Treas. Reg. § 1.751- l(a)(2). The Internal Revenue Service will generally accept the allocation of these assets by the partners, as each have conflicting arms-length motives for opposite treatments. Treas. Reg. § 1.751- l(c)(3).

b. Distributions Of Partnership Property.

Sometimes the parties may wish to distribute property from a partnership owned as marital property directly to one of the spouses upon dissolution of the marriage. Under the conduit theory of partnerships, a partner only recognizes gain to the extent that money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. I.R.C. § 731(a)(1); Treas. Reg. § 1.731-1(a)(1). Any gain to be recognized by a distributee partner is generally considered gain from the sale or exchange of a partnership interest (I.R.C. § 731(a); Treas. Reg. § 1.731-1(a)(3)) and is therefore ordinarily considered gain from the sale or exchange of a capital asset. A distributee partner generally recognizes no loss on a distribution of property (including money) that is not in liquidation of his entire interest. I.R.C. § 731(a)(2); Treas. Reg. § 1.731-1(a)(2).

c. Distributions In Liquidation And Termination Of A Partner's Interest.

If a partner disposes of his entire interest in the partnership through a liquidating distribution, the taxable year of the partnership closes as far as he or she is concerned at that time. I.R.C. § 706(c)(2)(A)(ii); Treas. Reg. §- 1.706-1(c)(2)(i). A partner's share of items of partnership income, gain or loss, deduction, and credit for the taxable year are determined in the same matter as if the partner had sold or exchanged his interest. The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest equals the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction.

3. <u>Sole Proprietorships.</u>

Where a sole proprietorship is sold, the transaction, for tax purposes, is not treated as a sale of the business as a single asset. *See William v. McGowan*, 152 F.2d 570 (2nd Cir. 1945). Instead, the purchase price of the proprietorship must be allocated among the different kinds of assets, depending on their relative value, in order to determine the gain or loss of the seller and the tax basis of the buyer. *See* Rev. Rul. 55- 79, 1955-1, C.B. 370. As such, once the allocation is made, the tax treatment is much like the sale or exchange of other assets discussed above. If spouses have any unused net operating losses from joint return years at the time of divorce, it is necessary to determine how such net operating losses are taken into account by the spouses in later years. In addition, if, subsequent to divorce, a spouse incurs a net operating loss that can be carried back to a joint return year, it is necessary to determine the effect of such a carryback on the other spouse. As a general rule, net operating losses can be carried back for three years and can be carried forward for 15 years. I.R.C. § 172(b)(1)(A) and (B). When a net operating loss on the joint return results from community income and deductions, each spouse will be entitled to one-half of the net operating loss for subsequent use.

II. TAX IMPLICATIONS OF ALIMONY.

Note: Pursuant to the terms of the Tax Cuts and Jobs Act, there is no deduction for alimony for the payer. Furthermore, alimony is not gross income to the recipient. As such, for divorces and legal separations that are executed (i.e., that come into legal existence due to a an agreement or court order) after 2018, the alimony-paying spouse will not be able to deduct the payments, and the alimony-receiving spouse does not include them in gross income or pay federal income tax on them. These new rules do not apply to existing divorces and separations.

Specifically, Section 11051(b)(1)(B) and (C) of the Tax Cuts and Jobs Act prospectively repeal §§ 71 and 682, and § 11051(b)(4)(A) makes conforming amendments to § 7701(a)(17). Section 11051(c) of the Act provides that the amendments made by § 11051 shall apply to: (1) any divorce or separation instrument (as defined in former § 71(b)(2)) executed after December 31, 2018, and (2) any divorce or separation instrument (as so defined) executed on or before such date and modified after such date if the modification expressly provides that the amendments made by such section apply to such modification.

Though not specifically provided for in the Tax Cuts and Jobs Act, the IRS has announced that it will be issuing regulations that will provide that I.R.C. § 682 (for alimony trusts), as in effect prior to December 22, 2017, will continue to apply with regard to trust income payable to a former spouse who was divorced or legally separated under a divorce or separation instrument (as defined in § 71(b)(2)) executed on or before December 31, 2018, unless such instrument is modified after that date and the modification provides that the changes made by § 11051 of the Act apply to the modification. See *Guidance in Connection with the Repeal of Section 682*, Notice 2018-37, April 2018.

The rules governing the taxation of alimony and separate maintenance payments were substantially revised in 1954, in 1984, and again in 1986. *See generally* Laurie Malman, Unfinished Reform: *The Tax Consequences of Divorce*, 61 N.Y.U. L. Rev. 363 (1986); Ronald Hjorth, *Divorce, Taxes and the 1984 Tax Reform; An Inadequate Response to an Old Problem*, 61 Wash. L. Rev. 151 (1986); Beverly I. Moran, *Welcome to the Funhouse: The Incredible Maze of Modern Divorce Taxation*, 26 Harv. J. On Legis. 1 (1989).

A. General Definition.

To be included in the income of the recipient spouse under I.R.C. § 71(a), an "alimony" payment must meet the following requirements:

1. <u>Cash Payment.</u>
Only cash payments can qualify as taxable alimony. I.R.C. § 71(b)(1).

2. <u>Divorce or Separation Instrument.</u>
The payments must be "received under" a qualified divorce or separation instrument. I.R.C. § 71(b)(1)(A). *See Mercurio v. Commissioner*, T.C. Memo 1995-312 (husband's payments to wife that the parties later stipulated in writing to be spousal support did not satisfy the writing requirement as there was no written agreement designating the payments as support at the time payments were made).

3. <u>Payment Must Not Be Designated as Nontaxable.</u>
Cash payments may be in the instrument as not includable in the income of the recipient nor deductible by the payor (excludible/nondeductible). A payment so designated, of course, is not taxable alimony. I.R.C. § 71(b)(1)(B). Absent a designation that cash payments are not deductible by the payor and includable by the payee, they will be deductible by the payor and includable by the payee even if an examination of the basis on which the state court calculated the alimony award reveals an underlying assumption that the payor and payee would not be taxable on the payments. *See Richardson v. Commissioner*, 125 F.3d 551 (7th Cir. 1997), aff'g 70 T.C.M. (CCH) 1390 (1995).

4. <u>Divorced Spouses Must Live in Separate Households.</u>
I.R.C. § 71(b)(1)(C)

5. <u>Payments Must Terminate on the Death of the Recipient.</u>
The obligation to make payments must terminate upon the death of the recipient, and the settlement must not provide a substitute for the terminated payments. I.R.C. § 71(b)(1)(D).

a. Lump Sum Payments.
Under § 71(b)(1)(D) a payment is not alimony unless the payor's liability to continue making payments ceases with the payee's death. *See Barrett v. United States*, 878 F. Supp. 892 (S.D. Miss. 1995) ("lump sum alimony" awarded as additional property settlement in action in which obligation to pay arrearage or future alimony was terminated was not alimony for purposes of § 71(b) because obligation would survive obligor's death); *Hoover v. Commissioner*, 69 T.C.M. (CCH) 2466 (1995) (obligation to pay "alimony as a division of equity" would not terminate upon obligee's death under state law; because decree was silent as to obligation to pay after death, payments were a property settlement, not includable and deductible alimony). Thus, a lump- sum payment made contemporaneously with execution of a divorce instrument or the entry of a judgment is not alimony if the payor's obligation to pay is unconditional and could have been enforced by the payee's estate. *Haydon v. Commissioner*, 60 T.C.M. (CCH) 1066 (1990).

b. Installment Payments.

The same principle should apply if the lump-sum is due in installments, as long as the payor's obligation to continue making installment payments would survive the obligee's death. Similarly, an obligation imposed on one spouse to pay debts on which the other spouse is liable (whether the debts are marital debts or separate debts) will not be alimony, and cannot be recharacterized as alimony by the parties, if, as is usually the case, the obligation to pay the debts is not extinguished by the death of the nonpayor spouse. *Compare Heffron v. Commissioner*, 69 T.C.M. (CCH) 2849 (1995), *aff'd by order sub nom. Murley v. Commissioner*, 104 F.3d 361 (6th Cir. 1996) (even though obligation to pay debts was labeled as "additional alimony" by the divorce settlement agreement, neither the divorce instrument nor state law unambiguously terminated husband's obligation to pay debts if ex-wife died), with *Burkes v. Commissioner*, 75 T.C.M. (CCH) 1772 (1998) (husband's payment of wife's attorney fees as "additional alimony" was taxable to her under § 71 because under state law "support alimony" obligation terminated on payee's death, but "property settlement" alimony did not so terminate, and examination of the language of the divorce instrument as a whole indicated that husband's obligation to pay wife's attorney's fees was "support alimony").

c. Termination In Decree or Agreement?

As originally enacted in 1984, I.R.C. § 71(b)(1)(D) required that the condition be specifically provided in the decree or agreement; but in 1986 this express requirement provision was repealed retroactively. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1843(b), 100 Stat. 2085, 2853. The 1986 amendments to § 71(b)(1)(D) invalidated Temp. Reg. § 1.71- 1T(b), Q&A-11, Q&A-12. As a result, the condition terminating payments upon the payee's death may be provided either by the terms of the decree or written agreement or by local law. See Notice 87-9, 1987-1 C.B. 421; *Cunningham v. Commissioner*, 68 T.C.M. (CCH) 801 (1994) (although written instrument did not expressly so provide, payment obligation was found to survive payee's death under North Carolina law, thus payments were not alimony); *Stokes v. Commissioner*, 68 T.C.M. (CCH) 705 (1994) (monthly alimony for a specified number of months was not deductible because under state law, as interpreted by the Tax Court, the obligation survived the payee's death). *See also Rosenthal v. Commissioner*, 70 T.C.M. (CCH) 1614 (1995) (if agreement specifically provides that support payments continue for a stated term regardless of either spouse's death, language in agreement specifically providing that support payments are intended to be deductible by husband and includable by wife does not create ambiguity; payments were not statutory alimony); and *Sugarman v. Commissioner*, T.C. Memo 1996-410 (payment to wife payable in 24 equal installments for her interest in certain marital property held not to terminate on death of payee under applicable state law, rendering alimony not deductible).

(1) Effect Of Local Law.

Local law generally will be consulted only if the divorce instrument is silent regarding whether or not the payment obligation terminates on the payee's death. An express provision in the divorce instrument will be determinative. *Hoover v. Commissioner*, 102 F.3d 842 (6th Cir. 1996) (payments designated "alimony" in divorce decree not treated as alimony for tax purposes where payments were secured and to be paid "in full"; liability to make the payments did not cease at payee's death under applicable state law); *Heller v. Commissioner*, 103 F.3d 138 (9th Cir. 1996)(unpub. opin)(applied California law that provides that a party's spousal support obligation under a support order terminated upon the death of either party); *Murley v. Commissioner*, T.C. Memo 1995-253 (follows Hoover where neither divorce agreement nor then-applicable state family law unambiguously provided for termination of payments upon ex-wife's death, payments for marital debts fail to qualify as alimony); *and* TAM 9542001 (husband's court-ordered payment of wife's attorney fees not alimony in absence of specific language in divorce decree or operation of provision of state law terminating husband's obligation to pay the fees in the event of wife's death).

(2) Texas Family Code Maintenance.

The Texas Family Code provides for maintenance, which if granted in accordance with the statutes authorizing such, terminates on the death of either party, and thus would meet this requirement. TEX. FAM. CODE ANN. § 8.007. The maintenance statutes are located at TEX. FAM. CODE ANN. §§ 8.001 - 8.011.

6. <u>Payments May Not Be Child Support</u>.

I.R.C. § 71(c)(1). Under § 71(c)(2), an amount is considered to be child support if the period over which it is payable is determined with reference to an event relating to a child, such as attaining a specified age, marrying, dying, or leaving school. For example, in *Hammond v. Commissioner*, 75 T.C.M. (CCH) 1745 (1998), the husband was obligated to make separate and distinct payments of "child support" in the amount of $1,140 per month until the couple's child attained the age of 18, died married, or joined the military and "alimony"of $2,012 per month until the earlier of the child's eighteenth birthday or the wife's remarriage. Notwithstanding the separate denomination and differences in terminating conditions, because the $2,012 per month payments terminated after the child's eighteenth birthday, they, as well as the specifically denominated child support payments, were child support, not alimony, for purposes of § 71.

7. <u>Restrictions on "Front-Loaded" Payments</u>.

If the amount paid decreases during the first three calendar years in which alimony payments are made, there may be a "recapture" in the third year. This restriction is intended to prevent too blatant an exchange of "property" rights for taxable alimony. I.R.C. § 71(f).

B. Deduction for Payor.

Payor may deduct alimony payments paid during the year, which payments are includible in the gross income of the recipient under I.R.C. § 71. I.R.C. § 215(a)-(b).

1. <u>Deduction Allowed In Computing Adjusted Gross Income.</u>

The alimony is a deduction from gross income, so the payor need not itemize in order to take the deduction. I.R.C. § 62(a)(10). Alimony is a nonbusiness deduction, however, so no carryover for alimony deductions in excess of taxable income.

2. Recipient's Taxpayer Identification Number.

The recipient of taxable alimony payments is required to furnish the recipient's TIN to the payor spouse, and the payor is required to include the recipient's TIN on the payor's income tax return for the year in which any taxable alimony payments are made. I.R.C. §§ 215(c); 6109(a)(1)-(a)(2). The sanctions for the failure to provide the recipient's TIN, by either party, are specified in I.R.C. § 6676(a) as apparently relatively minor penalties. In most cases, the payor and recipient will have filed joint returns while married, and the recipient's TIN should be readily available without the necessity of requesting the recipient to furnish same. When this is not true, the failure of the recipient to cooperate should be reasonable cause excusing the failure of the payor to include the TIN. In any event, this understandable but annoying requirement can and should be directly addressed in a settlement agreement.

C. Taxability of Cash Payments.

After the 1984 Amendments, any cash payment can qualify as taxable alimony. The source of the payor's obligation is irrelevant. Thus, cash payments which are required under a post-1984 "instrument" to be made after separation or divorce may be taxable to the recipient under I.R.C. § 71 and deductible by the payor under I.R.C. § 215 even though the payments are required to compensate the recipient for the release of property rights. This also means that the intended tax status of any such payments should be identified, and steps taken to assure that intended result.

D. Divorce or Separation Instruments.

The alimony rules depend on the existence of an "instrument" under which the payments are received by the payee spouse. Taxable alimony payments are defined as cash payments which, inter alia, are "received by . . . a spouse under a divorce or separation instrument." I.R.C. § 71(b)(1)(A). "The term 'divorce or separation instrument' means (A) a decree of divorce . . . or a written instrument incident to such decree, [or] (B) a written separation agreement ..." I.R.C. § 71(b)(2). The Temporary Regulations make clear that these terms have the same meaning that similar terms had under pre-1984 law (despite minor language changes) Temp. Treas. Reg. § 1.71-1T(a) A-4.

1. Divorce Decree.

A decree of divorce which requires the cash payments to be made according to its terms, whether or not incorporated pursuant to a stipulation, qualifies.

2. Written Separation Agreement**.**

A written agreement is a separation agreement if it sets forth the economic terms governing separation. *See Howard Bogard*, 59 T.C. 97 (1972), Acq., 1973-2 C.B. 1. The agreement need not specifically set out the fact of a separation. Nor need the agreement have been executed at the time of separation, so long as it provides for the payments which are to be taxed as alimony. Finally, the agreement apparently need not be legally enforceable, so long as it in fact represents an agreement of the parties and the payments are made "under" its terms. *See* Treas. Reg. § 1.71-1(b)(2)(i); *Judith A. Azenaro*, 58 T.C.M. (P-H) 1060 (1989) (Letter from husband's attorney to wife which was assented to by wife constitutes a "separation agreement.")

3. Written Instrument Incident to the Divorce Decree.

A written agreement need not be "incident" to the decree governing the parties' divorce if it is "incident" to the "status" of divorce. Treas. Reg. § 1.71-1(b)(1)(i). This issue is no longer litigated, and the old cases seem to indicate that any instrument (which need not be an agreement) governing the payment of alimony after a decree has been rendered is "incident" to the status of divorce because the existence of that status makes the instrument effective. Stipulations in open court which are read into the record of the proceeding will satisfy the requirement that the "instrument" be in writing. *See* Priv. Ltr. Rul. 88-21-069 (March 1, 1986). The instrument may also be an agreement executed before divorce if its provisions govern the payments to be made incident to the divorce, as support payments provided in an premarital agreement.

E. Must Live Apart.

I.R.C. § 71(b)(1)(C). Spouses who are legally married and do not file a joint return, if not physically separated, must file separate returns of married individuals, which are keyed to the joint return rates. Divorced spouses, on the other hand, would file as unmarried individuals, subject to more favorable rate schedules. These rate schedules are designed to represent the appropriate tax burden for individuals living alone even if keyed solely to the formal status of marriage. For this reason, tax incidence may not be shifted on cash payments between the parties unless they live in separate economic units.

1. Separate Households.

The Temporary Regulations require two separate "dwelling units," except for a one month period while one spouse prepares to depart (and does depart) the dwelling formerly shared by both. Temp. Reg. § 1.71-1T(b) A-9. For occupation of a single residence to meet the requirements of a separation, therefore, it must have completely separate dwelling units (a duplex?).

F. Payments Must Be Contingent on the Death of the Recipient.

1. Continuation Payments.

There can be "no liability to make any . . .[alimony] payment after the death of the [recipient] ...." I.R.C. § 71(b)(1)(D). This contingency may be implied by substantive support law. See I.R. Notice 87-9, 1987-1 C.B. 421, commenting on TRA 1986 § 1843(b), which eliminated the requirement that the instrument specifically provide that payments should terminate on the death of the payee retroactive to the effective date of the 1984 changes. The substantive law in some jurisdictions will imply such a contingency when payments are spousal support payments.

a. Temporary Support.

Most temporary support orders do not explicitly provide for termination on the death of the person for whose benefit the order was made, but termination on death is always an implicit term in such orders. The I.R.S. has taken the position that temporary support paid in a Texas divorce can be taxable alimony to the recipient and deductible by the payor. This is not normally a position that the I.R.S. will take, as if the payments were made with community property, then both the payor and recipient will be including half of the payments as a deduction, and each will also be including half of the payments as income – thereby cancelling each other out. If, however, the payor pays with separate property, then presumably all of the deduction would be his or hers to take, and this could create an imbalance of reporting obligations and create a real tax liability to the receiving spouse. Also, this can be an issue when the payor and recipient of the taxable alimony will be filing as if they were divorced, *i.e.*, under Sec. 66(a), or in situations where the recipient has otherwise qualified for innocent spouse status, thereby precluding him or her from taking the deduction for the payments made. As a practice tip, when it is desired for the temporary support payment to clearly not be qualifiable as taxable alimony, simply recite the provisions of I.R.C. § 71(b)(1)(B), which states that payments may be designated as not includable in the income of the recipient nor deductible by the payor. A payment so designated, of course, is not taxable alimony.

b. Partial Continuation.

The statutory language implies that any continuation of any payments under the instrument contaminates all payments required by the instrument. The Temporary Regulations interpret this provision, however, to apply to specific payment obligations. Thus, continuation of payments required by one provision in an instrument past the death of the recipient will not contaminate payments under a different provision of the same instrument which do terminate. *See* Temp. Treas. Reg. § 1.71-1T(b) A-11.

c. Noncontingent Installment Payment.

A noncontingent installment payment of a principal sum will not be taxable alimony, no matter how long the payout period. This is a change from pre-85 law, in which a noncontingent ten year payout would be "periodic" and thus could qualify as taxable alimony provided the installment payments were made because of a family support obligation. *Compare Harry A. Moore*, 58 T.C.M. (P-H) 217 (1989). The consequences of this rule for planning are discussed below. It is worth noting that prior law rules governing periodicity or whether the installment obligation was intended to satisfy property rights are completely irrelevant under the post-84 regime. *See Smith v. I.R.S.*, 75 A.F.T.R.2d 2253 (S.D. N.Y. 1995) (retroactive payment to wife of portion of winning lottery ticket annuity proceeds (rights to which were divided as marital property) already received was not deductible as alimony by husband even though already received and included by him).

2. <u>Substitute Payments or Transfers after Termination.</u>

There must be "no liability to make any payment (in cash or property) as a substitute for [terminated payments]." I.R.C. § 71(b)(1)(D). If it is intended that cash payments be taxable to the recipient, the payor may not be obligated to make compensating payments or transfers, on the death of the recipient after divorce, to the recipient's estate or in some other manner, to complete payment for a marital property right. Identifying substitute payments is dependent on the "facts and circumstances," but, generally, any payment to be made by the payor on or after the death of the recipient would be viewed as suspect.

a. Life Insurance Proceeds.

Insurance on the life of the recipient, such as reducing term life insurance, is one method for compensating the recipient for loss of payments should she die before payout is completed. This is so obviously an alternative that the implications of insurance was considered during the 1984 legislation, and according to the legislative history of the 1984 amendments, providing life insurance on the life of the recipient should not be treated as a "substitute" for terminated alimony payments. Thus, the fact that the recipient owns a life insurance policy on her own life, the premiums on which are paid directly or indirectly out of alimony payments should not disqualify the payments. Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1984, 98th Cong., 2d Sess., at page 715 (1984). Direct payment of the premiums by the payor is more risky for tax purposes than having the recipient pay her own premiums, since the tax treatment of such payments remains unsettled.

Note that the Treasury has from time to time indicated concern that so obvious a plan could work and thus may yet attempt to prevent the use of insurance under certain circumstances by disqualifying the alimony payments. The Temporary Regulations are disquietingly silent as to this problem. Query as to how the Service would distinguish a policy which is the recipient's own insurance policy, even if the source of the premiums appears to be the payor's alimony payments, from a policy purchased to insure the risk of early termination.

b. Other Examples.

The Temporary Regulations provide examples of disqualifying continuation payments to a trust for minor children, Temp. Treas. Reg. § 1.71-1T(b) A-14 Example (1), or to the estate of the recipient computed with reference to the remaining unpaid installments, Id., Example (2), but these are relatively easy examples. Compare a bequest from the payor's estate, the amount of which is computed with reference to the amount of alimony paid prior to the death of the payor.

3. <u>Other Contingencies.</u>

The only required contingency is the recipient's death. Any other contingency should be irrelevant.

a. Maximum Payouts.

Alimony payments may be limited by a maximum amount, or a certain number of payments. Indeed, a single, lump-sum will qualify as taxable alimony, provided payment is contingent on the recipient's survival and subject to the excess front-loading rule. So, for example, an instrument may specify that payments are to continue until the earlier of the recipient's death or for n months, where n is any number.

b. Remarriage Of The Recipient.

Alimony payments may continue after the remarriage of the recipient, provided that the payor is obligated to make the payments under the instrument. Under prior law, some courts concluded that such payments were not made because of the family relationship, and thus were no longer taxable alimony. *See Strealdorf v. Commissioner*, 726 F.2d 1521 (11th Cir. 1984); *William D. Roberts, Jr.*, 57 T.C.M. (CCH) 1331 (1989); Tech. Adv. Mem. 86-42-008 (July 8, 1986). Fortunately, this result cannot occur under present law. Thus, if the payments avoid the child support taint, a continuation of payments after remarriage will still be taxable. Query if the payments are reduced at the time of remarriage and there are minor children. The reduction may imply that the remaining payments are disguised child support, although the statutory language of I.R.C. § 71(c)(2) does not clearly apply to them.

c. Death Of The Payor.

This contingency never affected the taxability of payments made by the payor's successor following the death of the payor, if the payments were made under the instrument. Because the source of the payments is not relevant to their taxability, any payment meeting the definition will be includable in the income of the recipient. *See Ada M. Dixon*, 44 T.C. 709 (1965); *Daisy M. Twinam*, 22 T.C. 83 (1954), acq., 1954-2 C.B. 6.

(1) Deductibility of the Payments.

It is not settled whether alimony paid by the payor's successors should be deductible under I.R.C. § 215, or should instead be a distribution (or a nondeductible personal payment) from the estate (or by a successor). Under pre-1984 law, I.R.C. § 215 allowed a deduction only to spouse who made the payments; the payor's successor could not claim a deduction. In 1984, however, I.R.C. § 215(a) was amended to apply to an "individual," without limiting the identity of the individual to a spouse or ex-spouse. Arguably, this language also applies to an estate or trust required to make alimony payments after the death of the ex-spouse because the income of the estate or trust is "computed in the same manner as in the case of an individual." I.R.C. § 641(b). Because the alimony paid deduction is allowed "in the case of an individual," so the argument goes, it should likewise be allowed to the estate or trust. While the argument was suggested by staffers who worked on the 1984 Act, there has been no further public discussion.

(2) Funding Post-Death Liability.

Life insurance on the life of the payor is the most common means for funding a post-death obligation to pay support payments. The income tax consequences of such an arrangement are discussed with the use of trusts, infra, section V. Note, however, that a lump sum payment by an estate to discharge an alimony obligation imposed on the estate under a qualified instrument could be taxable to the recipient (if it otherwise meets the definition of taxable alimony) and deductible by the payor, even when the payment is made from exempt life insurance proceeds. This tax consequence may seem almost gratuitous, and if such a payment is part of the settlement, care should be taken in determining the income tax consequences.

4. Alimony Payments in Exchange for Property Interests.

When the payments are meant to compensate the payee for the release of property rights, it may be unlikely that any contingency in receipt of the payments would be acceptable to the recipient spouse. To be taxable alimony, however, the payor's obligation to make the payments must terminate upon the death of the payee. As noted above, noncontingent installment payouts will not qualify (that is, ten year installment payouts no longer work). Because the risk of the recipient's death prior to payout must be shifted with the payments, the recipient can be expected to negotiate for compensation for both the increased tax cost and the risk of her death.

a. Life Insurance On The Life Of The Recipient.

One way to compensate a spouse who will agree to released marital property rights in exchange for payments which are taxable to her is to increase the payments to cover the cost of reducing term insurance. The recipient probably should obtain the insurance herself as the applicant and owner as well as the insured, although estate planning considerations may dictate ownership of the policy by a third party, usually a trustee. Tax problems with such an explicitly negotiated provision are noted above.

b. Uninsurable Recipients.

If insurance is not an available solution to the risk of death before payout, either because it is not available or is too costly, some other means of compensating the spouse who assumes the risk will have to be found. Given the reduction in marginal tax rates under the 1986 Act, and the taxation of capital gain as ordinary income, direct transfers of property may be preferable (despite the possibility that a capital gains differential may be reinstated in the future).

G. Excess Front-Loading Rules.

These rules are intended to inhibit the use of taxable alimony (tax shifting payments) to fund a "property settlement"--viz., transfers of property which would be otherwise nontaxable to the recipient and nondeductible by the transferor. These rules were enacted in 1984 and substantially amended in 1986, so there are two sets of excess front-loading rules, the application of which depends upon the date of execution of the agreement. Note, however, that the 1984-86 rule applies only to instruments executed after December 31, 1984, and before January 1, 1987, a two year window, unless otherwise modified.

1. Stretch-out Rule.

This rule required some taxable payments to be made in each year of the "post-separation period" (the period beginning with the calendar year in which taxable alimony payments were paid).

a. Post-1986 Agreements.

There is no such requirement for current agreements, although a reduction in the amount of alimony payments during a three year period may result in a "recapture."

b. Post-1984 Agreements.

For agreements executed after December 31, 1984, and before January 1, 1987, there is a six year stretch-out requirement. I.R.C. § 71(f)(1), before amendment in 1986. Although the recapture period has been retroactively shortened to three years, the stretch-out period was left at six years, albeit without any sanction for reductions in alimony paid after the third year. Apparently, the Service believes that this stretch-out requirement applies even to agreements which were modified in calendar 1986, perhaps to disallow alimony treatment for payments in calendar 1985 under instruments which flunked the six year rule.

2. General Recapture Rule (Post-1986 Agreements).

If the amount of taxable alimony paid is reduced for any reason during the three post-separation year period (the "recapture period") by more than $15,000 (the "safe-harbor amount"), the "excess" is subject to "recapture" in the third post-separation year (and only in that third year). "Recapture" means inclusion in the income of the payor with a correlative deduction for the recipient.

a. Post-Separation Years.

The recapture period consists of the three consecutive calendar years beginning with the year in which a taxable alimony payment is paid by the payor to the recipient. The size of the payment, relative to the total obligation of the payor, is irrelevant. I.R.C. § 71(f)(6). Post-separation, pre-divorce (temporary) support can initiate the post-separation period, unless the payments are made under a support decree. I.R.C. § 71(f)(5)(8); Temp. Treas. Reg. § 1.71-1T(d).

b. Safe Harbor Amount.

Payments which are, in the aggregate, $15,000 or less in each calendar year are not subject to recapture under any circumstances. I.R.C. §§ 71(f)(3)(B)(ii), -(4)(B)(ii); *see* Temp. Treas. Reg. § 1.71-1T(d) A-20. Moreover, a reduction in alimony payments during the recapture period is subject to recapture only to the extent that the amount of the reduction exceeds $15,000.

c. Time Of Recapture.

Recapture can occur only in the third post-separation year. Therefore, the amount of taxable alimony paid in that third year is crucial.

d. Amount Subject To Recapture.

The "excess" which is subject to recapture is the sum of (a) the excess of payments made in the second year over the sum of (i) payments made in the third year plus (ii) $15,000 [I.R.C. § 71(f)(4)] and (b) the excess of payments in the first year over the sum of (i) the average of qualifying payments made in the second and third years plus (ii) $15,000. I.R.C. § 71(f)(3). An example is necessary.

e. Exceptions.

Exceptions to the recapture rule are provided for the following circumstances:

(1) Terminations Due to Standard Contingencies.

The death of either payor or the recipient or remarriage of the recipient. I.R.C. § 71(f)(5)(A). The payments must completely cease for this exception to apply. Note that there is no exception for any other contingency, whether or not the event is grounds for a modification in the payor's obligation.

(2) Payments Made under Temporary Support Decrees.

The excess front-loading rules simply do not apply to payments under support decrees (probably because such payments would not be ordered as part of a property settlement). I.R.C. § 71(f)(5)(B). Large payments at the time of divorce, e.g., to discharge marital debts or to pay fees, might be made the subject of a support decree to avoid the "recapture" rule. On the other hand, pre-divorce support can start the three "post-separation" year period if such payments are made under a written agreement. When pre-divorce taxable payments are contemplated, and there will be large alimony payments immediately following a final divorce, making a written agreement for support pending divorce may defuse potential problems with the excess front-loading rules.

(3) Payments Which Fluctuate.

Payments which fluctuate according to the income of the payor over a period of at least the three calendar years during which the recapture rules apply. *See* Temp. Treas. Reg. § 1.71-1T(d) A-25. I.R.C. § 71(f)(5)(C).

3. <u>Planning for the Recapture Rule</u>.

After 1986, the recapture rule will seldom be a barrier to designing a marital settlement requiring taxable payments.

a. Use Equal Payments.

To avoid recapture (usually a desirable result) relatively equal payments (differing by no more than $15,000) need to be made within each of three consecutive calendar years (viz., December of the first year to January of the third year), or a minimum total period of 14 months. This is more than a mere technicality, because taxable payments must terminate on the death of the recipient. Thus, throughout the recapture period, the obligation to make taxable payments will be contingent, which somewhat heightens the risk that the recipient may die before payout. In itself, this requirement would not prevent structuring a settlement with taxable payments, so long as the cost of the risk of the death of the recipient (and thus the loss of some portion of the settlement) can be negotiated.

b. Use Payments That Are Determined With Respect To The Income Of The Payor.

Payments determined as a percentage of all or part of the payor's income are not subject to recapture. I.R.C. § 71(f)(5)(C) ("a continuing liability to pay a fixed portion or portions of the income from a business or property or from compensation for employment or self-employment"). The "fixed portion or portions" referred to in the statute may be determined with respect to a percentage of the payor's income which varies with the amount of the income (viz., the percentage decreases as the payor's income rises), or may be subject to a maximum amount (a "cap"). Variable payments may also be subject to a minimum required payment (a "floor"), but in that case, a decrease in the amount paid below the floor may cause recapture.

c. Control over the Measuring Income.

The caption for the exception refers to "fluctuating payments not within the control of the payor," but the statute imposes no such requirement. By specifically permitting fluctuation with respect to compensation, it seems to admit that control over the payment of compensation will not vitiate the exception.

d. Cost and Design Considerations.

Because the terminability rule is more troublesome when compensation for property rights is intended, and the recapture period is relatively short, designing a variable payment may not be worth the trouble when the principal concern is to avoid the recapture rule for tax purposes.

4. Planning for Partial Alimony Treatment.

Any cash payment is potentially taxable alimony, even though such treatment may result in "recapture" in a later year. Such treatment may depend upon whether, under state law, the contingency of termination on the death of the recipient will be implied, which is the case under the law in most states, but not Texas. Cash payments post divorce will generally be treated as a property settlement, and not contingent on the death of the recipient. Cash payments will not be taxable as alimony under the following circumstances:

a. Using Noncontingent Installment Payouts.

Cash payments made as non-contingent installment payments of a principal sum. Actually, nontaxable payments may terminate on some occurrence other than the death of the recipient, e.g, the death of the payor, and not be taxable alimony. So, only the contingency of the recipient's death need be excluded.

b. Termination Should Be Expressly Provided.

In a Texas agreement, the default provision (no express mention of the effect of the recipient's death) seems to preclude alimony treatment for payments not expressly subject to termination on the death of the recipient. E.g., installment payments for a specified period or until a maximum amount is paid will not terminate on the death of the recipient. Failing expressly to so provide may leave the tax effect of the payments uncertain, so it is the better practice to make this explicit (and would be necessary in another state [*e.g.*, Virginia] where termination would be implied). *Compare Ann L. Denbow*, 58 T.C.M. (P-H) 437 (1989), which seems to have been decided against the taxpayer on a failure of proof.

c. Designation.

Cash payments may be designated as "not includible in gross income under [section 71] and not allowable as a deduction under section 215." I.R.C. § 71(b)(1)(C). This designation is relatively straightforward and may be made in any divorce or separation instrument, including a premarital agreement. Temp. Treas. Reg. § 1.71-1T(b) A-8. If the payments are made under a written separation agreement, the designation may be made in a separate writing signed by both spouses and referring the agreement. The designation should be used whenever cash payments are intended to be nontaxable.

d. Partial Designations.

The allocation of the incidence of income tax can be modulated by separate sets of payments, one set taxable and the other not. This technique may seem desirable if, for example, the payor retains appreciated property, and the parties have negotiated the transfer of an equivalent tax burden (viz., the nontaxable payments may represent the tax basis in property allocated to the payor, while the taxable payments may represent the untaxed appreciation in the property.) As in determining the net cost of any negotiated economic settlement, the effect of the deferral of tax on the property allocated to the payor, as a discounted cost, needs to be considered.

5. <u>Child Support</u>**.**

That part of a payment which the terms of the instrument "fix as payable for child support" will not be taxed as alimony. I.R.C. § 71(c)(1). The 1984 amendments have defined this statutory language to prevent the shifting of the incidence of tax on payments intended for the support of children through undifferentiated family support payments. This technique was sanctioned by the well known *Commissioner v. Lester*, 366 U.S. 299 (1961), which was effectively overruled. Under the Lester rule, undifferentiated taxable payments could be made to the custodial parent; the amount of the payments would be reduced upon the happening of one of a number of events directly associated with the children (e.g., death, emancipation, marriage, attaining majority, etc.). The amount of the reduction only gave rise to an inference that this amount was intended for the support of the child, in the view of the *Lester* Court; it did not "fix" that portion of the payment payable as child support. Under this rule agreements could specify that taxable support payments were meant for the support of the children, a more acceptable obligation for noncustodial parents. Focusing on the deduction of such undifferentiated support payments, Congress set out to separate "disguised child support" from spousal maintenance.

6. <u>Nondeductible Disguised Child Support</u>.

There are two rules limiting the treatment of support payments intended to benefit children as includible/deductible alimony.

a. Reductions in Payments due to Contingencies Related to Children.

That portion of an otherwise taxable payment equal to the amount of a reduction in the payment "on the happening of a contingency specified in the instrument relating to a child . . . will be treated as an amount fixed as payable for the support of children." I.R.C. § 71(c)(2)(A). Linking the extent of the payor's obligation to the welfare of his children thus converts what may have been intended as a taxable payment into nontaxable child support, even if the reduction is temporary. *See, e.g.*, Priv. Ltr. Rul. 87 46-085 (Aug. 21, 1987) (reduction in support payments when custody shifts for summer visitation fixes the rate of reduction for child support purposes).

b. Contingencies Related To A Child.

"A contingency relates to a child if it depends on any event relating to [the] child, regardless of whether such event is certain or likely to occur." Temp. Treas. Reg. § 1.71-1T A-

17. Reduction at the time the principal marital residence is sold would not seem to pass muster if the date of sale in turn depends upon, e.g., a child leaving the household. *Compare* Priv. Ltr. Rul. 88-18-006 (Jan. 25, 1988) (such an event, when subsequent payments are specifically child support, does not "fix" any amount as payable for child support under prior law).

c. Contingencies Not Specified In The Instrument.

Undifferentiated support payments might be required by an agreement on the idea that the emancipation, *etc*., of a child resident in the custodial parent's home will require a downward modification, which the parties agree will be sought at the appropriate time. This down- ward modification would then serve the same function as the specified reduction, but would not run afoul of the statutory prohibition because not "specified in the instrument." Use of this technique depends on the confidence of the payor in his ability to obtain a downward modification from the court, and may seem to be too costly, given the post-1986 marginal tax rates and potential problems in seeking judicial modification of a support obligation.

d. Reductions at a Time Associated with a Contingency Relating to Children.

That portion of an otherwise taxable payment equal to the amount of a reduction in the payment occurring "at a time which can clearly be associated with a contingency [relating to a child] . . . will be treated . . . as an amount fixed as payable for the support of children." I.R.C. § 71(c)(2)(B), and thus as nontaxable child support. The Temporary Regulations apply this rule by creating two "presumptions. The regulations provide that a date is presumed to be clearly associated with an event relating to a child only if (1) the date is within six months on either side of child's eighteenth or twenty-first birthday (or the age of majority under local law), or (2) payments are to be reduced on two or more dates that are within a year either side of a specified birthday between eighteen and twenty-four inclusive of two or more minor children. Temp. Treas. Reg. § 1.71-1T(c), Q&A-18. *Compare Estate of Craft v. Commissioner*, 68 T.C. 249, 263-264 (1997), aff'd, 608 F.2d 240 (5th Cir. 1979) (parol and extrinsic evidence regarding allocation of payments between alimony and child support is not admissible if the divorce instrument on its face is unambiguous) with *Wells v. Commissioner*, 75 T.C.M. (CCH) 1507 (1998) (extrinsic evidence regarding conditions that reduced California family support payments relating to children was admissible because the written agreement was ambiguous). If, for example, alimony is $1,000 per month and is reduced to $800 on July 1, 1999, and to $600 on December 31, 2001, and the two children of the payee and payor, of whom the payee has custody, attain age nineteen on August 1, 1999, and January 31, 2001, respectively, $400 of the $1,000 is clearly associated with the children's nineteenth birthdays and is, therefore, fixed as child support, unless the presumption is rebutted. This presumption can be overcome if the facts indicate that the termination of payments on a date near a child's birthday or another relevant event is based on other factors or is mere coincidence. *See Hill v. Commissioner*, 71 T.C.M. (CCH) 2759 (1996) (presumption overcome and all of designated "spousal support" payments that terminated no later than a specific date within six months of child's birthday (or on wife's earlier death) were alimony where child lived with payor, even though agreement provided for reduction of spousal support if designated child support payments ever resumed). *See also Israel v. Commissioner*, 70 T.C.M. (CCH) 1037 (1995) (one-third of rent husband paid for wife was alimony and two-thirds was child support because obligation to pay wife's rent was reduced by two-thirds if couple's son resided with husband for more than one-half of the year).

e. Single Reductions.

A reduction which occurs within 6 months of a significant birthday for a child is presumed to have occurred at a time "clearly associated" with a "contingency relating to a child." Temp. Treas. Reg. § 1.71-1T(c) A-18. A "reduction" for this purpose includes termination of payments. The termination date for a taxable stream of payments must be carefully set to avoid the significant birthdays of children in order to prevent the full amount of the payment being nontaxable child support. This presumption may be rebutted by showing that the time of the reduction "was determined independently of any contingencies relating to the children of the payor." Id. That is, there must be some compelling reason for setting the time of the reduction other than "any contingencies relating to the children of the payor." Reductions to accommodate the "recapture rule" (after three years) [the regulation appears to concede this] or according to a formula depending on the length of the marriage might succeed.

f. Multiple Reductions.

When there is more than one child and reductions are to occur on more than one occasion, the amount of the reductions are presumed to have occurred at times associated with contingencies related to the children (and thus are disguised child support) if each reduction occurs within one year (before or after) a common age which is attained by a different child at the times of the reductions. Temp. Treas. Reg. § 1.71-1T(c) A- 18. Apparently, the reductions need not be equal in amount.

III. TAX TREATMENT OF THE FAMILY RESIDENCE.

Often the largest asset in the divorcing couple's estate is their residential homestead. Couple this fact with the prevalence of divorce in the United States and one can readily see the impact of these often complex tax situations. Though there are a number of ways to divide a marital home, the tax consequences of its sale are not always consistent with the way the spouses may logically presume. In fact, unless the home is sold with the parties remaining together in the home until sale, it is probable that the terms of the divorce will create potentially costly aberrations from the ordinary tax treatment of the gain upon sale.

A. Sale of Primary Residence.

The Taxpayer Relief Act of 1997 repealed § 1034 for sales of principal residences after May 6, 1997. The rollover provision was replaced by an expanded and revised § 121, which generally provides complete nonrecognition of up to $500,000 of gain realized from the sale of a principal residence by married taxpayers filing a joint return and up to $250,000 of gain recognized by all other individual taxpayers. To qualify for exclusion under § 121, the taxpayer must have owned and used the property as his principal residence for two of the five years preceding the date of the sale. *See* Martin J. McMahon, Jr., Taxation of Sales of Principal Residences After the Taxpayer Relief Act of 1997, 75 TAXES 610 (Nov. 1997). Because § 121(d)(3)(A) applies whenever a transfer is subject to § 1041, which applies to all transfers between spouses, § 121(d)(3)(A) also assures that the ownership test is met whenever for any purpose there is a transfer of interests in the family's principal residence between spouses within two years preceding the sale of the residence, provided, however, that one or the other of the spouses owned the residence for at least two years prior to sale.

B. Sale or Exchange of Marital Residence Between the Spouses.

If the parties' personal residence is awarded to one or the other of them incident to their divorce, or if it is transferred from one spouse to another prior to the divorce, the "award" or "transfer" is deemed to be a gift and is non-income taxable. I.R.C. § 1041(b)(1). In this case, no gain or loss is recognized, and the spouse getting the house takes the basis of the house prior to the "award" or "transfer." I.R.C. § 1041(a); I.R.C. § 1041(b)(2). For a discussion of the laws and rules pertaining to inter-spousal transfers incident to divorce, *see, infra*.

C. Deductibility of Mortgage Payments, Ad Valorem Taxes, Insurance And Maintenance.

Interest and ad valorem taxes on a primary residence are deductible. I.R.C. § 163 (interest); I.R.C. § 164 (taxes). After the parties separate, one or both of them will usually be responsible for making these (and other) payments relating to the house. Who makes which payments in certain circumstances may affect the deductibility of such payments.

1. <u>Ad Valorem Taxes</u>.

Ad valorem taxes paid by the owner or co-owner of property are deductible by the payor. Rev. Rul. 62-38, 1962-1 C.B. 15. If the payments are made out of joint or community assets, it is presumed that each has paid half; however, the presumption can be rebutted by tracing funds. Rev. Rul. 71-268, 1971-1 C.B. 58.

2. <u>Interest.</u>

The interest component of mortgage payments made by an owner or co-owner or mortgage obligor is similarly deductible by the payor, so long as the payments are not being made pursuant to a temporary order or divorce instrument. I.R.C. § 163(h)(3) allows deduction of interest on a debt secured by a "qualified residence." Qualified residence includes the principal residence (as defined under I.R.C. § 1034) and a second residence as defined under I.R.C. § 280A(d)(1). I.R.C. § 163(h)(4). I.R.C. § 280A(d)(1) allows treatment as a second residence to a home owned by the taxpayer if used as a residence by the taxpayer, a co-owner, a member of the taxpayer's family (as defined in I.R.C. § 267(c)(4)) or by any individual so long as fair rental payment is not received. A taxpayer can have only one second residence.

3. <u>Payments Made Pursuant To Temporary Orders.</u>

Where the mortgage payments are required by temporary order or the divorce instrument, some or all of the mortgage interest and principal paid may be considered alimony under I.R.C. § 71, depending on whether such payments otherwise qualify as alimony. This would also be true for payments for non-deductible things, such as utilities and maintenance payments. *See, infra*, re alimony. The spouse who must include the amount paid on his or her behalf as alimony under

I.R.C.§ 71, however, would be entitled to a deduction on interest deemed paid on his or her behalf.

IV. THE INNOCENT SPOUSE DOCTRINE.

A. The Restructuring And Reform Act of 1998.

Innocent Spouse relief applies to *all* understatements of tax attributable to erroneous items of the other spouse. It is no longer necessary for an understatement to be "substantial," which eliminates the $500 minimum and the minimums based on the innocent spouse's adjusted gross income. In addition, it is no longer necessary for the items of the other spouse to which an understatement is attributable to be "grossly" erroneous. This eliminates the hurdle of demonstrating that the understatement has no factual or legal basis. I.R.C. § 6015(b)(1)(B), as added by the IRS Restructuring and Reform Act of 1998. The easing of the restrictions on innocent spouse relief makes the determination of eligibility for such relief simpler and fairer. The minimum thresholds for innocent spouse relief were arbitrary and had a disproportionate impact on low income taxpayers. The grossly erroneous standard could be used by the IRS to deny relief even for understatements whose justification was very tenuous.

1. <u>Partial Relief Available</u>.

Innocent spouse relief continues to be available only if the spouse invoking such relief establishes that, in signing the return, he or she did not know, and had no reason to know, that there was an understatement of tax. I.R.C. § 6015(b)(1)(C), as added by the 1998 Act. However, if the spouse establishes that, in signing the return, he or she did not know, and had no reason to know, the *extent* of the understatement, innocent spouse relief is available on an apportioned basis. In such a case, the spouse is relieved of liability to the extent it is attributable to the portion of the understatement that the spouse did not know or have reason to know. I.R.C. § 6015(b)(2), as added by the 1998 Act.

2. <u>Election.</u>

Taxpayers must elect innocent spouse relief using an IRS form. Taxpayers are entitled to elect such relief up to two years *after* the date the IRS begins collection activities with respect to the electing taxpayer. I.R.C. § 6015(b)(1)(E), as added by the 1998 Act. In reference to the separate liability election discussed below, the Senate Committee Report notes that the two-year period begins with collection activities that have the effect of notifying the electing spouse of the IRS's intention to collect from that spouse. Such activities would include garnishment of the electing spouse's wages and notice of levy against the electing spouse's property, but not notice of deficiency and demand for payment addressed to both spouses. Under the effective date provisions, this two-year period will not expire before two years after the date of the first collection activity that occurs after the date of enactment. The IRS must provide a form for such an election within 180 days after the date of enactment. § 3201(c) of the 1998 Act.

3. <u>Equitable Relief</u>.

The requirement that, under all the facts and circumstances, it would be inequitable to hold the innocent spouse liable for a tax deficiency due to an understatement continues to be a requirement for innocent spouse relief. I.R.C. § 6015(b)(1)(D), as added by the 1998 Act. The IRS is authorized, however, to provide equitable relief in cases in which innocent spouse relief is otherwise not available. I.R.C. § 6015(f), as added by the 1998 Act. The Conference Committee Report instructs the IRS to use its authority to grant equitable relief in tax underpayment situations. Thus, equitable relief is to be available to a spouse who did not know, and had no reason to know, that funds intended for paying tax were instead taken by the other spouse for the other spouse's benefit. The report emphasizes, however, that equitable relief should be available for both understatements and underpayments of tax.

4. Notice to the other joint filer.

The IRS must issue regulations that give a joint filer notice of, and an opportunity to participate in, any administrative proceeding with respect to the other joint filer's election of innocent spouse relief. I.R.C. § 6015(g)(2), as added by the 1998 Act.

5. Community property laws.

As under prior law, community property law is not taken into account in determining innocent spouse relief. I.R.C. § 6015(a), as added by the 1998 Act.

B. Separate Liability Election

Despite filing a joint return for a tax year, certain taxpayers may elect to limit their liability for any deficiency assessed with respect to the return. In general, liability is limited to the amount of deficiency arising from items that would have been allocated to the electing taxpayer if he or she had filed a separate return for the tax year.

1. Eligibility for election.

A taxpayer may elect separate liability under a joint return if (a) at the time of the election, the taxpayer is no longer married to or is legally separated from the person with whom the taxpayer filed the joint return; or (b) the taxpayer was not living in the same household as the person with whom the taxpayer filed the joint return at any time during the 12 months preceding the election. I.R.C. § 6015(c)(3)(A)(i), as added by the 1998 Act.

2. Election.

Taxpayers are entitled to elect separate liability up to two years *after* the date the IRS begins collection activities with respect to the electing taxpayer. I.R.C. § 6015(c)(3)(B), as added by the 1998 Act. The Senate Committee Report notes that the two-year period begins with collection activities that have the effect of notifying the electing taxpayer of the IRS's intention to collect from that taxpayer. Such activities would include garnishment of the electing taxpayer's wages and notice of levy against the electing taxpayer's property, but not notice of deficiency and demand for payment addressed to both spouses. Under the effective date provisions, this two-year period will not expire before two years after the date of the first collection activity that occurs after the date of enactment. The IRS must provide a form for such an election within 180 days after the date of enactment (§ 3201(c) of the 1998 Act).

3. Inappropriate elections prohibited.

An election to limit liability may be partially or completely ineffective due to the electing taxpayer's knowledge of an incorrect item on the joint return or transfers between the joint filers that are intended to avoid tax or are fraudulent.

a. Electing Taxpayer's Knowledge.

An election to limit the liability under a joint return is invalid with respect to a deficiency (or portion of a deficiency) if the IRS demonstrates that, at the time he or she signed the return, the taxpayer making the election had actual knowledge of any item giving rise to the deficiency (or portion thereof). An item of which the electing spouse had actual knowledge is allocable to both spouses. This provision does not apply if the electing taxpayer establishes that he or she signed the return under duress. I.R.C. § 6015(c)(3)(C), as added by the 1998 Act.

> **Example.** Tony and Tina Orlando, who are separated, file a joint return for 1998 reporting $90,000 of wage income earned by Tony, $60,000 of wage income earned by Tina, and $30,000 of investment income on the couple's jointly owned assets. The IRS assesses a $4,800 tax deficiency for $12,000 of unreported investment income from assets held in Tony's name. Tina knew about a bank account in Tony's name that generated $1,000 of interest income but had no knowledge of Tony's other separate investments. Under the rules discussed below, the $12,000 of unreported income is fully allocable to Tony, and he is liable for the entire $4,800 deficiency. If Tina elects separate liability, she will not be liable for $4,400 of the deficiency. This is the amount of the deficiency attributable to the $11,000 of unreported income of which Tina had no actual knowledge ($4,800 x. $11,000 / $12,000). Tina will, however, be liable for $400, which is the amount of the deficiency attributable to the $1,000 of unreported interest income from the bank account ($4,800 x. $1,000 / $12,000).

The Senate and Conference Committee Reports state that "actual knowledge must be established by the evidence and shall not be inferred based on indications that the electing spouse had reason to know."

b. Actual Knowledge Standard Much Narrower.

The standard of "actual" knowledge is much narrower than the standard of "known or should have known" that makes a taxpayer ineligible for innocent spouse relief. As the committee reports point out, knowledge of an erroneous item will not be imputed to a joint filer in determining that taxpayer's separate liability.

c. Transfers To Avoid Tax.

The liability of a joint filer electing separate liability is increased by the value of any "disqualified asset." A "disqualified asset" is any property or property right that is transferred by the other joint filer to the electing taxpayer for the principal purpose of avoiding tax or payment of tax. Any transfer by the other joint filer to the electing taxpayer within one year preceding the date on which the first letter of proposed deficiency is sent is presumed to have avoidance of tax or payment of tax as its principal purpose. This presumption can be rebutted by showing that the principal purpose of a transfer was not to avoid tax or payment of tax. In addition, the presumption does not apply to transfers made pursuant to a decree of divorce or separate maintenance. I.R.C. § 6015(c)(4), as added by the 1998 Act.

d. Fraudulent Transfers.

An election is invalid, and joint and several liability continues to apply to the entire return, if the IRS demonstrates that the taxpayers filing the joint return transferred assets between themselves as part of a fraudulent scheme. I.R.C. § 6015(c)(3)(A)(ii), as added by the 1998 Act.

C. Electing taxpayer's portion of deficiency.

An electing taxpayer's liability generally is limited to the portion of the deficiency that is attributable to items allocable to the taxpayer. An item giving rise to a deficiency generally is allocated in the manner it would had been allocated if the taxpayers had filed separate returns. I.R.C. § 6015(d)(1) and I.R.C. § 6015(d)(3)(A), as added by the 1998 Act.

> **Example (1)**. In 1998, Letta Thompson earns $30,000 from freelance work. She regards this income as her "play" money and does not tell her husband, Jerry, about it. The income is not reported on the Thompsons' joint return. Letta and Jerry get a divorce in 1999. If the IRS assesses a deficiency for the unreported income, Jerry may elect separate liability and owe none of the deficiency, regardless of the IRS's ability to collect the deficiency from Letta. Letta will be liable for the entire deficiency.

> **Example (2)**. Assume the same facts as in Example (1), except that on the couple's 1998 return Jerry claimed a $10,00 bad debt deduction for a loan he made to his cousin. The IRS assesses a deficiency attributable to $30,000 of unreported income and the $10,000 deduction, which it disallowed. If Jerry elects separate liability, his liability would be limited to 25% of the deficiency ($10,000 ÷. $30,000 + $10,000); if Letta elects separate liability, her liability would be limited to 75% of the deficiency. If either Jerry or Letta does not elect separate liability, the nonelecting spouse is liable for the entire deficiency unless it is reduced by innocent spouse relief or the IRS provides equitable relief.

The Senate Committee Report notes that, in general, items of income should be allocated according to which spouse earned the wages or owned the business or investment that produced the income. Income from a jointly-owned business or investment should be allocated equally between each spouse unless there is clear and convincing evidence that supports a different allocation.

D. Burden Of Proof.

A joint filer who elects separate liability bears the burden of proof in establishing his or her portion of the deficiency. I.R.C. § 6015(c)(2), as added by the 1998 Act.

E. Allocation Of Deduction Or Credit.

If a deficiency is attributable to the denial of a deduction or credit, the deficiency is allocated to the spouse to whom the deduction or credit is allocated. The Senate Committee Report explains that business deductions should be allocated according to ownership of the business. Personal deductions should be allocated equally between each spouse unless there is evidence that a different allocation is appropriate. For example, if one spouse produces evidence that an asset contributed to charity was the other spouse's property, a deficiency due to a valuation overstatement would be allocated to the other spouse. Separate treatment of disallowed credits and other taxes. If a deficiency (or portion of a deficiency) is attributable to the disallowance of a credit or a tax other than the income tax or alternative minimum tax (AMT) and the credit or tax is allocated to one spouse. I.R.C. § 6015(d)(2), as added by the 1998 Act. The Conference Committee Report explains this rule to mean that the portion of a deficiency attributable to a disallowed credit or tax other than the income tax or AMT is considered first.

F. Separate Returns Limitations Disregarded.

In determining a joint filer's separate liability, any provision disallowing a deduction or credit because a separate return is filed is disregarded. The deduction or credit is computed as if a joint return had been filed and appropriately allocated between the joint filers. I.R.C. § 6015(d)(4), as added by the 1998 Act.

G. Child's Tax Liability.

If a child's liability is included on a joint return, either joint filer's separate liability is first determined without regard to such liability. The child's liability is then allocated appropriately between the joint filers. I.R.C. § 6015(d)(5), as added by the 1998 Act.

H. Allocation Rule Overridden In Certain Circumstances.

The rule that an item giving rise to a deficiency generally is allocated in the manner it would have been allocated if the taxpayers had filed separately is subject to the following two exceptions:

1. Under rules to be prescribed by the IRS, an item otherwise allocable to one joint filer will be allocated to the other joint filer to the extent that the item created a tax benefit on the joint return for the other filer. I.R.C. § 6015(d)(3)(B), as added by the 1998 Act.

2. The IRS may provide for a different manner of allocation if it establishes that such an allocation is appropriate due to fraud of one or both joint filers. I.R.C. § 6015(d)(3)(C), as added by the 1998 Act.

Comment. The Senate Committee Report states that if the electing spouse establishes that he or she did not know, and had no reason to know, of an item and, considering the facts and circumstances, it is inequitable to hold the electing spouse responsible for any deficiency attributable to the item, the item may be equitably reallocated to the other spouse.

I. Community Property Laws.

Community property law is not taken into account in determining separate liability. I.R.C. § 6015(a), as added by the 1998 Act.

J. Equitable Relief.

The IRS is authorized to provide equitable relief in cases in which relief under a separate liability election is otherwise not available. I.R.C. § 6015(f), as added by the 1998 Act. The Conference Committee Report instructs the IRS to use its authority to grant equitable relief in tax underpayment situations. Thus, equitable relief is to be available to a spouse who did not know, and had no reason to know, that funds intended for paying tax were instead taken by the other spouse for the other spouse's benefit. The report emphasizes, however, that equitable relief should be available for both understatements and underpayments of tax.

K. Notice To Other Joint Filer.

The IRS must issue regulations that give a joint filer notice of, and an opportunity to participate in, any administrative proceeding with respect to the other joint filer's separate liability election. I.R.C. § 6015(g)(2), as added by the 1998 Act.

L. Tax Court Review

If a joint filer is denied an election for innocent spouse relief or separate liability, the taxpayer may petition the Tax Court for review. The petition must be filed within 90 days following date on which the IRS mails a determination to the taxpayer or, if earlier, six months after the election was filed. I.R.C. § 6015(e)(1)(A), as added by the 1998 Act.

1. *Res Judicata*.

A prior, final Tax Court decision is conclusive except with regard to the qualification of the petitioning taxpayer for innocent spouse relief or separate liability. The exception made for determining the taxpayer's qualification does not apply if the Tax Court determines that the petitioning taxpayer participated meaningfully in the prior proceeding. I.R.C. § 6015(e)(3)(B), as added by the 1998 Act.

2. Suits For Refund.

The Tax Court cedes jurisdiction over a claim for innocent spouse relief or separate liability to a U.S. district court or the U.S. Court of Federal Claims that acquires jurisdiction for a refund suit with respect to the same tax years. I.R.C. § 6015(e)(3)(C), as added by the 1998 Act.

3. Notice To Other Spouse.

The Tax Court must establish rules for giving joint filers who do not make an innocent spouse or separate liability election adequate notice and an opportunity to become a party to a proceeding regarding either election. I.R.C. § 6015(e)(4), as added by the 1998 Act.

4. Restrictions On Collection Activity.

Except for termination and jeopardy assessments, the IRS may not begin or proceed with a levy or collection action for an assessment to which an election for innocent spouse relief or separate liability relates until the 90-day period for petitioning the Tax Court has expired or a Tax Court decision becomes final. A levy or collection proceeding begun during the period in which it is prohibited may be enjoined in the proper court. In order for the Tax Court to have jurisdiction to enjoin such actions, the taxpayer must have filed a timely petition to the court, and the court's jurisdiction is limited to the amount of the assessment to which the innocent spouse or separate liability election relates. I.R.C. § 6015(e)(1)(B), as added by the 1998 Act. The period of limitations for collecting an assessment is suspended for the period during which the IRS is prohibited from collecting by levy or a court proceeding plus an additional 60 days. I.R.C. § 6015(e)(2), as added by the 1998 Act.

M. Equitable Relief for Married Taxpayers in Community Property States

Married taxpayers residing in community property states may be liable for the income tax on the community property share of the other spouse's income even if they file separate returns. Such taxpayers are entitled to a form of innocent spouse relief under I.R.C. § 66(c). In cases in which such relief is not available, the IRS is authorized to provide relief if failure to do so would be inequitable, taking into account all the facts and circumstances. I.R.C. § 66(c), as amended by the 1998 Act.

N. Can Innocent Spouses Be Protected By Partition?

There does not seem to be any doubt that the separate property of one spouse ─ absent the filing of a joint return ─ is not liable for the taxes incurred by the other spouse. Partition, however, solves the problem only prospectively, that is, with respect to income yet to be received (and taxes yet to be incurred). With respect to prior periods, half of the community income earned by each spouse was taxable to the other and the tax on such income, therefore, attaches to separate property (unless the "innocent spouse" rules apply). If "married, filing separately" returns have been filed, and the only source of a tax assessment is disallowed deductions, the separate property of the spouse not claiming the questioned deduction would appear to be safe. Note that the property needs to "get separate" before the assessment is made, in any event, as a lien securing payment of taxes arises immediately upon assessment, without the necessity of filing. I.R.C. § 6321. (Such unfiled tax lien is valid only against the taxpayer and others with actual knowledge, and is, therefore, distinguishable from the more familiar type of tax lien, which, like the liens of other creditors, is filed in the county records and is valid as to the claims of third parties). If there has been no assessment, then the only impediment to partition would appear to be the possibility that the partition would be a "transfer in fraud of creditors." TEX. FAM. CODE § 5.56(a) and TEX. BUS. & COMM. CODE § 24.01 *et seq.* In this regard, note that there is no federal "fraudulent conveyance" statute. The rights of the I.R.S. to set aside the partition would be governed by applicable state law. On the other hand, note that whatever transfers or partitions are made must be accomplished "with all the cards on the table." The "classic tax" evasion statute, I.R.C. § 7201, makes it a crime not only to evade taxes by underreporting, but also "to evade the *collection* of any tax." So, be careful not to get carried away.

O. Another Potential Form Of Partition Is Divorce.

Division of property upon divorce is not ordinarily to be attacked as "fraudulent." Cases concerning transfers of property to the alleged innocent spouse after termination of the marriage by divorce, death, or desertion, however, continue to trouble the courts. Evidence of direct or indirect benefit could consist of transfers of property several years after the year in which the omitted item of income should have been included. Treas. Reg. § 1.6013-5(b) indicates that a spouse who receives an inheritance of property or life insurance proceeds that are traceable to items omitted from gross income by the other spouse will have benefitted from those items. Tax refunds that can be traced to the disallowed deduction, in tax shelter cases for instance, can be a significant benefit as well. Divorce, by destroying the community, forever does away with issues like knowledge of the other person's wrongdoing or the obligation to report half of the community income. Note, however, that a number of federal cases hold that a valid divorce under state law will not be recognized *for federal tax purposes* where it is a sham, as where the parties immediately remarry or continue in a "common law" or "informal" state of marriage. *See, e.g., Boyter v. Commissioner*, 668 F.2d 1382 (4th Cir. 1981).

V. FILING STATUS AND DEPENDENCY EXEMPTIONS FOR DIVORCED COUPLES.

Note: Pursuant to the terms of the Tax Cuts and Jobs Act, though in 2017 (and prior years), taxpayers claimed a personal exemption for themselves, their spouse (if married filing jointly) and each qualifying child or qualifying relative, with each exemption reducing taxable income by over $4,000 (in 2017), such personal and dependent exemptions are eliminated from 2018 through 2025. In 2026, taxpayers can claim personal and dependent exemptions again.

In the meantime, divorcing parents can negotiate which parent should be allowed to claim the Child Tax Credit. However, it's important to remember that when personal exemptions return in 2026, the Child Tax Credit must go to the parent who claims the personal exemption for the child. See BNY Mellon Wealth Management, How the Tax Cuts and Jobs Act Affects Divorce Settlements, https://www.bnymellonwealth.com/ articles/strategy/how-the-tax-cuts-and-jobs-act-affects-divorce-settlements.jsp.

(When there is no citation to an authority for this section of the article, the source is I.R.S. Publication 504, Divorced Or Separated Individuals).

Filing status is used to determine a taxpayer's filing requirement, standard deduction and correct tax. It is also important in determining whether a taxpayer may claim certain deductions and credits. Filing status depends, in part, on the taxpayer's marital status on the last day of the tax year. The federal income tax filing status options for taxpayers are: (1) married filing jointly; (2) married filing separately; (3) single; (4) head of household; and (5) qualifying widow(er).3 The tax filing status is set by the spouses' marital status on the last day of the tax year. Spouses are treated for tax purposes as married for the entire year even if they are separated but have not obtained a final decree of divorce or separate maintenance by the last day of the tax year. It should be noted that an interlocutory decree is not a final decree.

A. Marital Status.

If a taxpayer is considered unmarried, his or her filing staus is single, or, if the taxpayer meets certain requirements, head of household. If the taxpayer is considered married, his or her filing status is either married filing a joint return or married filing a separate return. If both the taxpayer and his or her spouse have income, the spouses should usually figure tax on both a joint return and a separate return to see which one produces the lower tax.

1. "Considered Unmarried."

A taxpayer is considered unmarried for the whole year if either of the following applies:

a. The taxpayer has obtained a final decree of divorce by the last day of the taxpayer's tax year. Exception: The divorce must be a "good faith" divorce, and not just a temporary, pro forma divorce, or a divorce for "tax purposes only." Those will not be recognized by existing tax laws.

b. The taxpayer has obtained a decree of annulment, which holds that no valid marriage ever existed. In this case, the taxpayer must also file amended returns claiming unmarried status for all yax years affected by the annulment that are not closed by the statute of limitations. The statute of limitations generally does not end until three years after the due date of the taxpayer's original return.

2. "Considered Married."

A taxpayer is considered married for the whole year if the taxpayer is separated but not divorced by a decree of divorce by the last day of the tax year. There is, however, an exception to this rule. See the discussion, infra, on head of household.

B. Joint Return.

Married individuals may choose to file a joint return. Jont returns include all income, exemptions, deductions and credits of both spouses, even if only one spouse had any of such items.

1. Requirements For A Joint Return.

To file a joint return, generally, at least one spouse must be a U.S. citizen or resident at the end of the tax year. Both spouses must sign the return in order for it to be considered "joint."

2. The Effect Of Filing A Joint Return.

Both spouses are responsible, jointly and individually, for the tax and any interest or penalty due on the joint return. This means that one spouse may be held liable for all the tax due even if all the income was earned by the other spouse.

3. Divorced Taxpayers.

Even after divorce, taxpayer spouses are jointly and individually liable for all taxes, penalties and interest on any joint returns filed during the marriage. This responsibility applies even if the divorce decree states that one spouse will be responsible for any amounts due on previously filed joint returns. There are, however, exceptions for so-called "innocent spouses," which is handled in another portion of this article.

C. Married Filing Separately.

In a community property state like Texas, each spouse, on a separate return, must report one-
half of all community income and all of his or her separate income (i.e., oil royalties). Also, each spouse claims half of all tax pre-payments made during the year with community property (i.e., estimated tax payments and withholding).

1. Separate Liability.

If the spouses file separately, as far as the I.R.S. is concerned, each is only responsible for the tax due on his or her own return. A taxpayer is not responsible for reporting an item of community income if all of the following conditions exist: 1) The taxpayer does not file a joint return for the tax year, 2) The taxpayer does not include an item of community income in gross income on your separate return, 3) The taxpayer establishs that he or she did not know of, and had no reason to know of, that community income, and 4) Under all facts and circumstances, it would not be fair to include the item of community income in the taxpayer's gross income.

2. Spouses Living Apart All Year.

Special rules apply if all the following conditions exist. 1) The taxpayer and the taxpayer's spouse live apart all year. 2) The taxpayer and the taxpayer's spouse do not file a joint return for a tax year beginning or ending in the calendar year. 3) The taxpayer or the taxpayer's spouse has earned income for the calendar year that is community income. 4) The taxpayer and the taxpayer's spouse have not transferred, directly or indirectly, any of the earned income in (3) between yourselves before the end of the year. Do not take into account transfers satisfying child support obligations or transfers of very small amounts or value. If all of these conditions exist, the taxpayer and the taxpayer's spouse must report your community income as explained in the following discussions.

a. Earned Income.

Treat earned income that is not trade or business or partnership income as the income of the spouse who performed the services to earn the income. Earned income is wages, salaries, professional fees, and other compensation for personal services. Earned income does not include amounts paid by a corporation that are a distribution of earnings and profits rather than a reasonable allowance for personal services rendered.

b. Trade Or Business Income.

Treat income and related deductions from a trade or business that is not a partnership as those of the spouse carrying on the trade or business. If capital investment and personal services both produce business income, treat all of the income as trade or business income.

c. Partnership Income Or Loss.
Treat income or loss from a trade or business carried on by a partnership as the income or loss of the spouse who is the partner.

d. Separate Property Income.
Treat income from the separate property of one spouse as the income of that spouse.

e. Social Security Benefits.
Treat social security and equivalent railroad retirement benefits as the income of the spouse who receives the benefits.

f. Other Income.
Treat all other community income, such as dividends, interest, rents, royalties, or gains, as provided under your state's community property law.

3. <u>Negative Consequences Of Separate Returns.</u>
There are a number of reasons that militate against the benefit of separate liability. For example:

a. Innocent spouse status, generally, attaches only to the filing of a joint return.

b. If one spouse itemizes deductions, the other spouse may not take the standard deduction.

c. In most cases, the taxpayer may not take the credit for child and dependent care expenses in most cases.

d. The taxpayer cannot take the earned income credit.

e. The taxpayer cannot exclude the interest from Series EE savings bonds that was used for higher education expenses.

f. If the spouses lived with each other at any time during the tax year:

(1) Neither can claim the credit for the elderly or the disabled; and

(2) Both will have to include in income up to 85% of any social security or equivalent railroad retirement benefits received; and

g. The spouses will become subject to the limit on itemized deductions and the phaseout of the deduction for personal exemptions at income levels that are half of those for a joint return.

4. <u>Joint Return After Separate Return</u>.

If both spouses file separate returns, they can change to a joint return at any time within three years from the due date (not including extensions) of the separte returns. This applies even if the separate returns were filed as head of household. If the tax on the taxpayer's joint return is more than the total paid on the taxpayer's separate returns, the parties must pay the additional tax when they file Form 1040X.

5. Separate Return After Joint Return.

After the due date of the return, spouses cannot file separate returns if they previously filed a joint return.

D. Head Of Household.

Generally, a head of household is an unmarried person who paid more than half the cost of maintaining a home that was his or her principal home and the principal place of abode for any of the following: (1) A son or daughter, including a legally adopted child, or their descendants or a stepchild of the taxpayer. If any of these is married at the close of the taxpayer's tax year, that person must be one for whom the taxpayer is entitled to an exemption for a dependent, must receive more than one-half of his support from the taxpayer, and must not file a joint return. (2) Any other relative of the taxpayer eligible to be claimed as a dependent under I.R.C. § 152(a)(1)-
(8), except those eligible to be claimed under a multiple support agreement (I.R.C. § 2(b)(1)(A)(ii)).

1. Household: Principal Place Of Abode.

The household must constitute the principal place of abode for one or more of the persons mentioned above for more than one-half of the tax year. If a taxpayer maintains a home for a dependent parent, however, the home must be the parent's principal place of abode for the entire year. Nonresident aliens and persons who qualify as "surviving spouses" cannot qualify for "head of household" status. Nonresident aliens are excluded from qualification as "heads of households" under Treas. Reg. § 1.2-2(b)(6). Unremarried widows or widowers who attain "surviving spouse" status, under the definitional requirements of I.R.C. § 2(a), pay income tax at rates applicable to joint returns.

2. Married Individuals May Qualify.

Certain married individuals living apart from their spouses may qualify for head of household status if they satisfy certain conditions under I.R.C. § 7703(b). The provision was primarily designed to grant tax relief to families that had been abandoned by one spouse; however, the provision is broader in scope than that.

3. Marital Status.

In determining taxpayer's marital status as of the close of his tax year, the regulations apply much the same tests as those for determining eligibility for filing joint returns.

4. Temporary Absence.

Temporary absence from the common abode of either the taxpayer or the person used to qualify him will not disqualify him where the absence is due to illness, education, business, vacation, military service, or absence of a child under a custody agreement for less than six months in the tax year (Treas. Reg. § 1.2-2(c)(1)). However, if the taxpayer's child or dependent establishes a separate habitation of his own and only returns to the family household for visits or at intervals, the taxpayer will usually lose his head of household status.

5. Death Of Dependent Not Fatal To Status**.**

A taxpayer is not deprived of head of household benefits because the person who would otherwise qualify him for such benefits is born or dies during the tax year. In other words, if the relative through whom the taxpayer qualifies as a head of a household had no other principal place of abode for the remaining or preceding part of taxpayer's tax year, the statutory requirements are met. A taxpayer who maintains a household which is the principal place of abode of the taxpayer's child, stepchild, or grandchild from the date of birth during the tax year until the end of the tax year will qualify as the head of a household, assuming, of course, that the other statutory requirements are met. Rev. Rul. 55-329.

6. Pay More Than Half Cost Of Household.

More than half the cost of maintaining the household must be paid by the taxpayer if he is to qualify for head of household status. Such cost includes property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed in the home as well as domestic help (IRS Pub. 17, The taxpayer's Federal Income Tax, for 1997 returns). But cost does not include expenses incurred for clothing, education, medical treatment, vacations, life insurance, transportation, and any amount which represents the value of services performed in the household by the taxpayer or the person used to qualify him (Treas. Reg. § 1.2-2). Presumably, payment of the mortgage principal on a home is also excluded from the cost of maintaining a home. It is possible for a household to be a portion of a home, since it is a matter of intent and not of physical boundaries.

7. Benefits Of Head Of Household.

a. The taxpayer can claim the standard deduction even if his or her spouse itemizes deductions on a married filing separate return.

b. The standard deduction is higher than that allowed on a single or married filing separate return.

c. The tax rate may be lower than that on a single or married filing separate return.

d. The taxpayer may be able to claim certain credits that he or she could not claim on a married filing separate return.

e. The taxpayer will become subject to the limit on itemized deductions at an income level that is twice that for a married filing separate return

f. The taxpayer will become subject to the phaseout of the deduction for personal exemptions at a higher income level than those for a single or a married filing separate return.

E. Exemptions.

For 1998, taxpayers are allowed a $2,700 deduction for each exemption claimed. However, see Phaseout of Exemptions, later. The taxpayer can claim exemptions whether or not he or she itemize deductions. A taxpayer may claim his or her own exemption unless someone else can claim the taxpayer as a dependent. If the taxpayer is married, he or she may be able to take an exemption for his or her spouse. Also, a taxpayer can take an exemption for each person who qualifies as the taxpayer's dependent under the dependency tests discussed later.

1. Spousal Exemption.

The taxpayer's spouse is never considered the taxpayer's dependent. The taxpayer can take an exemption for the taxpayer's spouse only because the taxpayer is married.

a. Joint Return**.**

If the taxpayer and the taxpayer's spouse file a joint return, the taxpayer can claim an exemption for each of the taxpayer.

b. Separate Return.

If the taxpayer files a separate return, the taxpayer can take an exemption for the taxpayer's spouse only if the taxpayer's spouse had no gross income and was not the dependent of someone else. This is true even if the taxpayer's spouse is a nonresident alien.

c. Alimony Paid.

If the taxpayer paid alimony to the taxpayer's spouse and deduct it on the taxpayer's separate return, the taxpayer cannot take an exemption for the taxpayer's spouse. This is because alimony is gross income to the spouse who received it.

d. Former Spouse.

The taxpayer cannot take an exemption for the taxpayer's former spouse for the year in which the taxpayer were divorced or legally separated under a final decree. This rule applies even if the taxpayer paid all the taxpayer's former spouse's support that year.

2. Exemption For Dependents**.**

The taxpayer can take an exemption for each person who is the taxpayer's dependent. A dependent is any person who meets all five of the dependency tests discussed below. The right to claim a dependency exemption is controlled exclusively by § 152; a state court decree awarding a dependency exemption inconsistently with the provisions of § 152 is ineffective. *White v. Commissioner*, 72 T.C.M. (CCH) 786 (1996). If the taxpayer can claim an exemption for the taxpayer's dependent, the dependent cannot claim his or her own exemption on his or her own tax return. This is true even if the taxpayer do not claim the dependent's exemption or the exemption will be reduced or eliminated under the phaseout rule for high-income individuals.

a. Birth Or Death Of Dependent.

The taxpayer can take an exemption for a dependent who was born or who died during the year if he or she met the dependency tests while alive. This means that a child who lived only for a moment can be claimed as a dependent. Whether a child was born alive depends on state or local law. There must be proof of a live birth shown by an official document, such as a birth certificate. The taxpayer cannot claim an exemption for a stillborn child.

b. Dependency Tests.

A dependent must meet all the following tests:

(1) Test 1 - Relationship.

The dependent must either: Be related to you, or Have been a member of the taxpayer's household. If the dependent is not a member of the taxpayer's household, he or she must be related to the taxpayer (or the taxpayer's spouse if the taxpayer are filing a joint return) in one of the following ways: Child, Stepchild, Mother, Father, Grandparent, Great-Grandparent, Brother, Sister, Grandchild, Great-grandchild, etc., Half-brother, Half-sister, Stepbrother, Stepsister, Stepmother, Stepfather, Mother-In-Law, Father-In-Law, Brother-In-Law, Sister-In-Law, Son-In-Law, Daughter-In-Law, If related by blood: Uncle, Aunt, Nephew, Niece. Any relationships that have been established by marriage are not considered ended by death or divorce.

A child is: 1) A son, daughter, stepson, stepdaughter, or adopted son or daughter, 2) A child who lived in the taxpayer's home as a member of the taxpayer's family, if placed with the taxpayer by an authorized placement agency for legal adoption, or 3) A foster child (any child who lived in the taxpayer's home as a member of the taxpayer's family for the whole year, for whom the taxpayer did not receive qualified foster care payments).

If the dependent is not related to the taxpayer, he or she must have lived in the taxpayer's home as a member of the taxpayer's household for the whole year (except for temporary absences, such as for vacation or school). A person is not a member of the taxpayer's household if at any time during the taxpayer's tax year the relationship between the taxpayer and that person violates local law.

(2) Test 2 - Married Person.

The dependent cannot have filed a joint return for the year in question. However, this test does not have to be met if neither the dependent nor the dependent's spouse is required to file, but they file a joint return to get a refund of all tax withheld.

(3) Test 3 - Citizen or Resident.

To meet the citizen or resident test, a person must be a U.S. citizen or resident, or a resident of Canada or Mexico for some part of the calendar year in which the taxpayer's tax year begins.

Children usually are citizens or residents of the country of their parents.

If the taxpayer is a U.S. citizen when the taxpayer's child was born, the child may be a U.S. citizen although the other parent was a nonresident alien and the child was born in a foreign country. If so, and the other dependency tests are met, the child is the taxpayer's dependent and the taxpayer may take the exemption. It does not matter if the child lives abroad with the nonresident alien parent.

If the taxpayer is a U.S. citizen living abroad who has legally adopted a child who is not a U.S. citizen or resident, and the other dependency tests are met, the child is the taxpayer's dependent and the taxpayer may take the exemption if the taxpayer's home is the child's main home and the child is a member of the taxpayer's household for the taxpayer's entire tax year.

(4) Test 4 - Income.

The dependent must have received less than $2,500 of gross income in 1995. Gross income does not include nontaxable income, such as welfare benefits or nontaxable social security benefits. The income test does not apply if the taxpayer's child: 1) Was under age 19 at the end of the tax year, or 2) Was a student during the tax year and was under age 24 at the end of the tax year. To qualify as a student, the taxpayer's child must have been, during some part of each of 5 calendar months (not necessarily consecutive) during the tax year: 1) A full-time student at a school that has a regular teaching staff and course of study, and a regularly enrolled body of students in attendance, or 2) A student taking a full-time, on-farm training course given by a school described in (1) above or a state, county, or local government. A full-time student is one who was enrolled for the number of hours or courses the school considers to be full-time attendance. The term 'school' includes elementary schools, junior and senior high schools, colleges, universities, and technical, trade, and mechanical schools. It does not include on-the-job training courses, correspondence schools, or night schools.

(5) Test 5 - Support.

In general, the taxpayer must have given over half the dependent's support. If the taxpayer file a joint return, the support could have come from the taxpayer or the taxpayer's spouse. Even if the taxpayer did not give over half the dependent's support, the taxpayer will be treated as having given over half the support if the taxpayer meet the tests explained later under Multiple Support Agreement.

If the taxpayer is divorced or separated and the taxpayer or the other parent, or both together, gave over half the taxpayer's child's support in the tax year, the support test for the taxpayer's child may be based on a special rule.

In figuring total support, the taxpayer must include money the dependent used for his or her own support, even if this money was not taxable (for example, gifts, savings, and welfare benefits). If the taxpayer's child was a student, do not include amounts he or she received as scholarships.

Support includes items such as food, a place to live, clothes, medical and dental care, recreation, and education. In figuring support, use the actual cost of these items. However, the cost of a place to live is figured at its fair rental value.

Do not include in support items such as income tax and social security and Medicare taxes paid by persons from their own income, premiums for life insurance, or funeral expenses.

(6) Joint Ownership Of Home.

If the taxpayer's dependent lives with the taxpayer in a home that is jointly owned by the taxpayer and the taxpayer's spouse or former spouse, and each of the taxpayer has the right to use and live in the home, each of the taxpayer is considered to provide half the taxpayer's dependent's lodging. However, if the taxpayer's decree of divorce gives only the taxpayer the right to use and live in the home, the taxpayer is considered to provide the taxpayer's dependent's entire lodging, even though legal title to the home remains in the names of both the taxpayer and the taxpayer's former spouse.

(7) Capital Items.

The taxpayer must include capital items such as a car or furniture in figuring support, but only if they were actually given to, or bought by, the dependent for his or her use or benefit. Do not include the cost of a capital item for the household or for use by persons other than the dependent. For example, include in support a bicycle purchased by and used solely by the dependent for transportation; do not include a lawn mower the taxpayer purchase that is occasionally used by the dependent.

3. Children Of Divorced Or Separated Parents.

In general, a dependent must meet the support test explained earlier under Test 5 - Support. However, the support test for a child of divorced or separated parents is based on a special rule.

a. Special-Rule Requirements.

In determining whether the support test for a child of divorced or separated parents has been met, the special rule applies only if the parents meet all of the following three requirements.

(1) The parents were divorced or legally separated under a decree of divorce or separate maintenance, were separated under a written separation agreement, or lived apart at all times during the last 6 months of the calendar year.

(2) One or both parents provided more than half the child's total support for the calendar year.

(3) One or both parents had custody of the child for more than half the calendar year.

Child is defined earlier under Test 1 - Relationship.

b. Support Provided By Parents.

Support given to a child of a divorced or separated parent by a relative or friend is not included as support given by that parent.

Example. The taxpayer is divorced. During the whole year, the taxpayer and the taxpayer's child lived with the taxpayer's mother in a house she owns. The taxpayer must include the fair rental value of the home provided by the taxpayer's mother for the taxpayer's child in figuring total support but not as part of the support provided by the taxpayer.

c. Remarried Parent.
If the taxpayer remarried, the support the taxpayer's new spouse gave is treated as given by the taxpayer.

Example. The taxpayer have two children from a former marriage who lived with the taxpayer. The taxpayer remarried and lived in a home owned by the taxpayer's present spouse. The fair rental value of the home provided to the children by the taxpayer's present spouse is treated as provided by the taxpayer.

d. Exceptions.
This discussion does not apply in any of the following situations. 1) A third party, such as a relative or friend, gave half or more of the child's support. 2) The child was in the custody of someone other than the parents for half the year or more. 3) The child's support is determined under a multiple support agreement. 4) The parents were separated under a written separation agreement, or lived apart, but they file a joint return for the tax year. In these situations, support is determined under the regular method discussed earlier under Test 5 - Support.

4. Custodial Parent.
Under the special rule, the parent who had custody of the child for the greater part of the year (the custodial parent) is generally treated as the parent who provided more than half the child's support. This parent is usually allowed to claim the exemption for the child, if the other dependency tests are met. However, see Noncustodial Parent, later.

a. Custody or "Managing Conservatorship."
Custody is usually determined by the most recent decree of divorce or separate maintenance, or a later custody decree. If there is no decree, use the written separation agreement.

If neither a decree nor an agreement establishes custody, then the parent who had physical custody of the child for the greater part of the year is considered the custodial parent. This also applies if a decree or agreement calls for 'split' custody, or if the validity of a decree or agreement awarding custody is uncertain because of legal proceedings pending on the last day of the calendar year.

If the parents were divorced or separated during the year after having had joint custody of the child before the separation, the parent who had custody for the greater part of the rest of the year is considered the custodial parent for the tax year.

Example 1. Under the taxpayer's divorce decree, the taxpayer have custody of the taxpayer's child for 10 months of the year. The taxpayer's former spouse has custody for the other 2 months. The taxpayer and the taxpayer's former spouse provided the child's total support. The taxpayer is considered to have given more than half the child's support.

Example 2. The taxpayer and the taxpayer's former spouse provided the taxpayer's child's total support for the tax year. The taxpayer had custody of the taxpayer's child under the taxpayer's 1990 divorce decree, but on October 15, 1995, a new custody decree granted custody to the taxpayer's former spouse. Because the taxpayer had custody for the greater part of the year, the taxpayer is considered to have provided more than half the child's support.

Example 3. The taxpayer were separated on June 1. The taxpayer's child's support for the year was $1,200, of which the taxpayer gave $500, the taxpayer's spouse $400, and the child's grandparents $300. No multiple support agreement was entered into. (See Multiple Support Agreement, later.) Before the separation, the taxpayer and the taxpayer's spouse had joint custody of the taxpayer's child. The taxpayer's spouse had custody from June through September and the taxpayer had custody from October through December. Because the taxpayer's spouse had custody for 4 of the 7 months following the separation, the taxpayer's spouse was the custodial parent for the year and is treated as having given more than half the child's support for the year.

b. Noncustodial Parent

Under the special rule, the parent who did not have custody, or who had it for the shorter time, is treated as the parent who gave more than half the child's support if: 1) The custodial parent signs a statement agreeing not to claim the child's exemption, and the noncustodial parent attaches this statement to his or her return (see Form 8332, later), or 2) A decree or written agreement made before 1985 provides that the noncustodial parent can take the exemption and he or she gave at least $600 for the child's support during the year, unless the pre-1985 decree or agreement was modified after 1984 to specify that this provision will not apply.

Example 1. Under the taxpayer's 1983 divorce decree, the taxpayer's former spouse has custody of the taxpayer's child. The decree states that the taxpayer can claim the child's exemption. The taxpayer gave $1,000 of the taxpayer's child's support during the year and the taxpayer's spouse gave the rest. The taxpayer is considered to have given over half the child's support, even if the taxpayer's former spouse gave more than $1,000.

Example 2. The taxpayer and the taxpayer's spouse provided all of the taxpayer's child's support. Under the taxpayer's 1988 written separation agreement, the taxpayer's spouse has custody of the taxpayer's child. The agreement conditionally states that the taxpayer can claim the child's exemption. Because the agreement was made after 1984, the taxpayer is considered to have given over half the child's support only if the taxpayer's spouse agrees not to claim the child's exemption on Form 8332 or a similar statement.

Example 3. The taxpayer and the taxpayer's former spouse provided all of the taxpayer's child's support. The taxpayer's divorce decree gives custody of the taxpayer's child to the taxpayer's former spouse. It does not say who can claim the child's exemption. The taxpayer's former spouse is considered to have given over half the child's support, unless he or she agrees not to claim the child's exemption on Form 8332 or a similar statement.

(1) Form 8332.
The custodial parent can sign Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, or a similar statement, agreeing not to claim the child's exemption. The exemption may be released for a single year, for a number of specified years (for example, alternate years), or for all future years.

(2) Release.
If the taxpayer is the noncustodial parent, the taxpayer must attach the release to the taxpayer's return. If the exemption is released for more than one year, the taxpayer must attach the original release to the taxpayer's return the first year and a copy each following year.

(3) Similar Statement.
If the taxpayer's divorce decree or separation agreement made after 1984 unconditionally states that the taxpayer can claim the child as the taxpayer's dependent, the taxpayer can attach to the taxpayer's return copies of the following pages from the decree or agreement instead of Form 8332: 1) The cover page (write the other parent's social security number on this page), 2) The page that unconditionally states the taxpayer can claim the child as the taxpayer's dependent, and 3) The signature page with the other parent's signature and the date of the agreement. However, in *White v. Commissioner*, T.C. Memo 1996-438, the Tax Court upheld the I.R.S. in disallowing a noncustodial parent's claimed dependency exemption where he merely attached to his return a letter signed by his former wife which tracked the language of the divorce decree providing that the husband would be entitled to claim the children as dependents and that the wife would be required to sign any documents necessary to enable the husband to do so. According to the Tax Court, the letter, which failed to state that the wife would not claim the children as dependents and which lacked the other specific items of information required, failed to "conform to the substance" of Form 833.

(4) Children Over The Age Of Majority.
This special rule ceases to apply, however, when a child of divorced parents attains the age of majority and parental control terminates under state law; thereafter the normal dependency exemption rules apply. *See Rownd v. Commissioner*, 68 T.C.M. (CCH) 738 (1994) (noncustodial spouse entitled to exemption for 19 year old college student child for whom he provided more than one-half support even though divorce decree granted exemption to other former spouse).

(5) More Than Just Exemptions At Stake.
More than just the dependency exemption is at stake in applying § 152(e). The $500 per child credit under § 24 is available only to the parent who is entitled to claim the dependency

exemption. See I.R.C. § 24(c)(1)(A). Since the § 24 child credit is refundable against FICA taxes as well as income taxes if it exceeds the taxpayer's income tax liability and the taxpayer has three or more qualifying children, a custodial spouse often will be unwilling to surrender the exemption to the noncustodial spouse in exchange for additional child support or alimony, because the amount of the § 24 credit that would be lost would exceed the additional payment that the other spouse would be willing to make out of the taxes saved by obtaining the exemptions. For computation of the § 24 child credit generally, *see* Martin J. McMahon, Jr., The New Child Credits: Explainable Mechanics and Unfathomable Policy, 76 TAX NOTES 1625 (Sept. 22, 1997).

Similarly, only the parent who is entitled to the dependency exemption is entitled to claim either a Hope Scholarship or lifetime learning credits under § 25A with respect to tuition payments for children. I.R.C. § 25A(g)(3)(A); *see* Notice 97-60, 1997-46 I.R.B. 8, § 1, Q&A-10, § 2, Q&A-7. This is particularly significant because the credit is allowable to the parent who claims a child as a dependent even if the tuition with respect to which the credit is allowed is paid with the child's own funds. I.R.C. § 25A(g)(3)(B); *see* Notice 97-60, 1997-46 I.R.B. 8, § 1, Q&A-12, § 2, Q&A-8.

c. Agreements Made Before 1985.

If the taxpayer is a noncustodial parent who claims a child's exemption under a decree or agreement made before 1985, the taxpayer must give at least $600 for that child's support. Check the box on line 6d of the taxpayer's Form 1040 or line 6d of the taxpayer's Form 1040A.

(1) Child Support.

Child support payments received from the noncustodial parent are considered used for the child's support, even if actually spent on things other than support.

Example. The taxpayer's 1982 divorce decree requires the taxpayer to pay child support to the custodial parent and states that the taxpayer can claim the taxpayer's child's exemption. The custodial parent paid for all support items and put the $1,000 child support the taxpayer paid during the year into a savings account for the child. Because the taxpayer's payments are considered used for support, the taxpayer is considered to have given over half the child's support.

(2) Back Child Support.

Even if the taxpayer owed child support for an earlier year, the taxpayer's payments are considered support for the year paid, up to the amount of the taxpayer's required child support for that year. If the taxpayer paid back child support by paying more than the amount required for the year paid, the back child support is not considered support for either the year paid or the earlier year.

Example. The taxpayer and the taxpayer's former spouse provide all the taxpayer's child's support. The taxpayer's 1981 divorce decree requires the taxpayer to pay $800 child support each year to the custodial parent and allows the taxpayer to claim the taxpayer's child's exemption. Last year the taxpayer paid only $500, but the taxpayer made up the $300 the taxpayer owed by paying $1,100 this year. Because the taxpayer did not pay at least $600 last year, the taxpayer cannot take the exemption unless the custodial parent signs a Form 8332 or similar statement. The $300 back child support the taxpayer paid this year is not considered support for last year or for this year.

(3) Medical Expenses

A child of divorced or separated parents whose support test is based on the special rule described in this section is treated as a dependent of both parents for the medical expense deduction. Thus, a parent can deduct medical expenses he or she paid for the child even if an exemption for the child is claimed by the other parent.

5. Multiple Support Agreement.

Sometimes two or more people together pay over half a dependent's support, but no one alone pays over half. One of those people can claim an exemption for the dependent if all the following requirements are met. 1) The person paid over 10% of the dependent's support. 2) If not for the support test, the person could claim the dependent's exemption. 3) The person attaches to his or her tax return a signed Form 2120, Multiple Support Declaration, from every other person who meets the previous two requirements. This form states that the person who signs it will not claim the dependent's exemption for that year.

6. Phaseout Of Exemptions.

The amount the taxpayer can claim as a deduction for exemptions is phased out if the taxpayer's adjusted gross income (AGI) exceeds certain limits.

VI. DEDUCTIBILITY OF ATTORNEY'S FEES IN A DIVORCE.

Note: Pursuant to the terms of the Tax Cuts and Jobs Act, fees incurred for tax advice related to a divorce are no longer deductible. Additionally, fees that a divorced spouse pays to an investment management firm to manage assets are no longer deductible. See BNY Mellon Wealth Management, How the Tax Cuts and Jobs Act Affects Divorce Settlements, https://www.bnymellonwealth.com/ articles/strategy/how-the-tax-cuts-and-jobs-act-affects-divorce-settlements .jsp.

A. Fees Attributable To The Dissolving Marriage.

Fees assignable to obtaining a divorce are not deductible. Accordingly, professional fees to prepare pleadings, litigate custody issues, attend court appearances and negotiations for the granting of the divorce are viewed as personal and are not allowable as a deduction. There are, however, certain situations when the fees can be deductible.

B. Tax Advice.

A taxpayer may always deduct attorneys' fees related to tax advice. I.R.C. § 212(3) of the Code. Treas. Reg. § 1.212-1(1) states:

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

C. Production Or Collection Of Income.

Fees allocable to securing taxable income (alimony) are deductible. I.R.C. § 212(1). Accordingly, fees for legal services to obtain alimony taxable under I.R.C. § 71 are deductible to the recipient of the alimony. *Id.* Also, fees incurred in an unsuccessful attempt to secure alimony or other taxable income should be deductible. O'Connell, *Divorce Taxation* 17,026 (Prentice-Hall 1985). However, legal fees paid to resist the collection of income by the other spouse are not deductible, *Hunter v. U.S.,* 219 F.2d 69 (2d Cir., 1955), nor are fees deductible for a successful attempt to reduce his (or her) alimony obligation. *Francis A. Sunderland,* TC Memo 1977-116.

D. Protecting Income Producing Property.

Fees for protecting income producing properties are not deductible. *U.S. v. Gilmore,* 372 U.S. 39 (1963). The fees can, however, be added to the tax basis of the property. *George v. U.S.,* 434 F.2d 1336 (Ct. Cl. 1970). There is a problem in this area of basis adjustment. If a number of assets are received and the fees are not specifically allocated among the various assets, the IRS may successfully argue for a pro rata allocation of fees. *See Bernard D. Spector*, 71 TC 1017 *rev'd other reasons,* 641 F.2d 376 (5th Cir. 1981).

E. Allocation Of Fees.

Fees should be allocated for the client between those that are deductible and those that are not. If no allocation is made, the deduction could be disallowed. *Hall v. U.S.,* 41 AFTR 2d 78-
1106 (Ct. Cl. 1978).

VII. ESTATE & GIFT TAX CONSIDERATIONS IN A DIVORCE CONTEXT.

If a taxpayer transfers property to the taxpayer's spouse or former spouse in exchange for the release of marital rights, and the taxpayer does not qualify for an exception (explained later), the taxpayer generally must report the transfer on a gift tax return for the calendar year the transfer was made.

A. Release Of Marital Rights.

This is the giving up by the taxpayer's spouse or former spouse of marital rights in the taxpayer's property or estate. This does not include the release of spousal or child support rights. The transfer of property in exchange for support rights is not subject to gift tax. If the taxpayer transfers property in exchange for the release of both marital and support rights, the reportable amount is the value of the property less the value of the support rights given up.

1. <u>Exceptions</u>.

The taxpayer's transfer of property in exchange for the release of marital rights is not subject to gift tax if it meets any of the following exceptions.

a. It qualifies for the annual exclusion. The first $10,000 of gifts of present interests to any person during the calendar year is not subject to gift tax. The annual exclusion is $100,000 for transfers to a spouse who is not a U.S. citizen that would qualify for the marital deduction if the donee were a U.S. citizen. I.R.C. § 2503(b).

b. It is for qualified tuition or medical care. Amounts the taxpayer pay as tuition to a qualifying educational organization for the benefit of the taxpayer's spouse or former spouse and amounts the taxpayer pay to provide medical care for the taxpayer's spouse or former spouse are not subject to gift tax. I.R.C. § 2503(e).

c. It qualifies for the marital deduction. A transfer of property to a spouse before receiving a final decree of divorce or separate maintenance is not subject to gift tax. However, this rule does not apply to: Transfers of certain terminable interests, or Transfers to a spouse who is not a U.S. citizen. I.R.C. § 2523.

d. It is required by a divorce decree. A transfer of property under the decree of a divorce court having the power to prescribe a property settlement is not subject to gift tax. This rule also applies to a property settlement agreed on before the divorce if it was made part of or approved by the decree. *Harris v. Commissioner*, 340 U.S. 106 (1950).

e. It is made under a written agreement, and the taxpayer is divorced within a specified period. A transfer of property under a written agreement in exchange for the release of marital rights or to provide a reasonable child support allowance is not subject to gift tax if the taxpayer are divorced within the 3-year period beginning 1 year before and ending 2 years after the date of the agreement. This applies whether or not the agreement is part of or approved by the divorce decree. I.R.C. § 2516.

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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I. ACCOUNTING

A. Accounting Methods

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

1. Let's hope this tax services firm has more success on behalf of its clients. Amounts received from customers had to be included in income despite a promise to return the funds if the taxpayer did not obtain a successful result, and costs incurred on behalf of clients were not deductible. RJ Channels, Inc. v. Commissioner, T.C. Memo. 2018-27 (3/14/18). The taxpayer, a subchapter C corporation that used the accrual method of accounting, provided return preparation and other tax services. The taxpayer received payments from two different clients. It received approximately $215,000 in its taxable year ending May 31, 2012, and $153,000 in its taxable year ending May 31, 2013. The taxpayer represented to each client that, if it were unable to obtain a favorable result for the client through its provision of tax services, it would return the payment to the client. The taxpayer deposited the payments in its bank account and was able to use the funds without restriction. The taxpayer did not return either payment to the client and did not include either payment in gross income for the years in which it had received them. During its taxable year ending May 31, 2012, the taxpayer deducted certain costs it had paid on behalf of clients. The taxpayer characterized these amounts as "Legal and Professional Fees" and as "Taxes." The clients later reimbursed the taxpayer for these costs. The IRS issued a notice of deficiency with respect to the taxpayer's 2012 and 2013 tax years in which it included in the taxpayer's gross income the payments it had received from clients and disallowed the taxpayer's deduction of the costs paid on behalf of clients. The Tax Court (Judge Chiechi) ruled in favor of the IRS on both issues. With respect to the issue whether the payments received from clients were includible in income, the court characterized the question not as *whether* the payments should be included in income, but *when* the payments should be included in income. The court cited *Schlude v. Commissioner*, 372 U.S. 128 (1963), and *Charles Schwab Corp. v. Commissioner*, 107 T.C. 282 (1996), for the proposition that

> [t]he right of a taxpayer on the accrual method of accounting to receive income is fixed upon the earliest of (1) the taxpayer's receipt of payment, (2) the contractual due date of the payment, or (3) the taxpayer's performance.

The court also referred to the claim of right doctrine, under which a taxpayer that receives funds under a claim of right must include them in gross income in the year of receipt, even though the taxpayer might not be entitled to retain the funds and might be liable to return them. *See North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932). The court characterized the taxpayer's obligation to return the payments to its clients as a condition subsequent (rather than a condition precedent). Under this view, the taxpayer did not have a current obligation to return the funds, and under *Schlude* and *Charles Schwab*, was required to include them in gross income in the year of receipt. With respect to the issue whether the taxpayer could deduct amounts it had paid on behalf of clients, the court cited relied on *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943), as well as other authorities, for the proposition that amounts a taxpayer pays for the obligations of another taxpayer are not ordinary and necessary expenses within the meaning of § 162(a).

- With respect to the issue whether the taxpayer had to include the payments from clients in its gross income, the court rejected the taxpayer's reliance on *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990), as "inapposite." In *Indianapolis Power*, the Court held that amounts a utility company had received from customers were deposits, rather than advance payments, and therefore were not included in the taxpayer's income. The Court in *Indianapolis Power* emphasized that the utility had an obligation to return the amounts it had received, and that the timing and amount of any refund were within the customer's control. The Tax Court characterized *Indianapolis Power* as inapposite because it addressed the question *whether* the amounts received by the taxpayer constituted income, rather than *when* the amounts received constituted income.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

E. Depreciation & Amortization

F. Credits

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

I. At-Risk and Passive Activity Losses

1. California taxpayer with "trashy" tenants qualifies as real estate professional, but another with a bogus calendar that conflicted with bank statements does not. Franco v. Commissioner, T.C. Summary Op. 2018-9 (03/06/18); and Pourmirzaie v. Commissioner, T.C. Memo 2018-26 (03/08/18). These two recent cases issued just days apart somewhat humorously demonstrate what it takes to avoid the passive loss rules by establishing real estate professional status under § 469(c)(7). Rental activity is per se passive under § 469(c)(2); however, pursuant to § 469(c)(7), certain taxpayers may qualify for the so-called "real estate professional" exception to the passive loss rules. A taxpayer qualifies as a real estate professional if the taxpayer adequately establishes that (i) more than half of the personal services the taxpayer performed in trades or businesses during the year were performed in real property trades or businesses, and (ii) the taxpayer performed more than 750 hours of services in real property trades or businesses in which the taxpayer materially participateed during the year. Contemporaneous daily time reports, logs, or similar documents are the best way to prove hours worked and material participation, but Reg. § 1.469-5T(f)(4) also provides that hours worked and material participation may be established by any "reasonable means." In *Franco v. Commissioner*, Special Trial Judge Guy ruled that a California taxpayer who testified that his tenants "were not attentive to trash disposal matters" and that he therefore had made weekly trips to his rental properties to ensure that "trash bins were set out for collection" and who could produce an activity log, numerous emails, and home improvement store receipts relating to his rental properties qualified under § 469(c)(7). On the other hand, in *Pourmirzaie v. Commissioner*, a California couple who attempted to establish material participation through testimony and by producing a calendar that was reconstructed from memory during the course of the audit did not qualify as a real estate professional. Although the couple's testimony and reconstructed calendar in *Pourmirzaie* would have established material participation, the IRS pointed the Tax Court to the couple's bank statements. The bank statements showed purchases in London, Dallas, Philadelphia, Boca Raton, and New York on the same dates that the couple's reconstructed calendar showed work at their rental properties. Judge Halpern held the couple did not qualify for the § 469(c)(7) exception because "[s]imply stated, we do not believe" their testimony or the reconstructed calendar.

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. Taxpayer restores money-pit mansion to its former glory, but due to taxpayer's failure to rent or hold out for rental, gets "hammered" by capital loss. Keefe v. Commissioner, T.C. Memo 2018-28 (03/15/18). These married taxpayers, neither of whom was an architect or contractor, acquired and restored Wrentham House, a historic mansion in Newport, Rhode Island. From May of 2000 until May of 2008 the taxpayers spent approximately $10 million repairing and restoring the mansion with the ultimate goal of turning it into a luxury vacation rental property. Notwithstanding taxpayers' $10 million investment in the mansion, structural and other problems prevented the property from being marketable as a rental property until June of 2008. At that time, of course, the "Great Recession" was in full swing, and there was virtually no market and no prospect for luxury rentals. Consequently, the mansion was never rented or even seriously marketed for rental, and in August of 2009, the mansion was sold in a short sale for approximately $6 million. The taxpyer's claimed that the mansion was § 1231 property used in a trade or business thereby entitling them to ordinary loss treatment. The IRS contended that the mansion was not used in a trade or business but instead was a capital asset, so the loss on the short sale was a capital loss subject to the $3,000 per year limitation of § 1211(b). The Tax Court (Chief Judge Marvel) held for the IRS. Citing *Gilford v. Commissioner*, 201 F2d 735 (2d Cir. 1953) because the case would be appealable to the Second Circuit Court of Appeals, Judge Marvel explained that the taxpayers failed to show that their alleged rental activities were "sufficient, continous, and substantial enough to constitute a trade or business with respect to rental of the property." Accordingly, § 1231 did not apply to the mansion, so the mansion was a capital asset subject to the capital loss limitation of § 1211(b). The court also upheld the IRS's imposition of accuracy-related penalties.

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

1. Say it isn't so! Miscellaneous itemized deductions are no longer deductible beginning in 2018. The 2017 Tax Cuts and Jobs Act, § 11045, amended Code § 67 by adding § 67(g), which disallows as deductions all miscellaneous itemized deductions for taxable years beginning after 2017 and before 2026. Miscellaneous itemized deductions are defined in § 67(b) and, prior to the Tax Cuts and Jobs Act, were deductible to the extent that, in the aggregate, they exceeded 2 percent of the taxpayer's adjusted gross income. The largest categories of miscellaneous itemized deductions are: (1) investment-related expenses such as fees paid for investment advice or for a safe deposit box used to store investment-related items, (2) unreimbursed employee business expenses, and (3) tax preparation fees.

a. But estates and non-grantor trusts can breathe a sigh of relief. Notice 2018-61, 2018-31 I.R.B. 278 (07/13/18). Under § 67(e), the adjusted gross income of an estate or trust generally is computed in the same manner as that of an individual. Furthermore, prior to the Tax Cut and Jobs Act, estates and non-grantor trusts were subject to the 2 percent floor on miscellaneous itemized deductions like individuals *unless* a cost paid or incurred by the estate or non-grantor trust "would not have been incurred if the property were not held in such estate or trust." Put differently, estates and non-grantor trusts avoided the 2 percent floor on miscellaneous itemized deductions if they paid or incurred a cost that "commonly or customarily" would not have been paid or incurred by a hypothetical individual holding the same property as the estate or non-grantor trust. For example, Reg. § 1.67-4(b)(3) provides as follows:

> Tax preparation fees. Costs relating to all estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax returns are not subject to the 2-percent floor. The costs of preparing all other tax returns (for example, gift tax returns) are costs commonly and customarily incurred by individuals and thus are subject to the 2-percent floor.

If a fee (such as a tax preparation fee) paid or incurred by an estate or non-grantor trust was bundled so that it included costs that were both subject to the 2 percent floor (e.g., gift tax return) and not subject to the 2 percent floor (e.g., fiduciary income tax return), then the estate or non-grantor trust must allocate the bundled fee appropriately.

The enactment of new § 67(g), which states that "no miscellaneous itemized deduction" is allowed until 2026, left many estates and trusts wondering whether their investment-related and tax-related expenses (e.g., return preparation fees, trustee fees, financial advisor fees, etc.) peculiar to the administration of an estate or trust remain deductible either in whole or in part. Notice 2018-61 announces that Treasury and the IRS do not read new § 67(g) to disallow all investment- and tax-related expenses of estates and non-grantor trusts. Thus, the Treasury Department and the IRS intend to issue regulations clarifying that estates and non-grantor trusts may continue to deduct investment- and tax-related expenses just as they could prior to the enactment of new § 67(g). Notice 2018-61 also announces that Treasury and the IRS are aware of concerns surrounding whether new § 67(g) impacts a beneficiary's ability to deduct investment- and tax-related expenses pursuant to § 642(h) (unused loss carryovers and excess deductions) upon termination of an estate or non-grantor trust. Treasury and the IRS intend to issue regulations addressing these concerns as well.

D. Section 121

E. Section 1031

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

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

D. Deductions and Credits for Personal Expenses

E. Divorce Tax Issues

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

A. Rates

1. Back to the future: Remember the good ole days before 1986 when C corporations were tax shelters? By introducing a flat corporate tax rate of 21 percent, Congress has given new life to C corporations and will force us to relearn personal holding company, accumulated earnings tax, and other anti-abuse rules (e.g., § 269A) we've long ignored. The centerpiece of the 2017 Tax Cuts and Jobs Act is a permanent reduction in corporate tax rates effective for taxable years beginning after December 31, 2017. Section 13001 of the legislation amended § 11(b) to impose tax on taxable income of corporations, including personal service corporations, at a flat rate of 21 percent. Prior to this amendment, § 11(b) provided graduated rates with a top rate of 35 percent (which top rate applied to the first dollar of personal service corporation income). For personal service corporations and companies with significant profit from U.S. operations, the reduction in the corporate rate is a huge benefit. In fact, this rate reduction is estimated to reduce corporate income taxes by roughly $1.3 trillion over the next ten years. Prior to this change, most businesses avoided C corporation status unless they were (or planned to be) publicly traded, were so-called "blocker" corporations, or, in some cases, were taken private by investment funds. Venture capital backed companies also tended to choose C corporation status to simplify their capital structure and tax compliance obligations. Now, however, C corporation status may be a sensible choice for some personal service and other closely-held corporations, especially if the business will be held for the life of the major shareholders (thereby benefiting from the step-up in basis at death) or the shareholders will exit via a stock sale at some indeterminate time in the future. No doubt, the accumulated earnings tax (§§ 535-537) and the IRS's power to reallocate income between a shareholder and his or her personal service corporation (§ 269) will come into play to deter such strategies, but a 21 percent rate as compared to a 37 percent rate is tempting. Nevertheless, despite the reduced rate, subchapter C is still a double-tax regime. In particular, asset sales (or deemed asset sales at liquidation) by C corporations will continue to suffer a big tax bite notwithstanding the reduced corporate rate. Furthermore, new § 199A must be considered for any flow-through entities. *Bottom line:* Although the authors believe that flow-through status remains the best option in most situations, the choice-of-entity analysis just got more complicated and will require even more crystal-ball gazing.

a. Although we will have to relearn some old C corporation anti-abuse provisions, here's something we can forget: the corporate AMT. The 2017 Tax Cuts and Jobs Act, § 12001, repealed the corporate alternative minimum tax (by amending Code § 55) effective for taxable years beginning after 2017. Corporations that incurred AMT in past years will want to be sure to claim that amount as a credit against regular tax going forward. A special rule regarding the refundable portion of the AMT credit is designed to allow a corporation to use fully in 2018 through 2021 any AMT credits carried forward. Also, corporations that have had other credits (e.g, the R&D credit) limited in past years by the AMT may be able to claim those credits going forward.

b. Although we will have to relearn some old C corporation anti-abuse provisions, here's something we can forget: the corporate AMT. The 2017 Tax Cuts and Jobs Act, § 12001, repealed the corporate alternative minimum tax (by amending Code § 55) effective for taxable years beginning after 2017. Corporations that incurred AMT in past years will want to be sure to claim that amount as a credit against regular tax going forward. A special rule regarding the refundable portion of the AMT credit is designed to allow a corporation to use fully in 2018 through 2021 any AMT credits carried forward. Also, corporations that have had other credits (e.g, the R&D credit) limited in past years by the AMT may be able to claim those credits going forward.

c. But wait! Nothing about federal income taxation is ever simple, right? Notice 2018-38, 2018-18 I.R.B. 522 (04/16/18). The IRS has provided guidance to non-calendar taxable year C corporations with regard to the 2017 Tax Cuts and Jobs Act's reduction in the corporate rate and repeal of the AMT effective as of December 31, 2017. Essentially, in the case of a C corporation with a fiscal taxable year that includes (but does not start with) January 1, 2018, § 15 mandates that a blended rate apply for purposes of calculating regular income tax and the AMT for such fiscal taxable year. Notice 2018-38 provides the following examplesof the application of § 15:

> Example. Corporation X, a subchapter C corporation, uses a June 30 taxable year. For its taxable year beginning July 1, 2017, and ending June 30, 2018, X's taxable income is $1,000,000, and its [alternative mimimum taxable income or "AMTI"] in excess of its AMT exemption amount is $2,000,000.
>
> Computation under § 11
>
> Corporation X's corporate tax under § 11 of the Code is computed by applying § 15(a) as follows:

1) Taxable income (Line 30, Form 1120)	$ 1,000,000
2) Tax on Line 1 amount using § 11(b) rates before the Act	340,000
3) Number of days in Corporation X's taxable year before January, 1, 2018	184
4) Multiply Line 2 by Line 3	62,560,000
5) Tax on Line 1 amount using § 11(b) rate after the Act	210,000
6) Number of days in the taxable year after December 31, 2017	181
7) Multiply Line 5 by Line 6	38,010,000
8) Divide Line 4 by total number of days in the taxable year	171,397
9) Divide Line 7 by total number of days in the taxable year	104,137
10) Sum of Line 8 and Line 9	$ 275,534

> Under § 15(a), Corporation X's corporate tax for its taxable year ending June 30, 2018 is $275,534.
>
> Computation under § 55
>
> Corporation X's [tenative minimum tax or "TMT" under § 55] and resulting AMT under § 55 of the Code is computed by applying § 15(a) as follows:

1) AMTI in excess of AMT exemption amount (Line 9, Form 4626)	$2,000,000
2) TMT on Line 1 amount using § 55(b)(1)(B) rate before the Act	400,000
3) Number of days in Corporation X's taxable year before January, 1, 2018	184
4) Multiply Line 2 by Line 3	73,600,000
5) Divide Line 4 by total number of days in the taxable year	$ 201,644

It is unnecessary to compute a TMT for the portion of the taxable year beginning on and after the effective date of § 12001 of the Act because the TMT is repealed as of the effective date for purposes of applying § 15(a). Corporation X's TMT for its taxable year ending June 30, 2018 is $201,644. Because this TMT amount for the taxable year does not exceed Corporation X's corporate tax amount of $275,534, Corporation X does not have an AMT liability for its taxable year ending June 30, 2018.

B. Entity and Formation

C. Distributions and Redemptions

D. Liquidations

E. S Corporations

F. Mergers, Acquisitions and Reorganizations

G. Corporate Divisions

H. Affiliated Corporations and Consolidated Returns

I. Miscellaneous Corporate Issues

VII. PARTNERSHIPS

A. Formation and Taxable Years

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

C. Distributions and Transactions Between the Partnership and Partners

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

1. A disregarded LLC is a pass-thru partner for purposes of the small partnership exception to the TEFRA audit rules. Seaview Trading, LLC v. Commissioner, 858 F.3d 1281 (9th Cir. 6/7/17). Seaview Trading, LLC, a Delaware limited liability company that was classified as a partnership for federal tax purposes, had two members, each of which was a single-member LLC. One of these was AGK Investments LLC, which was wholly owned by Robert Kotick, and the other was KMC Investments LLC, wholly owned by Mr. Kotick's father. The IRS audited Mr. Kotick's 2001 return and disallowed certain deductions with respect to his investment in Seaview, but did not disallow his share of a loss passed through from Seaview, which arose from Seaview's investment in a common trust fund. After the limitations period on assessment for 2001 with respect to Mr. Kotick had expired, the IRS audited Seaview and issued a Final Partnership Administrative Adjustment (FPAA) in which the IRS disallowed Seaview's loss from its trust investment. Mr. Kotick challenged the FPAA by filing a petition in the Tax Court. AGK, Mr. Kotick's wholly owned LLC, filed a separate petition. Mr. Kotick argued that the FPAA was invalid because Seaview was not subject to the TEFRA audit rules pursuant to the small partnership exception of § 6231(a)(1)(B)(i). The Tax Court (Judge Foley) dismissed Mr. Kotick's petition on the grounds that (1) Seaview did not fall within the § 6231(a)(1)(B)(i) small partnership exception to the TEFRA audit rules, and (2) AGK, rather than Mr. Kotick, was the TMP of Seaview and therefore the court lacked jurisdiction to consider the petition filed by Mr. Kotick. In an opinion by Judge Smith, the U.S. Court of Appeals for the Ninth Circuit affirmed. Absent a contrary election by the partnership, the § 6231(a)(1)(B)(i) small partnership exception excludes from the TEFRA audit rules "any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner." However, pursuant to Reg. § 301.6231(a)(1)-1(a)(2), the small partnership exception does not apply "if any partner in the partnership during the taxable year is a pass-thru partner" as defined in § 6231(a)(9). Section 6231(a)(9) defines a pass-thu partner as "a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership …." The court acknowledged that the two single-member LLCs, AGK and KMC, were disregarded for federal tax purposes pursuant to the check-the-box regulations. Nevertheless, the court held, these LLCs were pass-thru partners. In reaching this conclusion, the court gave *Skidmore* deference to Rev. Rul. 2004-88, 2004-2 C.B. 165. *See Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). In Rev. Rul. 2004-88, the IRS ruled that, because a disregarded LLC held legal title to a partnership interest it was "a similar person through whom other persons hold an interest in the partnership" and therefore a pass-thru partner. The court also held that Mr. Kotick lacked standing to file a Tax Court petition on behalf of Seaview because he was not Seaview's TMP. Seaview had failed to designate a TMP for 2001, and therefore AGK, as the holder of the largest profits interest, was the TMP pursuant to § 6231(a)(7)(B). Accordingly, the court upheld the Tax Court's dismissal of Mr. Kotick's petition for lack of jurisdiction.

a. ♪♫They call me mellow yellow.♫♪ Well, actually, the D.C. Circuit calls it a TEFRA partnership. Mellow Partners v. Commissioner, 890 F.3d 1070 (D.C. Cir. 5/22/18). In an opinion by Judge Edwards, the U.S. Court of Appeals for the District of Columbia Circuit held that a partnership with two partners, each of which was a single-member LLC, was a TEFRA partnership that was subject to the TEFRA audit regime. The issue in the case was the same one presented in *Seaview Trading, LLC v. Commissioner*, 858 F.3d 1281 (9th Cir. 6/7/17), i.e., whether a partnerhip with a disregarded entity as a partner qualifies for the § 6231(a)(1)(B)(i) small partnership exception, which excludes from the TEFRA audit rules "any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner." Pursuant to Reg. § 301.6231(a)(1)-1(a)(2), the small partnership exception does not apply "if any partner in the partnership during the taxable year is a pass-thru partner" as defined in § 6231(a)(9). Section 6231(a)(9) defines a pass-thu partner as "a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership …." Like the Ninth Circuit in *Seaview Trading*, the D.C. Circuit held that a single-member LLC that is a disregarded entity is a pass-thru partner as defined in § 6231(a)(9). Therefore, the partnership did not qualify for the small partnership exception and was subject to the TEFRA audit rules. The court also rejected the taxpayer's challenge to the accuracy-related penalties that had been upheld by the Tax Court. The taxpayer challenged the penalties on the ground that the IRS had not obtained the written supervisory approval of the penalties as required by § 6751(b)(1). *See Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 3/20/17). The court declined to consider this argument because the taxpayer had failed to raise it in the Tax Court and therefore had not preserved it for appeal.

G. Miscellaneous

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

D. Tax Shelter Penalties

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Successful private colleges and universities really must be in the dog house because, in addition to taxing them for highly-paid coaches, Congress has decided to tax their endowments too! And, just to keep us on our toes, the legislative history says the statute turns on the number of an institution's "tuition paying" students, but § 4968 simply reads "students." The

2017 Tax Cuts and Jobs Act, § 13701, adds § 4968 which imposes a new 1.4 percent annual excise tax upon the net investment income of certain private colleges and universities and affiliated organizations with endowments worth $500,000 or more per full-time student. The excise tax imposed by new § 4968 is similar in many respects to the annual excise tax imposed upon private foundations under § 4940. In particular, new § 4968 applies to an "applicable educational institution" which is defined as institution: (i) that is an "eligible educational institution" as described in § 25A(f)(2) (which in turn refers to 20 U.S.C. § 1088); (ii) that has at least 500 students during the preceding taxable year more than 50 percent of which are in the U.S.; (iii) that is not described in the first section of § 511(a)(2)(B) (state colleges and universities); and (iv) that has assets (other than assets used directly in carrying out the institution's exempt purpose) with an aggregate fair market value as of end of the preceding taxable year of at least $500,000 per student. For this latter purpose, the number of students of an institution is based on the daily average number of full-time students attending the institution, with part-time students taken into account on a full-time student equivalent basis. Moreover, the legislative history of new § 4968 states that the $500,000 per student figure should be calculated based upon "tuition paying" students; however, the Senate Parliamentarian struck that language from § 4968 immediately before it was passed by the House and Senate. Whether regulations can fill in the gap is anybody's guess. New § 4968 is permanent and effective for taxable years beginning after 2017, again giving fiscal-year private colleges and universities time to cope.

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

b. Then again . . . maybe not! Notice 2018-55, 2018-26 I.R.B. 773 (06/08/18). The IRS has announced that proposed regulations under new § 4968 will determine "net investment income" gains and losses of an "applicable educational institution" by reference to an endowment asset's fair market value as of December 31, 2017, not its historical adjusted basis (unless historical adjusted basis is greater than fair market value as of December 31, 2017). This special rule allowing an applicable educational institution to use the *greater of* (i) fair market value as of the end of the taxable year of enactment of the statute or (ii) historical adjusted basis for purposes of calculating net investment income is patterned after the approach taken in 1969 with respect to private foundations subject to § 4940. *See* § 4940(c)(1) (greater of adjusted basis or fair market value as of December 31, 1969). Therefore, net investment income of applicable educational institutions subject to new § 4968 should be minimal for the next year or so. Notice 2018-55 further announces that proposed regulations under new § 4968 (i) will take into account net investment losses only to the extent of net investment gains (with no allowance for capital loss carryovers or carrybacks) and (ii) will permit related organizations described in § 4968(d)(2) to consolidate gains and losses for purposes of calculating net investment income. Notice 2018-55 also invites comments by September 6, 2018, regarding the to-be-proposed regulations under new § 4968.

2. Has so-called "dark money" become virtually invisible (except to the IRS, of course)? Rev. Proc. 2018-38, 2018-31 I.R.B. ____ (07/16/18). Oversimplifying a bit for the sake of convenience, since 1969 § 6033(b)(5) has required § 501(c)(3) organizations to disclose on their annual information returns (Forms 990) certain contributions as well as "the names and addresses of [the organization's] substantial contributors" for the year. Section 507(d)(2) defines a "substantial contributor" as any person contributing $5,000 or more to an organization if such amount is greater than 2 percent of the total contributions to the organization during the taxable year. Section 1.6033-2 of the regulations extended this disclosure requirement to other types of organizations exempt under § 501(a), including § 501(c)(4) "social welfare" organizations and § 501(c)(6) "trade associations." In particular, some § 501(c)(4) social welfare organizations have been created and funded to engage in lobbying and political campaign activity that is prohibited to § 501(c)(3) organizations. This use of § 501(c)(4) organizations has been termed "dark money" by some and is controversial. Although the names and addresses of "dark money" contributors were supposed to be redacted on the organization's Form 990 made publicly available by the IRS pursuant to § 6104(b), some inadvertent disclosures have occurred. Reportedly, a few of the largest organizations impacted have been entities affiliated with the National Rifle Association, the U.S. Chamber of Commerce, and Americans for Prosperity, the latter being tied to billionaires Charles and David Koch. *See* R. Rubin, "U.S. Treasury Restricts Donor Disclosure Requirement for Some Nonprofit Groups," Wall St. J. (July 16, 2018). After Rev. Proc. 2018-38, though, substantial contributors' names and addresses are no longer required to be disclosed on a non-(c)(3) organization's annual Form 990. As stated in the revenue procedure, "The IRS does not need personally identifiable information of [such] donors to be reported . . . in order for it to carry out its responsibilities. The requirement to report such information increases compliance costs for some private parties, consumes IRS resources in connection with the redaction of such information, and poses a risk of inadvertent disclosure of information that is not open to public inspection." The reporting changes announced by Rev. Proc. 2018-38 are effective for taxable years ending on or after December 31 2018. Notwithstanding this relief from disclosure granted to § 501(a) organizations other than (c)(3)s, Rev. Proc. 2018-38 states that the affected organizations must maintain donor information in the organization's books and records in case such information is requested by the IRS.

B. Charitable Giving

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

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

> The notice of deficiency clearly informed petitioners of the determination of the 20% penalty (as an alternative) and clearly set out the computation (albeit reduced to zero,

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

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

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

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

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

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

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

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

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

c. In determining whether the § 6751(b)(1) supervisory approval requirement has been met, an IRS settlement officer need not read the mind of the supervisor; a signature is sufficient. Blackburn v. Commissioner, 150 T.C. No. 9 (4/5/18). A corporation, which apparently was the taxpayer's employer, failed to pay its employment tax liabilities and failed to file certain Forms 941, Employer's Quarterly Federal Tax Return. The IRS assessed trust fund recovery penalties against the taxpayer under § 6672. In a collection due process hearing, the IRS settlement officer determined to uphold the IRS's proposed collection of the penalty. The taxpayer sought review of the IRS's determination in the Tax Court and argued that the settlement officer had failed to comply with § 6330(c)(1), which provides:

> The appeals officer shall at the hearing obtain verification from the Secretary that the requirements of any applicable law or administrative procedure have been met.

The taxpayer argued that the settlement officer had not verified the IRS's compliance with the supervisory approval requirement of § 6751(b)(1). The IRS's evidence of supervisory approval was Form 4183, Recommendation re: Trust Fund Recovery Penalty, which was dated prior to assessment of the trust fund recovery penalty. The Form 4183, which was generated by the IRS's computer system, did not contain the supervisor's signature but showed the supervisor's name in the signature block for the supervisor. The taxpayer argued that the signature of the supervisor, by itself, was inadequate to comply with § 6751(b)(1), and that § 6330(c)(1) requires a settlement officer to verify compliance by engaging in "a factual analysis of the thought process of the supervisor" and to make "a determination that the thought process was 'meaningful.'" The IRS argued that (1) the supervisory approval requirement of § 6751(b)(1) does not apply to the § 6672 trust fund recovery penalty, and (2) even if it does apply, it was not an abuse of discretion for the settlement officer to find compliance because there was sufficient evidence of supervisory approval. The Tax Court (Judge Goeke) declined to address the legal question whether the supervisory approval requirement of § 6751(b)(1) applies to the § 6672 trust fund recovery penalty. The court held that, even if supervisory approval was required, a record of compliance existed in this case. The court reasoned that its prior decisions "have consistently upheld a settlement officer's verification of assessments when the administrative record reflects compliance with administrative procedures" and have permitted "reliance upon standard administrative records" to verify assessments. In *Davis v. Commissioner*, 115 T.C. 35 (2000), the court held in connection with a CDP hearing that it was not an abuse of discretion for the IRS to rely on Form 4340, Certificate of Assessment and Payments, to verify assessment of a tax where the taxpayer had not shown any irregularity in the assessment procedure that would raise a question. Form 4340, like the Form 4183 in this case, does not require a signature. Accordingly, the court held that it was not an abuse of discretion for the settlement officer to find that the IRS had met the requirements of applicable law and administrative procedure. The court therefore granted the IRS's motion for summary judgment.

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

F. Liens and Collections

G. Innocent Spouse

H. Miscellaneous

1. When the Tax Court reviews an IRS determination regarding a whistleblower award, the court will limit its review to the administrative record and the appropriate standard of review is for abuse of discretion. Kasper v. Commissioner, 150 T.C. No. 2 (1/9/18). The petitioner sought a whistleblower award of more than $11 million pursuant to § 7623 by informing the IRS that his former employer had failed to pay overtime wages to its employees and therefore had failed to pay FICA and FUTA taxes on the unpaid wages. The IRS determined that the petitioner's claim raised an issue for the Department of Labor rather than the IRS and denied his claim. In the employer's bankruptcy proceedings, the IRS filed a proof of claim and ultimately entered into a closing agreement with the employer pursuant to which the IRS received $37.5 million in settlement of all of the employer's tax liabilities. The petitioner asserted that the IRS made use of his information "to keep 'held open' its bankruptcy claim …." The petitioner sought review of the IRS's determination in the Tax Court pursuant to § 7623(b)(4), which provides:

> Any determination regarding an award … may, within 30 days of such determination, be appealed to the Tax Court (and the Tax Court shall have jurisdiction with respect to such matter).

In a unanimous reviewed opinion by Judge Holmes (with Judge Paris not participating in the court's consideration of the opinion), the Tax Court held that the IRS did not abuse its discretion in rejecting the petitioner's whistleblower award claim. The court first considered the appropriate *scope of review* in a whistleblower award case and held that the court will limit its review to the administrative record but will permit the record to be supplemented if one of the recognized exceptions to the record rule applies. These exceptions are summarized in *Esch v. Yeutter*, 876 F.2d 976, 991 (D.C. Cir. 1989). The court reached this conclusion regarding the scope of review after considering, among other things, the language in § 7623(b)(4) and comparing it to the language in statutes that give the court jurisdiction to review IRS other determinations, such as those in innocent spouse cases and collection due process hearings. The court next held that the appropriate *standard of review* in a whistleblower award case is for abuse of discretion. The court reasoned in part that the underlying tax liability on which the whistleblower's claim is based is never at issue when the court reviews an IRS determination regarding a whistleblower award. Therefore, the court reasoned, applying an abuse of discretion standard is consistent with the court's approach in reviewing IRS determinations in CDP hearings, for which the court applies a de novo standard if the taxpayer's underlying tax liability is at issue and an abuse of discretion standard if it is not. Finally, the court applied the doctrine of *Securities and Exchange Commission v. Chenery Corp.*, 332 U.S. 194 (1947), 318 U.S. 80 (1943), which it described as "an administrative-law principle that says 'a reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency.'" In this case, the court held, the IRS's letter denying the petitioner's claim was "a completely inadequate explanation—it has no reasoning specific to Kasper's claim, recites only boilerplate, and then states a conclusion." The court further held that, although it would not consider post hoc rationalizations for an agency's action, it could consider contemporaneous explanations by the agency for its decision. In this case, the records of the IRS Whistleblower Office reflected the reason for the IRS's denial of an award, i.e., that the petitioner's claim raised an issue for the Department of Labor rather than the IRS. Although the court viewed as an error the IRS's failure to consider certain evidence in considering the petitioner's claim, "the error was harmless because the rest of the record shows that the IRS did not proceed with any action resulting in the collection of proceeds using [the petitioner's] information."

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. In this employment tax refund case concerning non-qualified stock options, Judge Posner tells railroads to take a hike, but Judge Manion dissents because "money remuneration" and "stock" were different in 1934; however, both apparently agree that "wampum" and "sheep" can be money (and no, we are not making this up)! Wisconsin Central Ltd. v. United States, 856 F.3d 490 (7th Cir. 5/8/17). Beginning in 1996, the taxpayer railroad companies began including non-qualified stock options in the compensation plans for their employees. The taxpayers previously had withheld and paid employment taxes (under the Railroad Retirement Tax Act, § 3231) when employees exercised non-qualified stock options, but subsequently the taxpayers filed claims for refunds with the IRS, which were denied. The United States District Court for the Northern District of Illinois (Judge Feinerman) also denied the taxpayers' refund claim, and the taxpayers appealed to the Seventh Circuit. The taxpayers argued that stock options are not "compensation" because they are not "money remuneration" within the meaning of § 3231. Section 3231(e)(1) defines taxable compensation as "any form of money remuneration paid to an individual for services rendered as an employee to one or more employers." Based upon this language, Judge Posner, writing for the majority, explained that even though the term "money remuneration" may not have commonly been understood to include stock when the Railroad Retirement Tax Act was passed in 1937, today stock and stock options are well-accepted forms of compensation and hence taxable under § 3231. Judge Posner wrote, "The dictionary definition of money may remain constant while the instruments that comprise it change over time: sheep may have once been a form of money; now stock is." In short, Judge Posner interprets the term "money remuneration" in § 3231 to be an evolving concept that changes with the times. Judge Manion, however, dissented, arguing that the 1934 edition of Webster's Dictionary defined money as "[a]nything customarily used as a medium of exchange and measure of value, as sheep, wampum, copper rings, quills of salt or of gold dust, shovel blades, etc." Thus, in Judge Manion's view, non-qualified stock options are not "money remuneration" and hence not subject to tax under § 3231. *We presume, somewhat sarcastically, that Judge Posner and Judge Manion would agree that "wampum" and "sheep" were taxable in 1937 under § 3231 and would be taxable today as well, although according to their opinions the law is unsettled on this point.*

a. The U.S. Supreme Court has reversd the Seventh Circuit and held that non-qualified stock options are not "money remuneration" and therefore are not taxable compensation for purposes of the Railroad Retirement Tax Act. Wisconsin Central Ltd. v. United States, ___ U.S. ___, 138 S. Ct. 2067 (6/21/18). In an opinion by Justice Gorsuch (joined by Justices Roberts, Kennedy, Thomas, and Alito), the U.S. Supreme Court reversed the decision of the Seventh Circuit and held that non-qualified stock options are not "compensation" within the meaning of § 3221 and therefore are not subject to taxation under the Railroad Retirement Tax Act. The Court focused on the definition of the term "compensation" in § 3231(e)(1), which defines compensation as "any form of money remuneration paid to an individual for services rendered as an employee to one or more employers." The Court looked for guidance to several dictionary definitions of the term "money" that existed contemporaneously with Congress's 1937 enactment of the Railroad Returement Tax Act. These definitions generally defined money as currency isued by a recognized authority and used as a medium of exchange. Stock options, the court reasoned,

> do not fall within that definition. While stock can be bought or sold for money, few of us buy groceries or pay rent or value goods and services in terms of stock. When was the last time you heard a friend say his new car cost "2,450 shares of Microsoft"? Good luck, too, trying to convince the IRS to treat your stock options as a medium of exchange at tax time.

The Court also noted the difference in the language used in the Railroad Retirement Tax Act and in the Federal Insurance Contributions Act (FICA), both of which were enacted by the same Congress. The Railroad Retirement Tax Act taxes "money remuneration." In contrast, FICA taxes "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash." According to the Court, "[t]he Congress that enacted both of these pension schemes knew well the difference between 'money' and 'all' forms of remuneration." The Court declined to give *Chevron* deference to Reg. § 31.3231(e)-1, which provides, "except as specifically limited by the Railroad Retirement Tax Act," that the term "compensation" in the Railroad Retirement Tax Act has the same meaning as the term "wages" in FICA. The statutory definition of "compensation," the Court held, is clear and leaves no room for agency interpretation.

- Justice Breyer, joined by Justices Ginsburg, Sotomayor, and Kagan, dissented. Justice Breyer characterized the railroads as "engaging in (and winning) a war of 1930's dictionaries." In Justice Breyer's view, the statutory definition of "money remuneration" is ambiguous, and therefore the Court should have deferred to the Treasury Department's interpretation of the statute. The Treasury Department, Justice Breyer argued, has consistently interpreted the term "money remuneration" in a manner that supports treating stock options as a form of money remuneration.

- The authors cannot help but wonder: *How would the U.S. Supreme Court treat a payment in Bitcoin?*

B. Self-employment Taxes

C. Excise Taxes

XII. TAX LEGISLATION

A. Enacted

XIII. TRUSTS, ESTATES & GIFTS

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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I. ACCOUNTING

A. Accounting Methods

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

II. BUSINESS INCOME AND DEDUCTIONS

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. Pyrrhotite cracking the foundation of your house? IRS to the rescue! Rev. Proc. 2017-60, 2017-50 I.R.B. 559 (11/23/17). Pyrrhotite is a naturally occurring mineral in stone aggregate used to produce concrete. Pyrrhotite oxidizes in the presence of water and oxygen, leading to expansion that cracks and deteriorates concrete foundations prematurely. As discovered and reported by the Connecticut Department of Consumer Protection, some homeowners in New England have suffered premature deterioration in their concrete foundations due to pyrrhotite. This had led taxpayers to inquire of the IRS whether the damage to their concrete foundations caused by pyrrhotite may be claimed as a personal casualty loss under § 165. Normally, a § 165 casualty loss is limited to an identifiable event that is sudden, unexpected, or unusual and that causes damage to property. The amount of a taxpayer's casualty loss ordinarily is the decrease in the fair market value of the property (less any insurance reimbursement) as a result of the casualty, not to exceed the taxpayer's adjusted basis in the damaged property. On the other hand, damage or loss resulting from progressive deterioration of property through a steadily operating cause generally is not considered a casualty loss within the meaning of § 165. *Matheson v. Commissioner*, 54 F.2d 537 (2d Cir. 1931). If a § 165 casualty loss is sustained for personal use property, a deduction is allowable only for (i) the amount of the loss that exceeds $100 per casualty and (ii) the net amount of all of the taxpayer's personal casualty losses (in excess of personal casualty gains, if any) that exceeds 10 percent of the taxpayer's adjusted gross income for the year. In Rev. Proc. 2017-60, the IRS concludes that damage to concrete foundations caused by pyrrhotite may qualify as a § 165 casualty loss if the loss is determined and reported in compliance with the guidance provided by the revenue procedure. Specifically, the revenue procedure creates a safe harbor under which a taxpayer who pays to repair damage to the taxpayer's personal residence caused by pyrrhotite may treat the amount paid as a casualty loss in the year of payment. To qualify for the safe harbor, an affected taxpayer must obtain either (1) a written evaluation from a licensed engineer indicating that the foundation was made with defective concrete and obtain a reassessment report that shows the reduced value of the property based on the written evaluation from the engineer and an inspection pursuant to Connecticut Public Act No. 16-45, or (2) a written evaluation from a licensed engineer indicating that the foundation was made with defective concrete containing the mineral pyrrhotite. The amount of the casualty loss is the amount paid by the taxpayer to repair the damage (limited by the taxpayer's basis in the property and reduced by any insurance proceeds received for the damage). The revenue procedure also specifies other guidelines for claiming a pyrrhotite casualty loss, including reporting the loss on IRS Form 4684 with "Revenue Procedure 2017-60" typed at the top of the form. The revenue procedure is effective for federal income tax returns (including amended returns) filed after November 21, 2017.

a. Thanks again to the IRS, you have until October 15, 2018, to address those pesky pyrrhotite problems. Rev. Proc. 2018-14, 2018-9 I.R.B. 378 (2/7/18). As noted above, Rev. Proc. 2017-60 allowed qualifying taxpayers to claim a casualty loss attributable to pyrrhotite damage in the year the taxpayer paid to repair the damage. For taxable years beginning after 2017 and before 2026, however, new Code § 165(h)(5) (added by § 11044 of the 2017 Tax Cuts and Jobs Act) eliminates the deduction for personal casualty losses (other than those attributable to a federally declared disaster). As a result, the victims of pyrrhotite damage, who otherwise were granted relief under Rev. Proc. 2017-60 above, are denied relief unless they made repair payments before January 1, 2018. This revenue procedure mercifully amends Rev. Proc. 2017-60 to extend the time for taxpayers to pay for pyrrhotite damage and claim a casualty loss deduction on their 2017 or earlier tax returns. Essentially, taxpayers may pay for pyrrhotite damage (as long as the offending concrete was poured before January 1, 2018) up until October 15, 2018, and if they otherwise qualify for relief under pre-TCJA § 165 and Rev. Proc. 2017-60, they may claim a casualty loss deduction for the payment on their original or amended tax return for 2017. Specifically, the revenue procedure provides:

> If a taxpayer pays to repair damage to that taxpayer's personal residence caused by a deteriorating concrete foundation during the taxpayer's 2016 taxable year or earlier, the taxpayer may treat the amount paid as a casualty loss on a timely Amended U.S. Individual Income Tax Return (Form 1040X) for the taxable year of payment. If a taxpayer pays to repair the damage during the taxpayer's 2017 taxable year or prior to a timely filed (including extensions) original U.S. Individual Income Tax Return (Form 1040, 1040A or 1040EZ) for the 2017 taxable year, the taxpayer may treat the amount paid as a casualty loss on the taxpayer's original 2017 income tax return (or a timely filed Form 1040X for the 2017 taxable year). If a taxpayer pays to repair the damage after filing an original 2017 income tax return and prior to the last day for filing a timely Form 1040X for the 2017 taxable year, the taxpayer may treat the amount paid as a casualty loss on a timely filed Form 1040X for the 2017 taxable year. For purposes of this revenue procedure, the term "deteriorating concrete foundation" means a concrete foundation that is damaged as a result of the presence of the mineral pyrrhotite in the concrete mixture used before January 1, 2018, in pouring the foundation.

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

D. Section 121

E. Section 1031

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

1. What's $19 million among friends? A taxpayer who received funds to invest but who used them for personal purposes had gross income. Sun v. Commissioner, 880 F.3d 173 (5th Cir. 1/18/18), *aff'g* T.C. Memo. 2015-56 (3/24/15). The taxpayer controlled and served as Chief Executive Officer of a corporation whose primary business was importing and distributing minerals. He also devoted a significant amount of time to investment activities, both through an LLC that he controlled and through his personal online brokerage account. The taxpayer and his business acquaintance and friend, a Chinese citizen and resident of Hong Kong, orally agreed that the taxpayer would invest his friend's funds. Over a period of two years, the friend sent $19 million to be invested. Of this amount, approximately $15 million was sent to the corporation the taxpayer controlled, where it was held in an officer loan account solely for the taxpayer's benefit. The corporation treated the balance in the account as funds the taxpayer had loaned to the corporation that eventually would be repaid to him. The remaining $4 million was sent either to the taxpayer's personal brokerage account or to the LLC through which he conducted investment activities. Although the taxpayer did invest these latter funds, they were commingled with the taxpayer's own funds and the taxpayer did not maintain a separate accounting of their performance. The taxpayer used several million of the funds in the officer loan account for personal purposes, including the purchase of a Mercedes Benz automobile and for gambling. The taxpayer informed his friend that he had lost approximately $2 million of the friend's funds through gambling. In notices of deficiency issued both to the corporation and to the taxpayer, the IRS asserted the following alternative theories: (1) the corporation must include in gross income the amounts received from the taxpayer's friend and must be treated as making dividend distributions to the taxpayer that resulted in gross income for the taxpayer, and the taxpayer also must include in gross income all fund he received directly from his friend, or (2) the corporation acted merely as a conduit and the taxpayer must include in gross income all amounts received by him and by the corporation. The taxpayer argued that none of the amounts received from his friend were included in the corporation's or his gross income because they were either loans or funds entrusted to the taxpayer for investment. The Tax Court (Judge Paris) held that the funds in question were neither gifts nor loans but were amounts entrusted to the taxpayer for investment; nevertheless, the Tax Court held that the taxpayer had to include in gross income all of the amounts sent by the taxpayer's friend because the taxpayer had misappropriated them. In an opinion by Judge Costa, the U.S. Court of Appeals for the Fifth Circuit affirmed the Tax Court's decision. The court acknowledged that, although the nature of the oral agreement between the taxpayer and his friend was not entirely clear, his friend expected to receive back some funds at some point. Nevertheless, the court relied on *James v. United States*, 366 U.S. 213 (1961), for the proposition that misappropriated funds are included in gross income:

> An obligation to "return some money at some point" is not, however, inconsistent with misappropriation. … For all but the riskiest of investments, an investor with a diversified portfolio expects to get some money back even if the investments do not turn out well. But that does not mean the recipient of the funds is allowed to make personal use of the money. And when the holder of the funds uses the money to enrich

> himself, he has received "economic value," which is the defining characteristic of income. …
>
> A vague understanding that some money will be returned at some undefined time is not the mutual recognition of an agreement to repay in full that *James* contemplates.

The court also affirmed the Tax Court's imposition of the 20 percent accuracy-related penalty of § 6662(a) and (b)(1) for negligence or disregard of rules or regulations in omitting the income in question.

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

A. Rates

B. Entity and Formation

C. Distributions and Redemptions

D. Liquidations

E. S Corporations

F. Mergers, Acquisitions and Reorganizations

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

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

G. Corporate Divisions

H. Affiliated Corporations and Consolidated Returns

I. Miscellaneous Corporate Issues

1. "Lucy, you got some 'splainin' to do" about taxable versus nontaxable contributions to capital. The 2017 Tax Cuts and Jobs Act, § 13312, amended Code § 118 to limit the exclusion for nonshareholder contributions to capital. Pursuant to new § 118(b)(2), nonshareholder contributions to capital made by "any governmental entity or civic group (other than a contribution made by a shareholder as such)" after December 22, 2017, no longer are excludable from the recipient corporation's gross income. Such nontaxable contributions have been made in the past by governmental entities and civic groups to incentivize acquisition and redevelopment projects considered important to those entities and groups. As a nod to these past arrangements, a transition rule grandfathers certain capital contributions made under master development plans approved by governmental entities on or before December 22, 2017. *See* TCJA § 13312(b)(2). Amended § 118 also provides Treasury with regulatory authority to interpret and implement the new rules. *See* § 118(c). The foregoing seems plain enough, but there's more to the story.

Convoluted legislative history. Notably, the House's version of the 2017 TCJA simply repealed § 118, but as mentioned above the conferees decided instead to amend § 118 merely to eliminate any exclusion from gross income for nonshareholder contributions to capital by governmental entities or civic groups. The Conference Report accompanying the amendment to § 118 clarifies that a municipal tax abatement for locating a business in a particular municipality is not considered a taxable contribution to capital. Moreover, the Conference Report states that the amendments to § 118 do not change the application of the meaningless gesture doctrine, described in *Lessinger v. Commissioner*, 872 F.2d 519 (2d. Cir. 1989) and related cases, as well as in prior administrative guidance. Thus, incremental shares of stock are not required to be issued by a corporation under § 351 to avoid gross income when existing shareholders of a corporation (including governmental entity or civic group shareholders) make pro-rata contributions to capital. Finally, in a curious reference to which we refer later in this outline in connection with recent partnership capital contribution cases, the Conference Report states "[t]he conferees intend that section 118, as modified, continue to apply only to corporations;" however, the Conference Report also states in part that "[t]he conference agreement follows the policy of the House bill" which, as noted above, repealed § 118. This nuance is important because the legislative history of the House bill stated in connection with the proposed repeal of § 118 that "a contribution of municipal land by a municipality that is not in exchange for stock (*or for a partnership interest or other interest*) of equivalent value is considered a contribution to capital that is includable in gross income." (Emphasis added.)

Some deeper background. Prior to the 2017 TCJA, the gross income of a corporation generally did not include contributions to capital made by nonshareholders. Section 118(a) continues to provide a general rule of excludability for nonshareholder contributions to capital, and thus the pre-TCJA version of § 118(a) remains intact. As summarized above, however, TCJA added a new limitation to the general rule of § 118(a). Specifically, §118(b)(2) carves out from the general rule of exclusion any nonshareholder contributions to capital made by governmental entities or civic groups. Other limitations on the exclusion existed and continue to exist under § 118 for certain capital contributions "in aid of construction" (as defined, but carving out contributions made by regulated water or sewage utilities) or "as a customer or potential customer." *See* § 118(b)(1). Notwithstanding the foregoing, the pre-TCJA version of § 118 ordinarily allowed a corporation to exclude from gross income nonshareholder contributions to capital made by governmental entities or civic groups for the purpose of inducing the corporation to acquire or construct property within a desired locale. *See, e.g.*, *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950). If property other than money was acquired by a corporation as a nontaxable contribution to capital, then the adjusted basis of the property was zero. If the contribution consisted of money, then the corporation had to reduce the basis of any property acquired with the contributed money within the following 12-month period, and then reduce the basis of other property held by the corporation. *See* § 362(c)(1) & (2); Reg. § 1.362–2. These rules regarding basis reductions remain unaffected for any nonshareholder contributions to capital that somehow remain excludable from gross income under amended § 118.

What about noncorporate entities? Section 118 expressly did not and still does not apply to noncorporate entities such as partnerships and LLCs taxed as partnerships. The IRS previously has taken the position that there is no exclusion from gross income for contributions to the capital of noncorporate entities made by a nonowner. Nevertheless, the IRS acknowledges that taxpayers have taken contrary positions under a "common law contribution to capital doctrine." *See generally* LMSB Coordinated Issue Paper LMSB4-1008-051, Exclusion of Income: Non-Corporate Entities and Contributions to Capital (Nov. 18, 2008). For those taxpayers, the convoluted language in the Conference Report perhaps should lead to the conclusion that those common law "groundrules" (*pun intended*) have changed, at least with respect to governmental entity and civic group capital contributions. In fact, considering two recent cases discussed later in this outline regarding LLCs taxed as partnerships, current trends suggest that contributions to the capital of noncorporate entities are not excludable from gross income notwithstanding any "common law contribution to capital doctrine."

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

1. Nonowner contributions to the capital of partnerships and LLCs taxed as partnerships are not excludable, and the common law contribution to capital doctrine is on life support if not dead. The 2017 TCJA amended Code § 118 effective after December 22, 2017, such that nonshareholder contributions to the capital of corporations made by governmental entities or civic groups no longer are excludable from the recipient corporation's gross income. Previously, such capital contributions were nontaxable, and they occasionally were made to incentivize corporations either to locate in particular communities or to acquire or redevelop distressed property in a community (or do both). In addition, the Conference Report accompanying the changes to § 118, along with the cases summarized below, probably leads to the conclusion that similarly-motivated capital contributions to noncorporate entities (i.e., partnerships and LLCs taxed as partnerships) no longer are excludable from gross income (if they ever were), even though such contributions are outside the purview of either old or amended § 118.

a. No good deed goes unpunished. Ginsburg v. United States, 136 Fed. Cl. 1 (1/31/18). In this decision, the Court of Federal Claims held that the State of New York's payment of approximately $1.8 million to an LLC (taxed as a partnership) to incentivize and reward redevelopment of brownfield property is includable in the taxpayer-member's gross income. The taxpayer owned 90%

of an LLC taxed as a partnership for federal income tax purposes. The taxpayer's LLC participated in New York's Brownfield Development Tax Credit program in connection with acquiring an abandoned shoe factory in 2004 and eventually restoring it as a 134-unit residential building by 2011. New York's Brownfield Tax Credit program allows certain credits against state income taxes based upon investment in qualifying brownfield propery. Further, if the credit is fully used by a taxpayer to offset applicable New York state income taxes, the excess of the credit over the amount used against state income taxes is paid to the taxpayer. Accordingly, after certifying that the taxpayer's LLC had complied with the terms of the Brownfield Development Tax Credit program, in 2013 New York paid the taxpayer's LLC approximately $1.8 million in satisfaction of the taxpayer's excess credit amount. The taxpayer took the position on his 2013 federal income tax return that his 90% allocable share of the $1.8 million payment was excludable from gross income as a nontaxable capital contribution to the LLC. (New York law allowed exclusion of the payment for New York income tax purposes.) Upon audit, the IRS determined that the payment constituted gross income to the LLC and thus to the taxpayer as part of his allocable share of partnership income. This adjustment resulted in additional gross income to the taxpayer for 2013 and a corresonding underpayment of approximately $602,000. The taxpayer paid the underpayment, filed a refund claim, and then brought this action in the Court of Federal Claims.

Analysis: Upon cross motions for summary judgment, Court of Federal Claims (Judge Hodges) agreed with the government that the $1.8 million constituted gross income to the taxpayer's LLC and thereby to the taxpayer. The government had argued, and the court agreed, that the payment was includable by the broad terms of § 61(a) (gross income from whatever source derived) and that no statutory exclusions or exceptions applied. The taxpayer argued unsuccessfully that the $1.8 million payment was (i) a nontaxable contribution to the LLC's capital, (ii) a nontaxable recovery of the LLC's investment in the Brownfield project owned by the LLC, or (iii) a nontaxable state "general-welfare" grant to the LLC. The taxpayer acknowledged that under any of the above theories the taxpayer's basis in the brownfield project would be adjusted downward by the amount excludable. Judge Hodges reasoned that, because the taxpayer could not point to an express provision of the Code to support his nontaxable contribution to capital theory, no such exclusion applied. Furthermore, Judge Hodges reasoned that the payment to the partnership could not be a recovery of the LLC's investment in the project because the payment came from a third party (the State of New York), not from the seller of the property. Judge Hodges expressed the view that the recovery of capital doctrine applies only in the context of buyers and sellers of "goods," and in that context, a payment can be nontaxable as a purchase price adjustment. (We believe the court was wrong about basis recovery being limited to sales of "goods." Regardless, the taxpayer's "recovery of investment" argument probably was not a winner anyway. For instance, see the court's analysis in *Uniquest Delaware*, discussed immediately below.) Finally, Judge Hodges determined that New York's payment to the taxpayer's LLC did not qualify for the "general-welfare" exclusion recognized in Rev. Rul. 2005-46, 2005-2 C.B. 120 (state disaster relief grants) because the tax credit in question was not conditioned on a showing of need.

- The holding of the Court of Federal Claims regarding the unavailability of the general welfare exclusion is consistent with the Tax Court's holding in *Maines v. Commissioner*, 144 T.C. 123 (2015). In *Maines*, the Tax Court held that the refundable portions of certain New York targeted economic development credits that remained after first reducing state tax liability were accessions to the taxpayers' wealth and were includable in gross income under § 61 for the year in which the taxpayers received payment or, under the constructive receipt doctrine, were entitled to receive payment, even if they elected to carry forward the credit. The Tax Court concluded that the taxpayers could not exclude the payments under the general welfare exclusion because the payments were not conditioned on a showing of need.

b. Yet again, no good deed goes unpunished. But perhaps there could have been a workaround? Uniquest Delaware, LLC v. United States, 294 F.Supp.3d 107 (W.D.N.Y. 3/27/18). In this decision, the U.S. District Court for the Western District of New York held that a grant paid by the New York State Empire State Development Corporation (which appears to have been a government-funded corporation) to an LLC taxed as a partnership was not excludable from the LLC's gross income as a contribution to capital. The taxpayer in this case was the LLC (unlike *Ginsburg v. United States*, 136 Fed. Cl. 1 (1/31/18), in which the taxpayer was a partner-member of the LLC). The

LLC, a TEFRA partnership, had two equal members, each of which was a disregarded single-member LLC, that in turn were each wholly-owned by separate subchapter S corporations. The case arose in connection with a TEFRA partnership audit of the LLC, a fact which was important to the court's ultimate decision (as explained further below). In 2009, the LLC received an $11 million grant from the New York State Empire State Development Corporation for the restoration of a building in Buffalo. The original grant proposal expressly stated that "[t]here is no element of compensation of specific, quantifiable or other services to the government agencies involved; the grants contemplated by this offer are being offered solely for the purpose of obtaining an advantage for the general community." The LLC did not include the $11 million grant in its income on its partnership tax return for 2009. During the audit and at IRS Appeals, the IRS asserted that the $11 million grant was included in the LLC's gross income in 2009 and ultimately issued an FPAA accordingly. The taxpayer-LLC then sought judicial review of the FPAA in the U.S. District Court for the Western District of New York.

Analysis: As in *Ginsburg*, the IRS's argument in this case was simple: § 61(a) requires inclusion of the $11 million grant in gross income, and no exception or exclusion in the Code provides otherwise. The taxpayer-LLC, similar to the taxpayer in *Ginsburg*, argued alternatively that the $11 million grant was either (i) excludable under the "common law contribution to capital doctrine" or (ii) akin to a "rebate" that resulted in an adjustment to the taxpayer-LLC's basis in the building, but which was not includable in gross income. [As to this latter "rebate" argument, see Rev. Rul. 76-96, 1976-1 C.B. 23 (rebates paid by car manufacturers, but not the dealer who sold the car, are not income but instead reduce the purchaser's basis in the car). Rev. Rul. 76-96 has been suspended in part on other grounds by Rev. Rul. 2005-28, 2005-1 C.B. 997.] Judge Wolford ruled against the taxpayer-LLC with respect to both arguments. Regarding the taxpayer-LLC's "common law contribution to capital doctrine" argument, the court reasoned that the cases supporting the doctrine involved corporate taxpayers only, and the holdings in these cases were codified by § 118 (the pre-TCJA version), which expressly does not apply to noncorporate entities. Regarding the taxpayer-LLC's "rebate" argument, Judge Wolford ruled that the $11 million grant is distinguishable, stating "unlike a retail customer who purchases a car with the knowledge that a rebate is forthcoming, [the taxpayer] purchased the [Buffalo Building] and then subsequently sought and received the [$11 million grant]. Therefore, the [$11 million grant] cannot be considered a discount or reduction in the purchase price of the building."

Indirect §§ 118/702 Argument: The taxpayer-LLC argued that, even if § 118 applies only to corporations, the court should indirectly rule it applicable to resolve the dispute with the IRS because the ultimate owners of the taxpayer-LLC were subchapter S corporations. The taxpayer further argued in this regard that § 118 (pre-TCJA) would have allowed the S corporation members of the taxpayer-LLC to exclude the grant from gross income. Therefore, the taxpayer-LLC argued, if the S corporation members could have excluded the grant under § 118, then the grant ultimately should be held nontaxable by virtue of § 702's distributive share approach to partner-level income. With respect to this final argument, Judge Wolford ruled that because TEFRA audit procedures treat the taxpayer-LLC as an entity separate from its owners, the partner-level treatment by the ultimate owners of the LLC was not within the court's subject-matter jurisdiction. *See* § 6226(f) and *American Boat Co., LLC v United States*, 583 F.3d 471, 478 (7th Cir. 2009) ("A court does not have jurisdiction to consider a partner-level defense in a partnership-level proceeding.")

Planning pointer: Had the subchapter S corporations first received the $11 million grant from New York and then contributed the funds to the taxpayer-LLC as additional capital contributions, we believe the grant would not have been taxable pursuant to the pre-TCJA version of § 118 and § 721, respectively. On the other hand, perhaps the terms of the grant would not allow the funds to be paid to the S corporation members because the acquisition and development was performed by the taxpayer-LLC, not the S corporation members.

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. Better be careful who you hire as CFO, and raise all your arguments against liability as a responsible person at the summary judgment stage, not afterwards. McClendon v. United States, 119 A.F.T.R.2d 2017-1037 (S.D. Tex. 3/6/17). The government successfully established through a motion for summary judgment that the taxpayer, a physician, was liable under § 6672 for a $4.3 million penalty equal to the amount of unpaid federal employment taxes owed by his medical practice. The CFO he had hired had embezzled funds and ultimately pleaded guilty to felony counts of theft. When the taxpayer learned of the unpaid taxes, he made a loan to the practice to allow it to make payroll, and these funds went to the employees rather than the government. The government used this preferential payment as the basis for establishing that the taxpayer had willfully violated his duty to pay the taxes due. The taxpayer moved for reconsideration and argued that his liability should be limited to the $100,000 preferential payment that was the basis for his liability. The court rejected this argument for two reasons. First, the taxpayer had failed to raise it in response to the government's motion for summary judgment. Second, even if he had raised it in a timely manner, the taxpayer had failed to meet his burden to prove the absence of funds available to pay the taxes due:

> At the summary judgment stage, as now, Dr. McClendon did not try to prove up the funds available to [the practice] or show that whatever funds existed were encumbered so that he had no obligation to pay them to the IRS. Instead, he effectively argues that, at summary judgment, it was the government's burden to demonstrate his liability for each dollar of the penalty. Not so. Dr. McClendon was presumptively liable for the balance of the IRS penalty assessed against him. The government moved for summary judgment and argued that the evidence did not create a genuine factual dispute material to deciding whether the IRS penalty was properly assessed. That discharged the government's summary judgment burden. Dr. McClendon, who would bear the burden at trial, then had the burden to submit or identify record evidence showing that he was not liable.

a. In this § 6672 trust fund recovery case, the Fifth Circuit has reversed and remanded for trial on the issue of the amount of available, unencumbered funds in the business's bank accounts after the responsible person became aware of the unpaid withholding taxes. McClendon v. United States, 892 F.3d 775 (5th Cir. 6/14/18). In the District Court, Dr. McClendon (now deceased) argued that his liability under § 6672 should be limited to $100,000, the amount of the loan he made to the business to allow it to make payroll after he had learned of the unpaid employment taxes. The District Court rejected this argument as untimely because Dr. McClendon had not raised it in his response to the government's motion for summary judgment and instead had raised it for the first time in his motion for reconsideration after the District Court had granted summary judgment in the government's favor. Nevertheless, the District Court considered the merits of the argument and concluded that Dr. McClendon had failed to meet his burden of submitting or identifying evidence in the record to show the amount of the business's funds that were unencumbered and available to pay the unpaid taxes. In an opinion by Judge Davis, the U.S. Court of Appeals for the Fifth Circuit has vacated the District Court's grant of summary judgment and remanded for trial on the issue of the amount of available, unencumbered funds in the business's bank accounts after discovery of the unpaid withholding taxes. The court first noted that its review of the District Court's denial of Dr. McClendon's motion to reconsider its grant of summary judgment is *de novo* because the District Court reached the merits of the motion and considered materials submitted in connection with it. The court cited *Barnett v. I.R.S.*, 988 F.2d 1449 (5th Cir. 1993), for the proposition that, when the government asserts that a responsible person willfully failed to pay employment taxes by using the business's unencumbered funds to pay the business's non-IRS creditors, the responsible person's liability under § 6672 is limited to the amount of "available, unencumbered funds deposited into [the business's] bank accounts after [the responsible person] became aware that the accrued withholding taxes were due." Dr. McClendon, the court explained, had testified in his deposition and in his affidavit regarding the actions taken and the funds available once the unpaid withholding taxes came to light, including his

$100,000 loan and the amount of receivables and insurance proceeds paid to the IRS, and had submitted copies of checks payable to the IRS that he asserted represented the closing balance in the business's accounts shortly after the unpaid taxes were discovered. To oppose the government's motion for summary judgment, the court stated, Dr. McClendon was not required to provide an accounting of the business's funds. The court cited the Eleventh Circuit's recent decision in *United States v. Stein*, 881 F.3d 853 (11th Cir. 2018), in which the court held that an affidavit can create an issue of material fact that precludes summary judgment even if the affidavit is self-serving and uncorroborated. Similarly, the Fifth Circuit reasoned, "[w]e can find no such corroboration requirement under § 6672." In the court's view, Dr. McClendon had come forward with sufficient evidence to establish an issue of material fact warranting trial regarding the amount of available, unencumbered funds.

Concurring Opinion. Judge Jones concurred in the court's opinion. She wrote separately to emphasize that, given Dr. McClendon and his partners had relied on their CFO for a decade before the CFO began embezzling, their reliance on his representations regarding the payment of employment taxes seemed plausible, and therefore she did not see how the District Court could rule as a matter of law on the government's argument that Dr. McClendon had willfully failed to pay employment taxes by acting with reckless disregard of a known or obvious risk that trust funds would not be remitted. She also stated that, in her view, the government had acted irresponsibly by introducing 285 pages of exhibits in support of its motion, including the business's records, and then arguing that Dr. McClendon had not met his burden at the summary judgment stage:

> To challenge the legal consequences of McClendon's $100,000 cash infusion is one thing; to claim, in the face of his sworn affidavit and documents, and their own access to corroborative financial records, that this isn't enough to raise a fact issue is irresponsible at best.

Dissenting Opinion. Judge Higginson dissented and argued that the court should affirm the District Court's grant of summary judgment in favor of the government.

2. Updated instructions on how to rat yourself out. Rev. Proc. 2018-11, 2018-5 I.R.B. 335 (1/26/18). This revenue procedure updates Rev. Proc. 2016-13, 2016-4 I.R.B. 290 (1/25/16), and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d), relating to the substantial understatement aspect of the accuracy-related penalty, and for the purpose of avoiding the tax return preparer penalty under § 6694(a), relating to understatements due to unreasonable positions. There have been no substantive changes. The revenue procedure does not apply with respect to any other penalty provisions, including § 6662(b)(1) accuracy-related penalties. If this revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275–R, as appropriate, attached to the return for the year or to a qualified amended return. A corporation's complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP, Uncertain Tax Position Statement, is treated as if the corporation had filed a Form 8275 or Form 8275-R regarding the tax position. The revenue procedure does not take into account the effect of tax law changes effective for tax years beginning after December 31, 2017. Accordingly, a taxpayer may have to file Form 8275 or Form 8275-R if a line referenced in the revenue procedure is affected by such a legislative change and requires additional reporting, at least until the IRS prescribes criteria for complying with the requirement.

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

F. Liens and Collections

1. The 30-day period for requesting review in the Tax Court of a notice of determination following a CDP hearing is jurisdictional and not subject to equitable tolling. Duggan v. Commissioner, 879 F.3d 1029 (9th Cir. 1/12/18), *aff'g* Duggan v. Commissioner, No. 4100-15L (U.S. Tax Court (6/26/15)). Following a collection due process hearing, the IRS issued two notices of determination upholding proposed collection action. The notices informed the taxpayer that, if he wished to contest the determinations, he could do so "by 'fil[ing] a petition with the United States Tax Court within a 30-day period beginning the day after the date of this letter.'" The notices were dated January 7, 2015. The taxpayer mailed his petition to the Tax Court on February 7, 2015, which was 31 days after the date of the notices of determination. The Tax Court (Judge Thornton) granted the IRS's motion to dismiss for lack of subject matter jurisdiction. On appeal, the taxpayer argued that he had been misled by the notices of determination, which caused him to believe that the day after the letter's date was day zero, the following day was day one etc., and that his attempts to comply had been reasonable. In an opinion by Judge Christen, the U.S. Court of Appeals for the Ninth Circuit affirmed the Tax Court's decision. The court held that the 30-day period specified in § 6330(d)(1) is jurisdictional and therefore is not subject to equitable tolling. In reaching this conclusion, the court relied on the plain language of § 6330(d)(1), which provides:

> A person may, within 30 days of a determination under this section, petition the Tax Court for review of such determination (and the Tax Court shall have jurisdiction with respect to such matter).

This provision, the court reasoned, "expressly contemplates the Tax Court's jurisdiction." The court also reasoned that § 6330(d)(1) was similar to statutory provisions establishing similar filing deadlines, such as the 90-day period specified by § 6015(e)(1)(A) for seeking review in the Tax Court of an IRS determination denying innocent spouse relief, which the Second Circuit concluded is jurisdictional. *See Matuszak v. Commissioner*, 862 F.3d 192 (2d Cir. 7/5/17). Because the 30-day period specified in § 6330(d)(1) is jurisdictional, the court concluded, the taxpayer's "failure to meet this deadline divested the Tax Court of the power to hear his case and foreclosed any argument for equitable tolling."

- In *Guralnik v. Commissioner*, 146 T.C. 230 (6/2/16), the Tax Court previously had held that the 30-day period specified in § 6330(d)(1) for seeking review in the Tax Court of an IRS notice of determination following a CDP hearing is jurisdictional and not subject to equitable tolling.

a. Assuming without deciding that the 30-day period for seeking review in the Tax Court of an IRS deternination following a CDP hearing is subject to equitable tolling, this taxpayer failed to establish circumstances that would justify doing so, says the Fourth Circuit. Cunningham v. Commissioner, 716 Fed. Appx. 182 (4th Cir. 1/18/18), *aff'g* Cunningham v. Commissioner, No. 14090-16 L (U.S. Tax Court (12/7/16)). The IRS issued a final notice of intent to levy, in response to which the taxpayer requested a collection due process hearing. Following the CDP hearing, the IRS issued a notice of determination upholding the proposed collection action. The notice of determination advised the taxpayer that, if she wished to contest the determination in the Tax Court, she must do so within the 30-day period prescribed by § 6330(d)(1), and that the 30-day period began to run on the day after the date of the letter. The letter was dated May 16, 2016. The taxpayer mailed her petition to the Tax Court on June 16, 2016, which was 31 days after the date of the letter. The Tax Court granted the IRS's motion to dismiss for lack of subject matter jurisdiction. On appeal, the taxpayer argued that the 30-day period for seeking review in the Tax Court was subject to equitable tolling. In an unpublished opinion by Judge Diaz, the U.S. Court of Appeals for the Fourth Circuit affirmed the Tax Court's decision. According to the Fourth Circuit, the taxpayer had to clear three hurdles in order for equitable tolling to apply: (1) the 30-day period specified by § 6330(d)(1) must be a mandatory claim-processing rule rather than a jurisdictional rule, (2) equitable tolling must be available for untimely actions under the statute, and (3) the circumstances must warrant equitable tolling. In connection with the second "hurdle," the court noted that "it is uncertain whether the presumption [established by *Irwin v. Department of Veterans Affairs*, 498 U.S. 89 (1990), that equitable tolling is available to litigants] applies at all outside the context of Article III courts." But the court rested its decision on the third condition. In the court's view, circumstances warranting equitable tolling were "wholly absent here." The taxpayer argued that she had been misled by the notice of determination, which caused her to believe that the day after the letter's date was day zero, the following day was day one etc. The court rejected this interpretation as contrary not only to Tax Court Rule 25(a), but also to the plain language of the letter and common sense. Equitable tolling, the court emphasized, is available only in rare instances in which it would be unconscionable to enforce a limitations period due to circumstances other than the party's own conduct. In this case, the court stated, the error resulted from the taxpayer's own mistake.

G. Innocent Spouse

1. Never, ever, never rely upon IRS correspondence concerning the law, and school your students and junior colleagues about the harsh reality that there is no equitable relief in tax from jurisdictional requirements. Rubel v. Commissioner, 856 F.3d 301 (3d Cir. 5/9/17), *aff'g* Rubel v. Commissioner, No. 9183-16 (U.S. Tax Court 7/11/16). In a case that went all the way to the U.S. Court of Appeals for the Third Circuit, the taxpayer, admirably represented by the Federal Tax Clinic at the Harvard Legal Services Center, claimed innocent spouse relief under § 6015 for the years 2005 through 2008. The IRS had denied the taxpayer's requests for each year via four separate notices of determination issued in January 2016. Section 6015(e)(1)(A) provides that a taxpayer who seeks innocent spouse relief may petition the Tax Court and that the Tax Court "shall have jurisdiction" if the petition is filed within specified time limits and no later than 90 days after the date the IRS mails the notice of determination. For the years 2006 through 2008, the taxpayer's petition in Tax Court was due by April 4, 2016. For 2005, the taxpayer's petition was due by April 12, 2016. Meanwhile, after receiving the notices, the taxpayer submitted additional information to the IRS concerning her claim for innocent spouse relief. The IRS again denied the taxpayer's claim via letter dated March 3, 2016; however, the letter misrepresented the due date for filing a petition in the Tax Court stating: "Please be advised this correspondence doesn't extend the time to file a petition with the U.S. Tax Court. Your time to petition the U.S. Tax Court began to run when we issued you our final determination [in January] and will end on Apr. 19, 2016. However, you may continue to work with us to resolve your tax matter." The taxpayer subsequently filed a petition in the Tax Court on April 19, 2016, and the IRS moved the Tax Court to dismiss the taxpayer's claim for lack of jurisdiction (because the petition was outside the 90-day period). The Tax Court agreed with the IRS and dismissed the petition. The taxpayer appealed to the Third Circuit arguing for equitable relief and estoppel against the IRS due to the misrepresentation in the March 3, 2016, IRS letter. The Third Circuit affirmed the Tax Court's dismissal of the case stating: "[T]he ninety-day deadline is jurisdictional and cannot be altered 'regardless of the equities' of the case."

a. Another case confirming that you cannot rely on what the IRS tells you about the filing deadline! The 90-day period for filing a Tax Court petition seeking review of an IRS determination denying innocent spouse relief is jurisdictional and not subject to equitable tolling. Matuszak v. Commissioner, 862 F.3d 192 (2d Cir. 7/5/17), *aff'g Matuzak v. Commissioner*, No. 471-15 (U.S. Tax Court 12/29/15). The IRS issued a notice of determination denying the taxpayer's request for innocent spouse relief. Under § 6015(e)(1)(A), the taxpayer then had 90 days from the date of mailing of the notice of determination to file a petition in the Tax Court. The taxpayer filed her petition in the Tax Court one day late. The Tax Court (Judge Marvel) granted the government's motion to dismiss the petition. The Tax Court subsequently denied the taxpayer's motion to vacate. See *Matuszak v. Commissioner*, No. 471-15 (7/29/16). In doing so, the Tax Court rejected the taxpayer's argument that the 90-day period for filing the petition could and should be equitably tolled because she had relied on erroneous verbal advice from IRS agents concerning the deadline for filing the petition. The taxpayer argued that recent developments in jurisdictional jurisprudence warranted overruling *Pollock v. Commissioner*, 132 T.C. 21 (2009), in which the court had concluded that the 90-day period of § 6015(e)(1)(A) is jurisdictional and not subject to equitable tolling. The Tax Court, however, declined to do so. The Tax Court noted that, in *Guralnik v. Commissioner*, 146 T.C. 230 (6/2/16), it had recently rejected a similar argument for changing its view on the jurisdictional nature of the 30-day period in § 6330(d)(1) for seeking review in the Tax Court of an IRS notice of determination following a CDP hearing. In a per curiam opinion, the U.S. Court of Appeals for the Second Circuit affirmed the Tax Court's decision. The Second Circuit acknowledged that recent decisions from the U.S. Supreme Court have distinguished between jurisdictional rules, which are not subject to equitable tolling, and non-jurisdictional claim-processing rules, which are. Nevertheless, the Second Circuit concluded that the 90-day period specified in § 6015(e)(1)(A) is jurisdictional. The court emphasized that the language of the statute provides that "the Tax Court shall have jurisdiction" if the petition is filed within the 90-day period. The court also noted that, in *Maier v. Commissioner*, 360 F.3d 61 (2d Cir. 2004), it had previously recognized the jurisdictional nature of § 6015 by concluding that the statute did not confer jurisdiction on the Tax Court over petitions seeking review of innocent spouse determinations filed by the non-electing spouse.

- The taxpayer was represented on the appeal by the Federal Tax Clinic at the Harvard Legal Services Center.

b. Things really are not looking good for those seeking to toll the 90-day period for filing a Tax Court petition to seek review of an IRS determination denying innocent spouse relief. The Fourth Circuit has agreed with the Second and Third Circuits. Nauflett v. Commissioner, 892 F.3d 649 (4th Cir. 6/14/18), *aff'g Nauflett v. Commissioner*, No. 24427-15 (U.S. Tax Court 8/9/16). The taxpayer in this case sought innocent spouse protection with respect to four years for which she had filed joint returns with her husband. The IRS denied the taxpayer's requested relief in multiple notices of determination dated July 17, 2015. The notices of determination informed the taxpayer of the rule set forth in § 6015(e)(1)(A), which provides that a taxpayer has 90 days from the date of mailing of the notice of determination to file a petition in the Tax Court. The taxpayer asserted that she had contacted both the IRS contact person listed on the notices and an employee at the IRS Taxpayer Advocate Service for assistance, and that they both incorrectly had informed her that she had until September 22, 2015, to file her petition. The taxpayer's petition to the Tax Court was postmarked September 22. However, the last day of the 90-day period specified by § 6015(e)(1)(A) was September 15, 2015. The Tax Court (Judge Marvel) granted the IRS's motion to dismiss the petition. The Tax Court subsequently denied the taxpayer's motion to vacate or revise. *See Nauflett v. Commissioner*, No. 24427-15 (U.S. Tax Court 5/25/17). In an opinion by Judge Agee, the U.S. Court of Appeals for the Fourth Circuit affirmed the Tax Court's decision. The court emphasized that the language of § 6015(e)(1)(A) provides that "the Tax Court shall have jurisdiction" if the petition is filed within the 90-day period. "We need not look beyond that mandate because Congress has, in fact, uttered 'magic words,' expressly conditioning the Tax Court's power on the timely filing of a petition." The court also relied on the "broader context of subsection (e)(1)(A) within § 6015." Because § 6015(e)(1)(A) is jurisidctional, the court concluded, courts do not have discretion to waive compliance based on equitable considerations.

H. Miscellaneous

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

- Judge Kavanaugh's opinion found six problems with the 2011 regulations: (1) tax return preparers were not "representatives" because they are not "agents" and, thus, lack "legal authority to act on the taxpayer's behalf"; (2) the preparation and filing of a tax return did not constitute "practice … before the Department of the Treasury" because that term implies "an investigation, adversarial hearing, or other adjudicative proceeding"; (3) the history of the statutory language originally enacted in 1884 "indicated that the statute contemplated representation in a contested proceeding"; (4) the regulation was inconsistent with the "broader statutory framework," (?!) in which Congress had enacted a number of statutes specifically directed at tax-return preparers and imposing civil penalties, which would not have been necessary if the IRS had authority to regulate tax-return preparers; (5) the statute would have been clearer had it granted power "for the first time to regulate hundreds of thousands of individuals in the multi-billion dollar tax-preparation industry" ["the enacting Congress did not intend to grow such a large elephant in such a small mousehole"]; and (6) the IRS's past approach showed that until 2011 it never maintained that it had authority to regulate tax return preparers.

- Judge Kavanaugh concluded: "The IRS may not unilaterally expand its authority through such an expansive, atextual, and ahistorical reading of Section 330."

a. In light of the IRS loss in *Loving v. IRS*, a new, voluntary Annual Filing Season Program to give tax return preparers the ability to claim they hold "a valid Annual Filing Season Program Record of Completion" and that they have "complied with the IRS requirements for receiving the Record of Completion." Rev. Proc. 2014-42, 2014-29 I.R.B. 192 (6/30/14). In order to encourage unenrolled tax return preparers, i.e., those who are not attorneys, CPAs or EAs, to complete continuing education courses in order to get a better understanding of federal tax law, the carrot of being able to claim superiority to the ordinary run-of-the-mill slob tax return preparers is offered. The requirements for this voluntary program include a six-hour refresher course, with a 100-question test at the end, plus other continuing education of two hours of ethics and ten hours of federal tax law topics. Holders of the Record of Completion may not use the terms "certified," "enrolled," or "licensed" to describe the designation.

b. The AICPA's challenge to the Annual Filing Season Program fails, but the court signals that others might successfully challenge it. American Institute of Certified Public Accountants vs. Internal Revenue Service, 199 F. Supp. 3d 55 (D.D.C. 8/3/16). The AICPA challenged as unlawful the voluntary Annual Filing Season Program established by the IRS in Rev. Proc. 2014-42, 2014-29 I.R.B. 192 (6/30/14), and the U.S. Court of Appeals for the District of Columbia ruled that the AICPA had standing to bring the challenge. *American Institute of Certified Public Accountants vs. Internal Revenue Service*, 804 F.3d 1193 (D.C. Cir. 10/30/15). In that opinion, the D.C. Circuit declined to address an issue raised by the IRS for the first time on appeal: that the AICPA's grievance does not "fall within the zone of interests protected or regulated by the statutory provision it invokes." On remand, the District Court (Judge Boasberg) held that the AICPA failed the zone of interests test because its grievance (which the court characterized as the grievance of the AICPA's members) is neither regulated nor protected by the relevant statute. Accordingly, the court granted the IRS's motion to dismiss. The court characterized the grievance of the AICPA and its members as competitive injury from brand dilution, i.e., that the AFS Program would dilute the credentials of the AICPA's members by introducing a government-backed credential and government-sponsored public listing. The relevant statute, the court concluded, is 31 U.S.C. § 330(a), which authorizes the Secretary of the Treasury to regulate the practice of representatives of persons before the Treasury Department and to require that certain conditions be satisfied, such as good character, before admitting a person to practice. The AICPA is not a representative of persons within the zone of interests *regulated* by the statute, the court concluded, because to satisfy this requirement the party must be regulated by the particular regulatory action being challenged. To demonstrate that it is in the zone of interests *protected* by the statute, the AICPA would have to demonstrate either that it is an intended beneficiary of the statute or that it is a "suitable challenger" to enforce the statute. The AICPA did not contend that it was an intended beneficiary of the statute, and the court concluded that the AICPA was not a suitable challenger. The court reasoned that the purpose of 31 U.S.C. § 330(a) is consumer protection, and that the AICPA's interest in avoiding intensified competition as a result of the AFS Program was not congruent with that purpose. "On the contrary, AICPA members' competitive interests are on a collision course with Congress's interest in safeguarding consumers."

- Although it dismissed the AICPA's challenge, the court added:

> A final word. While AICPA does not have a cause of action under the APA to bring this suit, the Court has little reason to doubt that there may be other challengers who could satisfy the rather undemanding strictures of the zone-of-interests test.

c. The D.C. Circuit had good news and bad news for the AICPA. The good news: the AICPA had standing to challenge the IRS's Annual Filing Season Program. The bad news: on the merits, the IRS had authority to adopt the program and the program does not violate the Administrative Procedure Act. American Institute of Certified Public Accountants v. Internal Revenue Service, 122 A.F.T.R.2d ¶2018-5507 (D.C. Cir. 8/14/18). The AICPA appealed the decision of the U.S. District Court for the District of Columbia that the AICPA lacked standing to challenge the IRS's Annual Filing Season (AFS) Program and the court's dismissal of the AICPA's challenge. In an opinion by Judge Ginsburg (with Judge Griffith concurring in part and dissenting in part), the U.S. Court of Appeals for the District of Columbia Circuit reversed the District Court on the issue of standing and, reaching the merits of the AICPA's challenge, held that the IRS had statutory authority to create the AFS Program and had not violated the Administrative Procedure Act in doing so. The court addressed three issues: (1) whether the AICPA had standing to challenge the AFS Program, (2) whether the IRS had statutory authority to adopt the AFS Program, and (3) whether the IRS followed the requisite procedures in creating the AFS Program.

Standing. With respect to standing, the court concluded that the AICPA had both constitutional and statutory standing to bring the challenge. The AICPA had constitutional standing, the court held, because its members who employ unenrolled return preparers are injured by the AFS Program, which applies Circular 230 to a new class of employees (the unenrolled preparers) and therefore imposes new supervisory responsibility requirements on those who employ them. On the issue of statutory standing, the court agreed with the District Court that the relevant statute is 31 U.S.C. § 330(a), which authorizes the Secretary of the Treasury to regulate the practice of representatives of persons before the Treasury Department and to require that certain conditions—such as good character—be satisfied before admitting a person to practice. In contrast to the District Court, however, the court held that the AICPA is a representative of persons within the zone of interests *regulated* by the statute. The relevant zone of interests regulated or protected by the statute, the court reasoned, is consumer protection and regulation of those who practice before the IRS. According to the court, the AICPA's injury fell within this zone of interests because its members who employ unenrolled agents are injured by the AFS Program, which imposes new supervisory responsibility requirements on them. In other words, the additional supervisory responsibilities of which the AICPA complained established both constitutional and statutory standing.

Statutory Authority for the AFS Program. The court recognized that, when it reverses a District Court's dismissal of a case for lack of standing, its normal practice is to remand to allow the District Court to address the merits. Nevertheless, the court chose to reach the merits of the AICPA's challenge because it presented purely legal issues that the parties had fully briefed. The court considered whether two statutes provided the IRS with authority to implement the AFS Program. First, the court considered 31 U.S.C. § 330(a), which authorizes the Secretary of the Treasury to regulate the practice of representatives of persons before the Treasury Department. The court rejected the AICPA's argument that the AFS Program relies on this statute to regulate the business of tax return preparation, contrary to the court's decision in *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014). To the contrary, the court reasoned, unenrolled preparers who participate in the AFS Program do not consent to be subject to Circular 230 in connection with their preparation of tax returns, but rather in connection with their limited right to represent clients before the IRS. The court held that the AFS Program is thus within the IRS's statutory authority to regulate those who practice before the IRS. Second, the court analyzed Code § 7803(a)(2)(A), which authorizes the IRS to "administer … the execution and application of the internal revenue laws or related statutes." This provision, the court concluded, does not provide any additional substantive authority for the AFS Program, but does authorize the IRS to publish the public directory of those who hold a "Record of Completion" of the AFS Program. "In sum, § 330(a) authorizes the IRS to establish and operate the Program, and § 7803(a)(2)(A) authorizes the agency to publish the results of the Program."

Procedural Requirements. The court also considered the AICPA's argument that the IRS had violated the Administrative Procedure Act by issuing Rev. Proc. 2014-42, 2014-29 I.R.B. 192 (6/30/14), to create the AFS Program. The revenue procedure, the AICPA argued, was a legislative rule that could be adopted only by following a notice-and-comment process, which the IRS had failed to do. The court rejected this argument for two reasons. First, the court explained, agency action constitutes a legislative rule only if it binds private parties or the agency with the force of law, which the AFS Program does not do because it "merely provides an opportunity for those unenrolled preparers who choose to participate and satisfy its requirements." Second, the court reasoned, Revenue Procedure 2014-42 did not withdraw a benefit that had been created through a notice-and-comment process and therefore could not be regarded as a legislative rule on that basis. Prior to 2011, when the IRS issued the regulations that ultimately were held invalid in *Loving*, all unenrolled tax return preparers had the ability to represent a taxpayer during an examination if the preparer had prepared and signed the return under examination. Revenue Procedure 2014-42 limits this right to unenrolled preparers who have a Record of Completion under the AFS Program. Nevertheless, the court held, the pre-2011 right of unenrolled preparers to represent taxpayers "was the product of Revenue Procedure 81-38, which—like Revenue Procedure 2014-42—was issued without notice and comment."

Dissenting Opinion. Judge Griffith concurred with the majority on the first two issues (standing of the AICPA and statutory authority for the AFS Program). In a lengthy dissenting opinion, however, he dissented on the issue whether Revenue Procedure 2014-42 was a legislative rule that could be issued only following a notice-and-comment process. In Judge Griffith's view, the revenue procedure is a legislative rule because it binds private parties with the force of law. Specifically, he emphasized, although it is voluntary for those unenrolled preparers who participate, it (1) imposes new supervisory responsibility requirements on enrolled practitioners who employ unenrolled preparers with a Record of Completion, and (2) precludes unenrolled preparers who do not hold a Record of Completion from representing taxpayers before the IRS as they formerly could. In addition, Judge Griffith reasoned, the revenue procedure is a legislative rule because it modifies a rule that had been created following a notice-and-comment process. Contrary to the majority, Judge Griffith expressed the view that the limited practice right of unenrolled preparers had been created not by Rev. Proc. 81-38, but rather by a 1959 regulation, which was subject to notice and comment. *See* Appearance of Unenrolled Preparers of Returns, 24 Fed. Reg. 1157 (2/14/59). Because Judge Griffith viewed Revenue Procedure 2014-42 as a legislative rule that had not been issued following a notice-and-comment process, the AFS Program, he concluded, is unlawful and should be vacated.

2. "All explanations tend to be self-serving." And that's okay, says the Eleventh Circuit. An affidavit that satisfies FRCP 56 can create an issue of material fact and preclude summary judgment even if it is self-serving and uncorroborated. United States v. Stein, 881 F.3d 853 (11th Cir. 1/31/18) (en banc). The government brought this action against the taxpayer to collect assessed but unpaid taxes, penalties, and interest with respect to several years. In the District Court, the government moved for summary judgment and submitted copies of the taxpayer's returns, transcripts of her accounts, and an affidavit from an IRS officer. The taxpayer responded by submitting an affidavit in which she stated that, after her husband's death, she had retained an accounting firm to prepare and file joint returns for the relevant years and that, "to the best of [her] recollection," she had paid the amounts in question. Her affidavit specified, for each year, when she had filed the return, the amount she had paid, and whether the IRS had a record of that payment. Her affidavit also stated that she no longer had bank records for the years in question and could not obtain them. The District Court granted the government's motion for summary judgment on the ground that the taxpayer had the burden to overcome the presumption of correctness that is attributed to the government's documentation, that the taxpayer had failed to meet that burden, and therefore there was no genuine issue of material fact and the government was entitled to judgment as a matter of law. On appeal, a panel of the United States Court of Appeals for the Eleventh Circuit affirmed and cited its previous opinion in *May v. United States*, 763 F.2d 1295 (11th Cir. 1985), for the proposition that "general and self-serving assertions that [the taxpayer] paid the taxes owed and related late penalties for [the relevant] tax years failed to rebut the presumption established by the [IRS's] assessments. The Eleventh Circuit subsequently vacated the panel's opinion and granted rehearing en banc. In a unanimous opinion by Judge Jordan, the Eleventh Circuit held that, if an affidavit satisfies Rule 56 of the Federal Rules of Civil Procedure, it can create an issue of material fact and preclude summary judgment even if the affidavit is self-serving and uncorroborated. The court overruled *May v. United States*, 763 F.2d 1295 (11th Cir. 1985), "to the extent it holds or suggests that self-serving and uncorroborated statements in a taxpayer's affidavit cannot create an issue of material fact with respect to the correctness of the government's assessments." The court reasoned that, if an affidavit is otherwise admissible, nothing in Rule 56 prohibits it from being self-serving or imposes a corroboration requirement. An affidavit cannot be conclusory, the court emphasized, but most of its prior decisions had concluded that a litigant's self-serving statements based on personal knowledge or observation can defeat summary judgment. Tax cases, the court explained, are no different. The court also explained that it was not holding that a self-serving or uncorroborated affidavit always is sufficient to defeat a motion for summary judgment; rather, the court held only that the self-serving and/or uncorroborated nature of an affidavit cannot prevent it from creating an issue of material fact. The court remanded to the panel to determine the impact of the taxpayer's affidavit.

a. The Eleventh Circuit panel remanded to the District Court. United States v. Stein, 889 F.3d 1200 (11th Cir. 5/9/18). After remand to the original Eleventh Circuit panel, the court, in a per curiam opinion, vacated the summary judgment entered by the District Court and remanded for further consideration. In doing so, the Eleventh Circuit panel declined to address arguments that the parties had not presented to the District Court, such as the government's argument that, to defeat summary judgment, the taxpayer had to "show that funds were actually delivered to the [Internal Revenue Service]."

3. Successive motions to vacate or revise a Tax Court decision that raise substantially the same grounds as prior motions do not affect the 90-day period for filing a notice of appeal. Annamalai v. Commissioner, 884 F.3d 530 (5th Cir. 3/8/18). Addressing an issue of first impression, the U.S. Court of Appeals for the Fifth Circuit has held that successive motions to vacate or revise a Tax Court decision that raise substantially the same grounds as a prior motion do not affect the time period in which a party may appeal the Tax Court's decision. Under Federal Rule of Appellate Procedure 13(a), a party who wishes to appeal a decision of the Tax Court must file a notice of appeal within ninety days. The 90-day period runs from either (1) the entry of the Tax Court's decision, or (2) if a party moves to vacate or revise the Tax Court's decision, from the entry of the Tax Court's ruling on that motion. In this case, the Tax Court entered its decision on June 23, 2016. On July 13, 2016, the taxpayers filed motions to vacate the Tax Court's decision. The Tax Court denied those motions on November 18, 2016. On December 12, 2016, the taxpayers jointly filed a motion to vacate that did not raise any substantially new grounds or arguments. The Tax Court denied this second motion on December 22, 2016. On March 15, 2017, the taxpayers filed a notice of appeal with the clerk of the Tax Court. In a per curiam opinion, the Fifth Circuit held that the taxpayers' second motion to vacate, which raised substantially the same grounds as their first, had no effect on the period within which they could appeal the Tax Court's decision. The court found support for its conclusion in its prior decisions concluding that a successive motion for reconsideration based on substantially the same grounds as a prior motion does not toll the running of the thirty-day period provided by Federal Rule of Appellate Procedure 4(a) for appealing decisions in civil cases. The court also noted that its conclusion was consistent with that of the Tenth Circuit, which similarly had held that a taxpayer's "renewed" motion to vacate a decision of the Tax Court did not affect the running of the 90-day period for appeal. *See Okon v. Commissioner*, 26 F.3d 1025 (10th Cir. 1994); *see also Dean v. Commissioner*, 2017 WL 4232520 (D.C. Cir. 9/13/17) (unpublished opinion); *Robertson v. Commissioner*, 22 Fed. Appx. 215 (4th Cir. 2001). Because the taxpayers had filed their notice of appeal more than ninety days after November 18, 2016, the date on which the Tax Court denied their initial motions to vacate, the Fifth Circuit dismissed their appeal as untimely.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

B. Self-employment Taxes

C. Excise Taxes

XII. TAX LEGISLATION

A. Enacted

XIII. TRUSTS, ESTATES & GIFTS

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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Note: This outline was prepared jointly with Cassady V. ("Cass") Brewer, Associate Professor of Law, Georgia State University College of Law, Atlanta, GA.

I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

1. Could we see compensation levels of top corporate officers actually decline? Code § 162(m) limits to $1 million the deduction of publicly traded corporations for compensation to covered employees (generally, certain top corporate officers). Certain types of compensation are not subject to this limit and are not taken into account in determining whether compensation exceeds $1 million, including remuneration payable (1) on a commission basis, or (2) solely on account of attainment of one or more performance-based goals if certain approval requirements are met ("performance-based compensation"). The 2017 Tax Cuts and Jobs Act, § 13601, amended Code § 162(m) to eliminate the exceptions for commissions and performance-based compensation. Accordingly, such compensation must be taken into account in determining the amount of compensation with respect to a covered employee for a taxable year that exceeds $1 million and therefore is not deductible. The legislation also amended the definition of "covered employee" in four ways: (1) the statutory definition now includes the principal executive officer and principal financial officer (whereas formerly the statutory definition referred only to the chief executive officer), (2) the definition includes persons who served as principal executive officer or principal financial officer *at* *any time during the taxable year* (rather than at the end of the year), (3) the definition includes officers whose compensation must be reported to shareholders under the Securities Exchange Act of 1934 by reason of their being among the *three* highest compensated officers (rather than four highest compensated officers), and (4) the definition now includes a person who was a covered employee for any preceding taxable year beginning after 2016 (which means the limit applies to compensation paid after termination of employment or after the employee's death). Finally, the legislation expands the category of corporations subject to the § 162(m) limit by defining "publicly traded corporation" to include foreign corporations publicly traded through American depositary receipts (ADRs) and certain large private corporations and S corporations. These changes apply to taxable years beginning after 2017. A transition rule provides that the changes do not apply to remuneration provided pursuant to a written binding contract that was in effect on November 2, 2017 as long as the contract is not materially modified after that date. Compensation provided pursuant to a renewal of a grandfathered contract is subject to the new rules.

a. Initial guidance on amended § 162(m). Notice 2018-68, 2018-36 I.R.B. 418 (8/21/18). The IRS has provided guidance on certain aspects of the amendments made to § 162(m) by the 2017 Tax Cuts and Jobs Act. Very generally, the notice addresses the amended rules for identifying covered employees and the operation of the grandfather rule for remuneration provided pursuant to a written binding contract that was in effect on November 2, 2017, including when such a contract will be considered materially modified so that it is no longer grandfathered. Treasury and the IRS expect to issue proposed regulations under § 162(m) that will incorporate the guidance provided in this notice.

D. Miscellaneous Deductions

1. Standard mileage rates for 2018. Notice 2018-3, 2018-2 I.R.B. 285 (12/14/17). The standard mileage rate for business miles in 2018 goes up to 54.5 cents per mile (from 53.5 cents in 2017) and the medical/moving rate goes up to 18 cents per mile (from 17 cents in 2017). The charitable mileage rate remains fixed by § 170(i) at 14 cents. The portion of the business standard mileage rate treated as depreciation is 25 cents per mile for 2018 (unchanged from 2017).

a. Minor changes to reflect the 2017 Tax Cuts and Jobs Act. Notice 2018-42, 2018-24 I.R.B. 750 (5/25/18). This notice modifies Notice 2018-3. 2018-2 I.R.B. 285 (12/14/17) to reflect changes made by Congress in the 2017 Tax Cuts and Jobs Act. Specifically, the notice clarifies that (1) the business standard mileage rate listed in Notice 2018-3 cannot be used to claim an itemized deduction for unreimbursed employee travel expenses because Congress disallowed miscellaneous itemized deductions for 2018, and (2) the standard mileage rate for moving is not applicable for the use of an automobile as part of a move because Congress disallowed the deduction of moving expenses for 2018 (except for members of the military on active duty who move pursuant to military orders, who can still use the standard mileage rate for moving). The notice also modifies Notice 2018-3 to reflect the 2017 Tax Cuts and Jobs Act's increase to the depreciation limitations for passenger automobiles placed in service after December 31, 2017. Notice 2018-3 had identified a maximum standard automobile cost of $27,300 for passenger automobiles and $31,000 for trucks and vans for purposes of computing the allowance under a fixed and variable rate (FAVR) plan. This notice provides that the maximum standard automobile cost may not exceed $50,000 for passenger automobiles (including trucks and vans) placed in service after December 31, 2017.

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

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

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

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

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

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

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

4. *Qualified business income—§ 199A(c).* One component of the § 199A deduction is 20 percent of the taxpayer's qualified business income, which is generally defined as the net amount from a qualified trade or business of items of income, gain, deduction, and loss included or allowed

in determining taxable income. Excluded from the definition are: (1) income not effectively connected with the conduct of a trade or business in the United States, (2) specified investment-related items of income, gain, deduction, or loss, (3) amounts paid to an S corporation shareholder that are reasonable compensation, (4) guaranteed payments to a partner for services, (5) to the extent provided in regulations, payments to a partner for services rendered other than in the partner's capacity as a partner, and (6) qualified REIT dividends or qualified publicly traded partnership income (because these two categories are separate components of the § 199A deduction).

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

6. *Revised rules for cooperatives and their patrons.* The Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, Division T, § 101, signed by the President on March 23, 2018, amended § 199A to fix what was commonly referred to as the "grain glitch." Under 199A as originally enacted, farmers selling goods to agricultural cooperatives were permitted to claim a deduction effectively equal to 20 percent of gross sales, while farmers selling goods to independent buyers effectively could claim a deduction equal to 20 percent of net income. Some independent buyers argued that this difference created an unintended market preference for producers to sell to agricultural cooperatives. Under the amended version of § 199A, agricultural cooperatives would determine their deduction under rules set forth in § 199A(g) that are similar to those in old (and now repealed) section § 199. The § 199A deduction of an agricultural cooperative is equal to 9 percent of the lesser of (1) the cooperative's qualified production activities income, or (2) taxable income calculated without regard to specified items. The cooperative's § 199A deduction cannot exceed 50 percent of the W-2 wages paid of the cooperative. A cooperative can pass its § 199A deduction through to their farmer patrons. In addition, the legislation modified the original version of § 199A to eliminate the 20-percent deduction for qualified cooperative dividends received by a taxpayer other than a corporation. Instead, under the amended statute, taxpayers are entitled to a deduction equal to the lesser of 20 percent of net income recognized from agricultural and horticultural commodity sales or their overall taxable income, subject to a wage and capital limitation.

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

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

a. Let the games begin! Treasury and the IRS have issued proposed regulations under § 199A. REG-107892-18, Qualified Business Income, 83 F.R. 40884 (8/16/18). The Treasury Department and the IRS have published proposed regulations under § 199A. The proposed regulations address the following six general areas. In addition, Prop. Reg. § 1.643(f)-1 provides anti-avoidance rules for multiple trusts.

Operational rules. Prop. 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 Prop. Reg. § 1.199A-1(b)(13), a "trade or business" is "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 that is commonly controlled (within the meaning of Prop. Reg. § 1.199A-1(b)(1)(i)), then the rental or licensing activity is treated as a trade or business for purposes of § 199A even if the rental or licensing activity would not, on its own, rise to the level of a trade or business. The operational rules also provide guidance on computation of the § 199A deduction for those with taxable income below and above the $157,500/$315,000 thresholds mentioned earlier as well as rules for determining the carryover of negative amounts of qualified business income and negative amounts of combined qualified REIT dividends and qualified publicly traded partnership income. The proposed 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. The operational rules also provide rules that apply in certain special situations, such as Prop. 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. Prop. 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 Prop. 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 proposed regulations provide special rules for application of the W-2 wage limitation to situations in which a taxpayer acquires or disposes of a trade or business. Simultaneously with the issuance of these proposed regulations, the IRS issued Notice 2018-64, 2018-35 I.R.B. 347 (8/8/18), which contains a proposed revenue procedure that provides guidance on methods for calculating W–2 wages for purposes of § 199A. The proposed regulations also provide guidance on determining the UBIA of qualified property. Prop. 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 proposed 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. Prop. 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 proposed 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. Prop. 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 Prop. 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 proposed regulations permit aggregation if the following five requirements are met: **(1)** the same person, or group of persons, directly or indirectly owns a majority interest in 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 proposed 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 proposed 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. Prop. 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 proposed regulations provide guidance on what is means to be considered providing services in each of these categories. Regarding the last category, the proposed 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 proposed regulations set forth several examples. The proposed 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. Prop. Reg. § 1.199-6 provides guidance for passthrough entities, publicly traded partnerships trusts, and estates may need to follow in determining the § 199A deduction of the entity or its owners. The proposed 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 proposed regulations generally are proposed to apply to taxable years ending after the date of publication of final regulations in the Federal Register. Nevertheless, taxpayers can rely on the proposed regulations in their entirety until final regulations are published. However, to prevent abuse, certain provisions of the proposed regulations are proposed to apply to taxable years ending after December 17, 2017, the date of enactment of the 2017 TCJA. In addition, Prop. Reg. § 1.643(f)-1, which provides anti-avoidance rules for multiple trusts, is proposed to apply to taxable years ending after August 16, 2018.

b. The IRS has issued a proposed revenue procedure that provides guidance on methods for calculating W-2 wages for purposes of § 199A. Notice 2018-64, 2018-35 I.R.B. 347 (8/8/18). This proposed 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 § 199A. The IRS has requested comments on the proposed revenue procedure. The proposed revenue procedure is proposed to apply generally to taxable years ending after December 31, 2017.

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

IV. COMPENSATION ISSUES

A. Fringe Benefits

B. Qualified Deferred Compensation Plans

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

D. Individual Retirement Accounts

1. Relief for certain closed defined benefit pension plans. Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13). This notice provides temporary nondiscrimination relief for certain "closed" defined benefit pension plans (i.e., those that provide ongoing accruals but that have been amended to limit those accruals to some or all of the employees who participated in the plan on a specified date). Typically, new hires are offered only a defined contribution plan, and the closed defined benefit plan has an increased proportion of highly compensated employees.

a. The relief is extended to plan years beginning before 2017. Notice 2015-28, 2015-14 I.R.B. 848 (3/19/15). This notice extends for an additional year the temporary nondiscrimination relief originally provided in Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13), by applying that relief to plan years beginning before 2017. The notice cautions that all remaining provisions of the nondiscrimination regulations under § 401(a)(4) (including the rules relating to the timing of plan amendments under Reg. § 1.401(a)(4)-5) continue to apply. Treasury and the IRS anticipate issuing proposed amendments to the § 401(a)(4) regulations that would be finalized and apply after the relief under Notice 2014-5 and this notice expires.

b. Proposed regulations provide nondiscrimination relief for certain closed plans and formulas and make other changes. REG-125761-14, Nondiscrimination Relief for Closed Defined Benefit Pension Plans and Additional Changes to the Retirement Plan Nondiscrimination Requirements, 81 F.R. 4976 (1/29/16). The Treasury Department and the IRS have published proposed amendments to the regulations under § 401(a)(4), which provides generally that a plan is a qualified plan only if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees. The proposed regulations modify a number of provisions in the existing regulations under § 401(a)(4) to address situations and plan designs that were not contemplated in the development of the existing regulations. Many of the changes in the proposed regulations provide nondiscrimination relief for certain closed plans and formulas, but the proposed regulations also include other changes that are not limited to closed plans and formulas. The proposed amendments generally would apply to plan years beginning on or after the date of publication of final regulations and, subject to some significant exceptions, taxpayers are permitted to apply the provisions of the proposed regulations for plan years beginning on or after 1/1/14.

c. The relief is extended to plan years beginning before 2018. Notice 2016-57, 2016-40 I.R.B. 432 (9/19/16). This notice extends for an additional year the temporary nondiscrimination relief originally provided in Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13), by applying that relief to plan years beginning before 2018. The IRS has done so because it anticipates that the proposed regulations (REG-125761-14, Nondiscrimination Relief for Closed Defined Benefit Pension Plans and Additional Changes to the Retirement Plan Nondiscrimination Requirements, 81 F.R. 4976 (1/29/16)) will not be published as final regulations in time for plan sponsors to make plan design decisions based on the final regulations before expiration of the relief provided under Notice 2014-5 (as extended by Notice 2015-28). Therefore, the IRS has extended the relief for an additional year.

d. The relief is extended to plan years beginning before 2019. Notice 2017-45, 2017-38 I.R.B. 232 (8/31/17). This notice extends for an additional year the temporary nondiscrimination relief originally provided in Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13), by applying that relief to plan years beginning before 2019. The IRS has done so because it anticipates that the proposed regulations (REG-125761-14, Nondiscrimination Relief for Closed Defined Benefit Pension Plans and Additional Changes to the Retirement Plan Nondiscrimination Requirements, 81 F.R. 4976 (1/29/16)) will not be published as final regulations in time for plan sponsors to make plan design decisions based on the final regulations before expiration of the relief provided under Notice 2014-5 (as last extended by Notice 2016-57). Therefore, the IRS has extended the relief for an additional year.

e. The relief is extended to plan years beginning before 2020. Notice 2018-69, 2018-37 I.R.B. 426 (8/24/18). This notice extends for an additional year the temporary nondiscrimination relief originally provided in Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13), by applying that relief to plan years beginning before 2020. The IRS has done so because it anticipates that the proposed regulations (REG-125761-14, Nondiscrimination Relief for Closed Defined Benefit Pension Plans and Additional Changes to the Retirement Plan Nondiscrimination Requirements, 81 F.R. 4976 (1/29/16)) will not be published as final regulations in time for plan sponsors to make plan design decisions based on the final regulations before expiration of the relief provided under Notice 2014-5 (as last extended by Notice 2017-45). Therefore, the IRS has extended the relief for an additional year.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

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

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

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

c. Guidance is forthcoming on tax-free rollovers from a § 529 college savings account to an ABLE account. Notice 2018-58, 2018-33 I.R.B. 305 (07/30/18). In this notice, the IRS has announced that Treasury and the IRS intend to issue proposed regulations that will provide, pursuant to the 2017 amendment of § 529, that distributions from a § 529 account made after December 22, 2017, and before January 1, 2026, to the ABLE account of the designated beneficiary of that § 529 account (or family member of that designated beneficiary) are not subject to income tax if two requirements are met. **First**, the distributed funds must be contributed to the ABLE account within 60 days after their withdrawal from the § 529 account. **Second**, the distributed funds, when added to all other contributions made to the ABLE account for the taxable year that are subject to the limitation under § 529A(b)(2)(B)(i) must not exceed that limitation. Generally, the limitation under

§ 529A(b)(2)(B)(i) is the annual gift tax exclusion under § 2503(b) plus, for beneficiaries who are employees, the lower of the beneficiary's taxable compensation or the federal poverty line for a one-person household as determined for the immediately preceding year. The notice provides that taxpayers, beneficiaries, and administrators of § 529 accounts and ABLE accounts can rely on this guidance before the proposed regulations are issued.

d. More guidance is forthcoming on the increased contribution limits for beneficiaries of ABLE accounts who are employed or self-employed. Notice 2018-62 , 2018-34 I.R.B. 316 (08/03/18). The 2017 Tax Cuts and Jobs Act, § 11024, amended Code § 529A to increase the contribution limit under § 529A(b)(2)(B) for contributions made to an ABLE account before 2026. Under the increased limit, once the overall limitation on contributions is reached, an ABLE account's designated beneficiary who is an employee (as defined) can contribute an additional amount equal to the lesser of: (1) the compensation includible in the beneficiary's income for the year, or (2) the federal poverty line for a one-person household as determined for the immediately preceding year ($12,486 for a single individual under age 65 in 2016). In this notice, the IRS has announced that Treasury and the IRS intend to issue proposed regulations that will (1) confirm that the employed designated beneficiary, or the person acting on his or her behalf, is solely responsible for ensuring that the requirements for additional contributions are met and for maintaining adequate records for that purpose; (2) provide that ABLE programs may allow a designated beneficiary to certify under penalties of perjury that he or she is a designated beneficiary described in § 529A(b)(7) and that his or her contributions do not exceed the increased limit set forth in § 529A(b)(2)(B)(ii); (3) clarify that the relevant federal poverty guidelines for purposes of the increased contribution limit are those updated periodically in the Federal Register by the U.S. Department of Health and Human Services for the state in which the beneficiary resides, and (4) provide that a program will not be treated as a qualified ABLE program if it accepts contributions that are not in cash or that exceed the contribution limits in § 529A(b)(2)(B). Because ABLE programs may need to adjust their systems and account documents to be in compliance with regulatory requirements, and because some necessary changes might require state legislative action, Treasury and the IRS anticipate that final regulations will provide transition relief to allow adequate time for any necessary changes.

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

D. Deductions and Credits for Personal Expenses

1. Has the federal deduction for your high property or state income taxes made them easier to bear? Brace yourself! The deduction for state and local taxes not paid or accrued in carrying on a trade or business or an income-producing activity is limited to $10,000. The 2017 Tax Cuts and Jobs Act, § 11042, amended Code § 164(b) by adding § 164(b)(6). For individual taxpayers, this provision generally (1) eliminates the deduction for foreign real property taxes, and (2) limits to $10,000 ($5,000 for married individuals filing separately) a taxpayer's itemized deductions on Schedule A for the aggregate of state or local property taxes, income taxes, and sales taxes deducted in lieu of income taxes. This provision applies to taxable years beginning after 2017 and before 2026. The provision does *not* affect the deduction of state or local property taxes or sales taxes that are paid or accrued in carrying on a trade or business or an income-producing activity (i.e., an activity described in § 212) that are properly deductible on Schedules C, E, or F. For example, property taxes imposed on residential rental property will continue to be deductible. With respect to income taxes, an individual can deduct only *foreign* income taxes paid or accrued in carrying on a trade or business or an income-producing activity. As under current law, an individual cannot deduct state or local income taxes as a business expense even if the individual is engaged in a trade or business as a sole proprietor. *See* Reg. § 1.62-1T(d).

a. The IRS is not going to give blue states a pass on creative workarounds to the new $10,000 limitation on the personal deduction for state and local taxes. Notice 2018-54, 2018-23 I.R.B. (05/23/18). In response to new § 164(b)(6), many states—including Connecticut, New Jersey, and New York—have enacted workarounds to the $10,000 limitation. For instance, New Jersey reportedly has enacted legislation giving property owners a special tax credit against otherwise assessable property taxes if the owner makes a contribution to charitable funds designated by local governments. Connecticut reportedly has enacted a new provision that taxes the income of pass-through entities such as S corporations and partnerships, but allows the shareholders or members a corresponding tax credit against certain state and local taxes assessed against them individually. Notice 2018-54 announces that the IRS and Treasury are aware of these workarounds and that proposed regulations will be issued to "make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers." In other words blue states, don't bank on a charitable contribution or a flow-through income tax substituting for otherwise assessable state and local taxes to avoid new § 164(b)(6).

b. And like Rameses II in *The Ten Commandments*, Treasury says, "So let it be written; so let it (finally!) be done." REG-112176-18, Contributions in Exchange for State and Local Tax Credits, 83 F.R. 43563 (8/27/18). Moving swiftly, Treasury has published proposed regulations under § 170 that purport to close the door on any state-enacted workarounds to new § 164(b)(6). Prop. Reg. § 1.170A-1(h)(3) generally requires taxpayers to reduce the amount of any federal income tax charitable contribution deduction by the amount of any corresponding state or local tax *credit* the taxpayer receives or expects to receive. The proposed regulations further provide that a corresponding state or local tax *deduction* normally will not reduce the taxpayer's federal deduction provided the state and local deduction does not exceed the taxpayer's federal deduction. To the extent the state and local charitable deduction exceeds the taxpayer's federal deduction, the taxpayer's federal deduction is reduced. Finally, the proposed regulations provide an exception whereby the taxpayer's federal charitable contribution deduction is not reduced if the corresponding state or local credit does not exceed 15 percent of the taxpayer's federal deduction. Three examples illustrate the application of the proposed regulation:

- *Example 1*. A, an individual, makes a payment of $1,000 to X, an entity listed in section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70% of the amount of A's payment to X. Under paragraph (h)(3)(i) of this section, A's charitable contribution deduction is reduced by $700 (70% × $1,000). This reduction occurs regardless of whether A is able to claim the state tax credit in that year. Thus, A's charitable contribution deduction for the $1,000 payment to X may not exceed $300.

- *Example 2*. B, an individual, transfers a painting to Y, an entity listed in section 170(c). At the time of the transfer, the painting has a fair market value of $100,000. In exchange for the painting, B receives or expects to receive a state tax credit equal to 10% of the fair market value of the painting. Under paragraph (h)(3)(vi) of this section, B is not required to apply the general rule of paragraph (h)(3)(i) of this section because the amount of the tax credit received or expected to be received by B does not exceed 15% of the fair market value of the property transferred to Y. Accordingly, the amount of B's charitable contribution deduction for the transfer of the painting is not reduced under paragraph (h)(3)(i) of this section.

- *Example 3*. C, an individual, makes a payment of $1,000 to Z, an entity listed in section 170(c). In exchange for the payment, under state M law, C is entitled to receive a state tax deduction equal to the amount paid by C to Z. Under paragraph (h)(3)(ii)(A) of this section, C is not required to reduce its charitable contribution deduction under section 170(a) on account of the state tax deduction.

The proposed regulation is effective for charitable contributions made after August 27, 2018.

- **On the other hand . . . .** The looming trouble spot here is how taxpayers and the IRS discern the difference between abusive "workarounds" enacted in response to new § 164(b)(6) and legitimate state and local tax credit programs such as the Georgia Rural Hospital Tax Credit that preceded TCJA. The Georgia Rural Hospital Tax Credit program was enacted in 2017 to combat the closure of many rural hospitals in Georgia due to financial difficulties. Under the program, individuals and corporations making contributions to designated rural hospitals receive a 90% dollar-for-dollar tax credit against their Georgia state income tax liability. Is the Georgia Rural Hospital Tax Credit program adversely affected by proposed regulations under § 164(b)(6)? In our view, the answer is "yes" and a Georgia taxpayer's federal charitable contribution deduction for a donation to a Georgia rural hospital is reduced by 90 percent. This follows because the proposed regulations do not condition the reduction in a taxpayer's federal charitable contribution deduction on whether the taxpayer's state and local deduction otherwise would exceed the $10,000 cap of new § 164(b)(6). We note, however, that it may be possible under state or local law for a taxpayer to waive any corresponding state or local tax credit and thereby claim a full charitable contribution for federal income tax purposes. *See* Rev. Rul. 67-246, 1967-2 C.B. 104.

E. Divorce Tax Issues

F. Education

1. Private elementary and secondary schools have a new incentive to raise tuition: up to $10,000 per year can be withdrawn tax-free from § 529 accounts to pay it. The 2017 Tax Cuts and Jobs Act, § 11032, amended Code § 529(c) by adding § 529(c)(7), which permits tax-free distributions from § 529 accounts to pay "expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school." The limit on distributions for this purpose is $10,000 during the taxable year, which applies per student, not per account. Thus, if a student is a designated beneficiary of more than one § 529 account, the student can receive only $10,000 free of tax for this purpose in a given year regardless of whether the funds are distributed from multiple accounts. This provision applies to distributions occurring after 2017.

a. Breaking news! "Elementary or secondary" school means kindergarten through grade 12. Notice 2018-58, 2018-33 I.R.B. 305 (07/30/18). In this notice, the IRS has announced that Treasury and the IRS intend to issue proposed regulations regarding § 529 accounts that will provide, pursuant to the 2017 enactment of new § 529(c)(7), that (1) tuition in connection with a designated beneficiary's enrollment or attendance at an elementary or secondary public, private, or religious school constitutes a qualified higher education expense, and therefore amounts can be withdrawn tax-free to pay it, but that such tax-free distributions are limited to a total of $10,000 per year per designated beneficiary, regardless of whether the funds are distributed from multiple § 529 accounts, and (2) the term "elementary or secondary" means kindergarten through grade 12 as determined under state law, which is consistent with the definition set forth in § 530(b)(3)(B) for Coverdell education savings accounts. The notice also provides that the proposed regulations will address the recontribution of refunded qualified higher education expenses, which might occur, for example, if a student drops a class and receives a refund of tuition. Under § 529(c)(3)(D) (enacted by the 2015 PATH Act), the portion of a distribution that is refunded to an individual who is the beneficiary of a § 529 account by an eligible educational institution is not subject to income tax to the extent the refund is recontributed to a § 529 account of which that individual is the beneficiary not later than 60 days after the date of the refund and does not exceed the refunded amount. The proposed regulations will provide that the entire recontributed amount will be treated as principal (rather than earnings), which is a rule of administrative convenience that avoids certain complexities that otherwise would arise under the rules governing rollovers previously set forth in Notice 2001-81, 2001-52 I.R.B. 617. The notice provides that taxpayers, beneficiaries, and administrators of § 529 accounts can rely on this guidance before the proposed regulations are issued.

G. Alternative Minimum Tax

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

C. Liquidations

D. S Corporations

E. Mergers, Acquisitions and Reorganizations

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

1. ♪♬"Shed a tear 'cause I'm missin' you … All we need is just a little patience"♪♬ Treasury and the IRS propose to withdraw the final regulations regarding documentation issued under § 385, but they may be back in modified form. REG-130244-17, Proposed Removal of Section 385 Documentation Regulations, 83 F.R. 48265 (9/24/18). Treasury and the IRS have issued a notice of proposed rulemaking that would remove the final regulations issued in 2016 setting forth minimum documentation requirements that ordinarily must be satisfied for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes.

Documentation Regulations. In 2016, Treasury and the IRS published Reg. § 1.385-2, which provides detailed requirements for documentation and financial analysis of instruments issued as indebtedness between related parties similar to what generally would be expected on issuance of debt instruments between unrelated parties. *See* T.D. 9790, Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 F.R. 72858 (10/21/16). Under this regulation, for an instrument to be treated as debt, documentation and information must be developed at the time an instrument is issued to demonstrate (1) a binding obligation to repay a fixed or determinable sum certain on demand or at one or more fixed dates, (2) that the creditor has the typical legal rights of a creditor to enforce the terms of the instrument including rights to trigger a default and accelerate payments, (3) a reasonable expectation that the issuer intends and would be able to repay, such as cash flow projections, financial statements, business forecasts, asset appraisals, determinations of debt-to-equity and other relevant financial ratios of the issuer (compared to industry averages), and (4) timely evidence of an on-going debtor-creditor relationship. Reg. § 1.385-2(c)(2). The documentation rules generally apply only to interests among members of an "expanded group" (very generally, an affiliated group within the meaning of § 1504(a) connected through stock possessing 80 percent of *either* voting power *or* value) if, on the date the interest is created, (1) the stock of any member of the expanded group is publicly traded, (2) all or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding $100 million, or (3) the expanded group's financial results are reported on financial statements that reflect annual total revenue that exceeds $50 million. The documentation rules do not apply to intercompany obligations among members of a consolidated group. Reg. § 1.385-2 originally was to apply to interests issued or deemed issued on or after January 1, 2018. In Notice 2017-36, 33 I.R.B. 208 (7/28/17), due to concerns expressed by taxpayers that the applicability date of the proposed regulations did not give taxpayers sufficient time to develop processes to comply with the documentation requirements, the IRS announced that Reg. § 1.385-2 would be amended to apply only to interests issued or deemed issued on or after January 1, 2019.

Withdrawal of the Documentation Regulations. On April 21, 2017, President Trump issued Executive Order 13789 directing the Secretary of the Treasury to review "all significant tax regulations" issued on or after January 1, 2016, that "impose an undue financial burden," "add undue complexity," or "exceed [the IRS's] statutory authority," and to submit two reports to the President. The second report, issued by Treasury Secretary Mnuchin on October 2, 2017, recommended certain actions with respect to eight sets of regulations, one of which was the documentation rules set forth in the regulations under § 385. Treasury and the IRS now have proposed to withdraw the documentation rules, which are found primarily in Reg. § 1.385-2. The preamble to these proposed regulations states that Treasury and the IRS will continue to study the issues addressed by the documentation rules and may propose a modified version of them. Any revised regulation setting forth documentation requirements "would be substantially simplified and streamlined to reduce the burden on U.S. corporations and yet would still require sufficient documentation and other information for tax administration purposes." The proposed withdrawal will be effective on the date these proposed regulations are published as final regulations.

VII. PARTNERSHIPS

A. Formation and Taxable Years

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

1. They were just kidding! Treasury and the IRS have proposed to remove temporary regulations regarding the allocation of partnership liabilities for purposes of the § 707

disguised sale rules. REG-131186-17, Proposed Removal of Temporary Regulations on a Partner's Share of a Partnership Liability for Disguised Sale Purposes, 83 F.R. 28397 (6/19/18). In 2016, Treasury and the IRS published temporary regulations (707 Temporary Regulations) regarding the allocation of partnership liabilities for purposes of applying the disguised sale rules of § 707. T.D. 9788, Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 F.R. 69282 (10/5/16). On April 21, 2017, President Trump issued Executive Order 13789 directing the Secretary of the Treasury to review "all significant tax regulations" issued on or after January 1, 2016, that "impose an undue financial burden," "add undue complexity," or "exceed [the IRS's] statutory authority," and to submit two reports to the President. The second report, issued by Treasury Secretary Mnuchin on October 2, 2017, recommended certain actions with respect to eight sets of regulations, one of which was the 707 Temporary Regulations. The second report stated that the novel approach implemented in the 707 Temporary Regulations should be studied systematically and that the Treasury Department and the IRS therefore would consider removing the 707 Temporary Regulations and reinstating prior regulations. Treasury and the IRS now have proposed to do so.

The 707 Temporary Regulations Issued in 2016. Temp. Reg. § 1.707-5T(a)(2), published in 2016, provides that, for purposes of the disguised sale rules, a partner's share of any partnership liabilities, regardless of whether they are recourse or nonrecourse under Reg. § 1.752-1 through 1.752-3, must be allocated by applying the same percentage used to determine the partner's share of "excess nonrecourse liabilities" under Reg. § 1.752-3(a)(3), "but such share shall not exceed the partner's share of the partnership liability under section 752 and applicable regulations (as limited in the application of § 1.752-3(a)(3) to this paragraph (a)(2))." Reg. § 1.752-3(a)(3) (as amended in T.D. 9787, 81 F.R. 69291 (10/5/16)), provides that, for purposes of the disguised sale rules of Reg. § 1.707-5(a)(2), a partner's share of an excess nonrecourse liability is determined solely in accordance with the partner's interest in partnership profits and that the significant item method, alternative method, and additional method do not apply. The combined effect of these rules is that, for purposes of the disguised sale rules, and regardless of whether a liability is recourse or nonrecourse, (1) a contributing partner's share of a partnership liability is determined solely by the partner's share of partnership profits and cannot be determined either under the other methods normally authorized for allocating excess nonrecourse liabilities or with reference to that partner's economic risk of loss under Reg. § 1.752-2, and (2) no portion of any partnership liability for which another partner bears the risk of loss can be allocated to the contributing partner under the profit-share method. Treasury and the IRS expressed the belief that, for purposes of the disguised sale rules, this allocation method reflects the overall economic arrangement of the partners. According to the preamble to the 707 Temporary Regulations, "[i]n most cases, a partnership will satisfy its liabilities with partnership profits, the partnership's assets do not become worthless, and the payment obligations of partners or related persons are not called upon." These rules were designed to be the death knell of leveraged partnership disguised sale transactions ala *Canal Corp. v. Commissioner*, 135 T.C. 199 (2010), to which reference is made in the 2016 preamble.

The Proposed Withdrawal of the 707 Temporary Regulations. The Treasury Department and the IRS have proposed to remove the 707 Temporary Regulations and to reinstate the regulations under § 1.707-5(a)(2) as in effect prior to the 707 Temporary Regulations. Under those prior rules, (1) a partner's share of a partnership's recourse liability is the partner's share of the liability under § 752 and the regulations thereunder, i.e., recourse liabilities are allocated for purposes of the disguised sale rules under the normal rules for allocating recourse liabilities, and (2) nonrecourse liabilities are allocated by applying the same percentage used to determine the partner's share of "excess nonrecourse liabilities" under Reg. § 1.752-3(a)(3), which means that a contributing partner's share of a nonrecourse liability is determined for purposes of the disguised sale rules solely by the partner's share of partnership profits and that the significant item method, alternative method, and additional method do not apply. The proposed regulations also would reinstate the rule in former Reg. § 1.707-5(a)(2)(i) and (ii) for so-called § 1.752-7 contingent liabilities that a partnership liability is a recourse or nonrecourse liability to the extent that the obligation would be a recourse liability under Reg. § 1.752-1(a)(1) or a nonrecourse liability under § 1.752-1(a)(2), respectively, if the liability was treated as a partnership liability for purposes of section 752. The preamble to the proposed regulations indicates that "[t]he Treasury Department and the IRS continue to study the issue of the effect of contingent liabilities with respect to section 707, as well as other sections of the Code." Finally, the proposed regulations would reinstate Examples 2, 3, 7, and 8 under Reg. § 1.752-1-5(f) with a modification to the language in Example 3 to reflect an amendment made in 2016 to Reg. § 1.707-5(a)(3) regarding an anticipated reduction in a partner's share of a liability that is not subject to the entrepreneurial risks of partnership operations.

Temporary Regulations on Bottom Dollar Guarantees Unaffected. The proposed regulations do *not* propose to withdraw Temp. Reg. § 1.752-2T(b)(3), issued in 2016, which addresses so-called bottom-dollar guarantees. Under Reg. § 1.752-2, a partnership liability is recourse to the extent that any partner or related person bears the economic risk of loss (EROL) for the liability. A partner or related person bears the EROL to the extent the partner or related person would have a payment obligation if the partnership liquidated in a worst-case scenario in which all partnership liabilities are due and all partnership assets generally are worthless. In 2016, along with the 707 Temporary Regulations, Treasury and the IRS issued Temp. Reg. § 1.752-2T(b)(3), which (like the final regulation that preceded it) provides that "[t]he determination of the extent to which a partner or related person has an obligation to make a payment under [Reg. § 1.752-2(b)(1)] is based on the facts and circumstances at the time of the determination," and that "[a]ll statutory and contractual obligations relating to the partnership liability are taken into account." However, the Temp. Reg. § 1.752-2T(b)(3) carves out an exception under which "bottom dollar" guarantees and indemnities (or their equivalent, termed "bottom dollar payments") will not be recognized. The second report mentioned earlier, issued by Treasury Secretary Mnuchin on October 2, 2017, stated that Treasury and the IRS believe that Temp. Reg. § 1.752-2T(b)(3) concerning bottom dollar payment obligations does not meaningfully increase regulatory burdens and should be retained to prevent abuses. Accordingly, the proposed regulations do not propose to withdraw Temp. Reg. § 1.752-2T(b)(3).

Effective Date. The 707 Temporary Regulations are proposed to be removed thirty days following the date that these proposed regulations are published as final regulations. The amendments to Reg. § 1.707-5 are proposed to apply to any transaction with respect to which all transfers occur on or after thirty days following the date these proposed regulations are published as final regulations. Nevertheless, taxpayers can apply these proposed regulations instead of the 707 Temporary Regulations to any transaction with respect to which all transfers occur on or after January 3, 2017.

C. Distributions and Transactions Between the Partnership and Partners

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

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

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

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

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

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. Used underwear is just not worth what it "used" to be! T.D. 9836, Substantiation and Reporting Requirements for Cash and Noncash Charitable Contribution Deductions, 83 F.R. 36417 (7/30/18). The Treasury Department and the IRS have finalized, with only minor changes, proposed regulations (which addressed the deductibility of "good condition" but used clothing and other household items, among other things) (REG-140029-07, Substantiation and Reporting Requirements for Cash and Noncash Charitable Contribution Deductions, 73 F.R 45908 (8/7/8)) regarding substantiation and reporting requirements for cash and noncash charitable contributions. The proposed and now final regulations [principally, Reg. §§ 1.170A-15 through 1.170A-18] reflect the enactment of certain provisions of the American Jobs Creation Act of 2004

[§ 170(f)(11) and (12)] and the Pension Protection Act of 2006 [§ 170(f)(16) and (17)]. Section 170(f) contains numerous limitations on the charitable contribution deduction with respect to donations of certain items of property (e.g., remainder interests, partial interests, insurance policies, used vehicles, stuffed animals, used clothing and household goods, etc.). Complicating matters further, § 170 also contains three distinct subsections [§ 170(f)(8), (11), and (17)] pertaining to substantiation and recordkeeping requirements for both cash and "noncash" (i.e., property) contributions. The proposed and now final regulations attempt to clarify and reconcile several of the foregoing limitations in § 170 with the distinct substantiation and recordkeeping rules in § 170. The five major changes from the proposed regulations (REG-140029-07) are as follows. **One,** due to the Tax Court's decision in *Crimi v. Commissioner*, T.C. Memo 2013-51 (reasonable-cause is inherently facts and circumstances specific), the final regulations do not provide a standard for a "reasonable-cause" excuse for failure to meet the substantiation requirements. **Two,** when substantiating noncash contributions that exceed $500, a donor can treat similar items contributed during the tax year as one property. **Three,** the substantiation requirements apply to carryover years as well as the year of donation. Four, if a Form 8323 is required in connection with a donation, the appraiser's taxpayer identification number (or EIN of the appraiser's business) must be included. **Lastly,** the final regulations clarify that a completed Form 8323 does not substitute for any required contemporaneous written acknowledgment. Thankfully, no changes were made to the rules regarding donations of used clothing, so we can continue to take a deduction (albeit small) for donations of old underwear. The final regulations are effective for contributions made after July 30, 2018. For further details, read on.

Cash or Monetary Contributions. Reg. § 1.170A-15 provides that the substantiation requirements of § 170(f)(17) regarding *cash or monetary contributions of less than $250* may be met if the taxpayer has one of two items: (i) a "bank record" (a monthly bank statement with a photocopy or image obtained from the bank of the front of the check indicating the name of the charity, or a credit card statement for contributions made via credit card), or (ii) a "written communication" (essentially, a receipt) from the charity showing the name of the charity, the date of the contribution, and the amount of the contribution. Separate contributions of less than $250 made during a year are not aggregated for this purpose. See Reg. § 1.170a-13(F)(1). Notwithstanding the foregoing, a written communication is not required to substantiate contributions of less than $250 to certain charitable trusts (*see* Reg. § 1.170A-15(g)); however, if the contribution is $250 or more, a "contemporaneous written acknowledgment" (see below) from the charitable trust apparently is required. Further, a written communication from a charity is not necessary to substantiate unreimbursed, out-of-pocket" expenses of less than $250 incurred incident to the rendition of services to a charitable organization; however, taxpayers must maintain records of such expenses. For *cash or monetary contributions of $250 or more*, pursuant to § 170(f)(8), the minimal "bank record" or "written communication" requirement must be met plus the donor must have a so-called "contemporaneous written acknowledgment" from the charity indicating the name of the donor, whether the charity provided goods or services in exchange for the contribution, and the amount of the contribution. The contemporaneous written acknowledgment may be electronic and, in general, is "contemporary" if it is delivered to the taxpayer before the taxpayer files a return for the year of the contribution. Further, the contemporaneous written acknowledgment may substitute for the minimal "written communication" requirement for cash or monetary contributions under $250 (and, as a practical matter, almost always will be provided in lieu of a receipt) if it also shows the date of the contribution. For unreimbursed "out of pocket" expenses of $250 or more, a donor may meet the substantiation requirement by having a written record of each such expense and a contemporaneous statement by the charity describing the services and indicating whether goods or services were provided to the taxpayer in return for the expense. A contribution made by payroll deduction may be substantiated by (i) a pay stub, Form W-2, or other document furnished by the employer that sets forth the amount withheld during the taxable year for payment to a charity, together with (ii) a pledge card or other document prepared by or at the direction of the charity that shows the name of the organization.

Noncash Contributions. Reg. § 1.170A-16 provides that for *noncash contributions of less than $250*, a taxpayer must substantiate the deduction with a "written communication" (essentially, a receipt) from the charity showing the name and address of the charity, the date of the contribution, and an adequate description of the property (*see* Reg. § 1.170A-16(a)(iii) for what is considered "adequate," especially for securities). If obtaining a written communication from the charity is impractical (such as for contributions made at unattended drop sites), then a taxpayer must substantiate the donation with "reliable written records" (generally, the same information as a charity-provided receipt, but see Reg. § 1.170A-16(a)(2) for details). For *noncash contributions of $250 or more up to $500*, the taxpayer must substantiate such contributions with a contemporary written acknowledgment from the charity. For *noncash contributions of more than $500 but not more than $5,000*, substantiation requires a contemporaneous written acknowledgment plus a properly completed Form 8283 (Section A) (which requires detailed information concerning the property contributed, including the taxpayer's cost or other basis in the property). For *noncash contributions of more than $5,000*, substantiation requires a contemporaneous written acknowledgment, a "qualified appraisal" prepared by a "qualified appraiser," and a properly completed Form 8283 (Section B); however, a qualified appraisal is not required for publicly-traded securities and certain other readily-valuable property. *See* Reg. § 1.170A-16(d)(2). For *noncash contributions of more than $500,000*, substantiation requires that all of the above requirements be met plus the qualified appraisal must be attached to the taxpayer's return claiming the deduction.

Qualified appraisal and qualified appraiser. Reg. § 1.170A-17 sets forth the detailed requirements for a "qualified appraisal" and a "qualified appraiser." These requirements did not change significantly from those set forth in the proposed regulations; however, in order to provide appraisers with a reasonable amount of time to meet new education and experience requirements, the final regulations under § 1.170A-17 apply only to contributions made after January 1, 2019.

2. Deduction for charitable contribution of façade easement denied to long-term lessee of building. Harbor Lofts Associates v. Commissioner, 151 T.C. No. 3 (8/27/18). The Tax Court has held that a taxpayer with a long-term lease of two historic buildings was not entitled to a charitable contribution deduction for donating façade easements over the buildings to a historical preservation organization. The taxpayer was a partnership that had leased the buildings for a 47-year term from the fee owner, the Economic Development & Industrial Corporation of Lynn ("EDIC"), a public corporation authorized under Massachusetts law. The 47-year lease between the taxpayer and EDIC made the taxpayer responsible for all insurance, utility, maintenance, and other costs associated with occupying the buildings and entitled the taxpayer to a portion of any proceeds if the land and buildings were taken under eminent domain. The taxpayer-lessee and EDIC jointly contributed the façade easement to the historical preservation organization in December of 2009. The taxpayer then claimed a charitable contribution deduction of almost $4.5 million on its 2009 return. On audit, the IRS challenged the claimed charitable contribution deduction arguing that, although the façade easement may have been "granted in perpetuity" by EDIC, the taxpayer's contribution of a façade easement essentially was a waiver of the taxpayer's "time-limited" contract rights. Thus, the taxpayer did not make a contribution of a "qualified real property interest" as required by § 170(h)(2)(C). In response, the taxpayer argued that by jointly contributing the façade easement with the fee owner, EDIC, the "granted in perpetuity" requirement was met and that the taxpayer's long-term leasehold interest in the façade of the buildings coupled with EDIC's fee interest equated with a "qualified real property interest." Moreover, the taxpayer argued that it should be treated as the equitable and tax owner of the buildings due to the nature of the long-term lease. The Tax Court (Judge Buch) denied the taxpayer's charitable contribution deduction. Judge Buch concluded that, under Massachusetts law, the taxpayer held only a leasehold interest, not a fee interest, and that Massachusetts law characterized the taxpayer's leasehold interest as personal property. Judge Buch further reasoned that the taxpayer's leasehold was a personal property right, not a "qualified real property interest" within the meaning of § 170(h)(2)(C). Judge Buch also determined that, in any even,t the taxpayer was incapable of granting a perpetual restriction over the façade of the buildings because the taxpayer did not hold perpetual rights. Judge Buch distinguished the facts in this case from one in which tenants-in-common grant deductible conservation easements due to the fact that EDIC and the taxpayer were not tenants in common, but rather lessor and lessee under Massachusetts law. Finally, Judge Buch ruled that, even if the taxpayer were considered the equitable owner of the buildings for federal income tax purposes, the façade easement granted by the taxpayer was not a "grant in perpetuity" because it was limited by the 47-year term of the lease.

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

B. Discovery: Summonses and FOIA

1. Citing § 7611, purported church exorcises devilish IRS summons. The lesson for the IRS? For God's sake, get the "John Hancock" of at least the TE/GE Commissioner before sending a church tax inquiry or examination notice under § 7611! United States v. Bible Study Time, Inc., 295 F.Supp.3d 606 (3/13/18). The District Court of South Carolina stayed a summons enforcement action because the IRS failed to substantially comply with the notice requirements of § 7611(a) (church tax inquiries and examinations). The taxpayer, Bible Study Time, Inc., purported to be a church. The IRS issued a summons to the taxpayer in connection with an inquiry and examination of the taxpayer's tax-exempt status as a church. [Previously, the taxpayer had failed in its efforts to quash several IRS third-party summonses issued to the taxpayer's banks. *See Bible Study Time, Inc. v. United States*, 240 F.Supp.3d 409 (D.S.C. 2017).] Under § 7611, the IRS must navigate certain procedural and notice rules prior to conducting a church tax inquiry or examination. One such rule requires an "appropriate high-level Treasury official" to sign off before a church tax inquiry or examination can begin. *See* § 7611(a). Furthermore, § 7611(e) provides that "any proceeding to compel compliance with respect to any church tax inquiry or examination shall be stayed until the court finds that all practicable steps to correct the noncompliance have been taken." Due largely to the IRS's reorganization begun in 1998 and Congress's failure to update § 7611 thereafter (as well as Treasury's failure to update interpreting regulations), the law is unclear as to who is an "appropriate high-level Treasury official" within the meaning of § 7611. *See generally United States v. Living Word Christian Center*, 102 A.F.T.R.2d 2008-7220 (D. Minn. 2008) (IRS Director of Exempt Organizations, Examinations, is not an "appropriate high-level Treasury official). In this case, the IRS Tax-Exempt/Governmental Entities ("TE/GE") Commissioner and the Director, Exempt Organizations ("DEO"), who reports to the TE/GE Commissioner, had signed off on an "Approval Cover Sheet" for the § 7611 notice, but for reasons that are unclear, only the DEO signed the actual § 7611 notice itself. The IRS compounded this error by failing to communicate to the taxpayer that the TE/GE Commissioner had signed the "Approval Cover Sheet," a fact which the taxpayer discovered only after contesting the summons. In response to the IRS's summons enforcement action, the taxpayer argued that the DEO was not of sufficiently high rank to comply with § 7611 and that even if the TE/GE Commissioner was of high enough rank, the IRS's failure to communicate that fact violated § 7611. The IRS argued that the DEO was of sufficient rank, but regardless the TE/GE Commissioner's signature on the § 7611 Approval Cover Sheet "substantially complied" (see § 7611(e)(1)) with § 7611, making the summons enforceable. Ultimately, after noting the IRS's reorganization during and after 1998 and the resulting ambiguity created under § 7611, the District Court of South Carolina (Judge Currie) ruled as follows: (i) pursuant to Delegation Order 193 (Nov. 8, 2000), the TE/GE Commissioner is of sufficiently high rank to sign a § 7611 notice; (ii) the DEO is not of sufficiently high rank; and (iii) the IRS's failure to communicate the TE/GE Commissioner's authorization under § 7611 to the taxpayer requires a stay of the summons enforcement proceeding until the TE/GE Commissioner signs and delivers the actual § 7611 notice to the taxpayer.

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

F. Liens and Collections

G. Innocent Spouse

H. Miscellaneous

1. The IRS has provided extensions of filing and payment due dates for those affected by California wildfires, flooding, mudflows and debris flows. In news release CA-2018-1 (1/17/18), the IRS has extended to April 30, 2018, several filing and payment due dates for those affected by the wildfires, flooding, mudflows and debris flows that took place beginning on Dececember 4, 2017, in parts of California. The relief is available to individuals and businesses in the counties of Los Angeles, San Diego, Santa Barbara, and Ventura. The due dates extended include the January 16, 2018, due date for quarterly estimated tax payments and the April 17, 2018, due date for 2017 individual returns. More generally, taxpayers have until April 30, 2018, to file most tax returns (including individual, corporate, and estate and trust income tax returns; partnership returns, S corporation returns, and trust returns; estate, gift, and generation-skipping transfer tax returns; and employment and certain excise tax returns; annual information returns of tax-exempt organizations; and employment and certain excise tax returns), that have either an original or extended due date occurring on or after December 4, 2017, and before April 30, 2018. The IRS will automatically provide filing and penalty relief to any taxpayer with an address of record in one of these disaster areas. Taxpayers in one of these areas who receive a notice from the IRS regarding a late-filing or late-payment penalty should contact the IRS at the number listed on the notice to have the penalty abated. Affected taxpayers who reside or have a business located outside the covered disaster area must call the IRS disaster hotline at 866-562-5227 to request this tax relief.

a. The IRS has extended several filing and payment deadlines for those affected by wildfires and high winds that began July 23, 2018, in parts of California. In news release CA-2018-11 (8/6/18), the IRS has extended to November 30, 2018, several filing and payment due dates that occurred beginning on July 23, 2018, for those in areas affected by wildfires and high winds that began July 23, 2018 in parts of California. The relief is available to individuals and businesses in Lake and Shasta Counties, to relief workers who live elsewhere who are affiliated with a recognized government or philanthropic organization assisting in relief efforts in the covered areas, and to those visiting the areas who are killed or injured as a result of the disaster. The due dates extended include (1) the September 17, 2018, due date for quarterly estimated tax payments; (2) the September 17, 2018, due date for certain returns, such as those for calendar-year partnerships that filed timely extension requests for 2017; (3) the October 15, 2018, due date for 2017 individual returns for individuals who filed timely extension requests; (4) the October 31, 2018, due date for quarterly payroll and excise tax returns; (5) the November 15, 2018, due date for 2017 returns of calendar-year tax-exempt organizations that filed timely extension requests, and (6) due dates on or after after July 23, 2018, and before November 30, 2018 for the filing of Form 5500 series returns. The IRS will automatically provide filing and penalty relief to any taxpayer with an address of record in one of these disaster areas. Taxpayers in one of these areas who receive a notice from the IRS regarding a late-filing or late-payment penalty should contact the IRS at the number listed on the notice to have the penalty abated.

b. The IRS has provided extensions of filing and payment due dates for those in areas affected by Hurricane Florence. In news releases IR-2018-187 (9/15/18) and SC-2018-01 (9/24/18), the IRS has provided relief from several filing and payment deadlines to those in areas affected by Hurricane Florence. The relief is available to individuals and businesses in parts of North Carolina and South Carolina, to relief workers affiliated with a recognized government or philanthropic organization assisting in relief efforts in the covered areas, and to those visiting the areas who are killed or injured as a result of the disaster.

Deadlines extended to January 31, 2019. For those in affected areas, the following due dates have been extended to January 31, 2019: (1) the September 17, 2018, and January 15, 2019, due dates for quarterly estimated tax payments; (2) the September 17, 2018, due date for certain returns, such as those for calendar-year partnerships that filed timely extension requests for 2017; (3) the October 15, 2018, due date for 2017 individual returns for individuals who filed timely extension requests; (4) the October 31, 2018, due date for quarterly payroll and excise tax returns; (5) the November 15, 2018, due date for 2017 returns of calendar-year tax-exempt organizations that filed timely extension requests, and (6) due dates after September 7, 2018, and before January 31, 2019 for the filing of Form 5500 series returns. *Note:* individuals who filed a timely request for an extension of time to file their 2017 returns do not obtain any relief for tax payments related to the 2017 return because those payments were due on April 18, 2018.

Waiver of late-deposit penalties for federal payroll and excise taxes. For those in affected areas, the IRS has waived late-deposit penalties for federal payroll and excise taxes due on or after September 7, 2018, and before September 24, 2018, as long as the deposits are made by September 24, 2018.

Relief provided automatically. The IRS will automatically provide filing and penalty relief to any taxpayer with an address of record in one of the designated disaster areas. Taxpayers in one of these areas who receive a notice from the IRS regarding a late-filing or late-payment penalty should contact the IRS at the number listed on the notice to have the penalty abated. In contrast, affected taxpayers who reside or have a business outside the covered disaster area must call the IRS to request relief.

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

XIII. TRUSTS, ESTATES & GIFTS

State Bar of Texas Tax Section Annual Meeting

"Tax Reform: Now What?"

Eric Solomon
June 22, 2018

Introduction

- On December 22, 2017, the President signed "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018" (P.L. 115-97), hereinafter called the 2017 Tax Act (or the Act).
- The 2017 Tax Act made substantial changes to the Internal Revenue Code, particularly lowering the corporate tax rate and revising the international tax provisions.
- In the words of Mark Prater, Deputy Staff Director and Chief Tax Counsel for the Senate Finance Committee, three important factors in the development of this Act were policy, process and politics.

Key Drivers for the 2017 Tax Act

- There were several key policy drivers for the 2017 Tax Act:
  1. A tax reduction for individual taxpayers, especially the middle class;
  2. A lower corporate tax rate;
  3. Replacement of the U.S. worldwide international tax system with a dividend exemption system;
  4. Inclusion of base erosion measures; and
  5. Encouragement of business activity in the United States rather than abroad.
- Each of these drivers and how they were addressed in the Act will be discussed in more detail later.

Key Limitations

- Because the Senate is nearly equally divided between Republicans and Democrats, and because 60 votes are needed in the Senate to overcome a filibuster, the Republicans needed to employ reconciliation procedures for this tax bill.
- Under reconciliation procedures, it takes only 51 votes to pass a law in the Senate and a filibuster can be avoided.
- A budget resolution passed by both the House and Senate authorized the use of reconciliation procedures. Because of concerns by some members of Congress about increasing deficits, the budget resolution limited the allowable revenue loss to $1.5 trillion over 10 years.

Key Limitations (cont'd)

- Reconciliation procedures impose various limitations on a bill, including (under the so-called Byrd rule) that the bill must not lose revenue after the budget window (10 years).
- The limitations had a substantial impact on the ultimate shape of the Act. For example, to avoid losing revenue after 10 years, most of the provisions affecting individuals will expire at the end of 2025.

Key Driver #1: Tax Cut for Individuals

- A goal of the Act was to provide a tax cut for individuals, especially the middle class.
  - In total, the individual tax provisions provide net tax relief to individuals of over $700 billion over 10 years (not including over $400 billion in tax relief over 10 years as a result of the provision providing a 20% tax deduction to owners of businesses conducted through sole proprietorships and pass-through entities).
- The Act includes various taxpayer-favorable provisions. In particular, the Act:
  - Lowered tax rates;
  - Raised the tax brackets;
  - Doubled the standard deduction;
  - Repealed the overall limitation on itemized deductions (the "Pease" limitation);
  - Enhanced the child tax credit;
  - Increased the exemption for alternative minimum tax; and
  - Increased the exemption for estate tax.

Key Driver #1: Tax Cut for Individuals (cont'd)

- On the other hand, the Act includes various taxpayer-unfavorable provisions. In particular, the Act:
  - Repealed personal exemptions;
  - Limited the deduction for state and local taxes to $10,000;
  - Limited the deduction for home mortgage interest;
  - Repealed various itemized deductions;
  - Limited the use of business losses against other income; and
  - Selected a slower inflation measure for determining tax brackets.
- In addition, the Act repealed the requirement in the Affordable Care Act requiring individuals to obtain healthcare coverage. (This provision raises over $300 billion over 10 years.)

Key Driver #1: Tax Cut for Individuals (cont'd)

- In general, the individual tax provisions will reduce taxes for individuals.
  - Higher-income individuals will receive larger benefits in absolute amounts (as compared to percentage amounts), especially as a result of the increase in the estate tax exemption.
- However, each individual will need to do the calculation to determine if there is a tax reduction. For example, some taxpayers in states with high state and local taxes may be worse off.
- Also note that most of the individual tax provisions will expire at the end of 2025.

Key Driver #2: Lower Corporate Tax Rate

- Under prior law, the U.S. federal statutory corporate tax rate was 35%, among the highest in the world. The average global statutory corporate tax rate is approximately 25%.
- Because of various deductions and other preferences, the effective U.S. corporate tax rate was significantly lower for various industries and companies, but not for others.
- The high U.S. tax rate encouraged companies to organize and do business elsewhere.
- The high U.S. tax rate encouraged multinational companies to use techniques to reduce U.S. tax liability, such as placing lots of debt in U.S. members of the multinational group, resulting in large U.S. interest deductions.
- The Act lowered the U.S. corporate tax rate to 21%. This will encourage U.S. and foreign companies to undertake more business activities in the United States. It will also reduce the incentive to erode the U.S. tax base by deductions.

Key Driver #2: Lower Corporate Tax Rate (cont'd)

- The Act also includes a provision to lower the tax rate on business earnings of owners of sole proprietorships and pass-through entities, including partnerships, limited liability companies taxed as partnerships, and S corporations.
- The provision provides a 20% deduction for such earnings, reducing the tax rate on qualifying earnings from the highest individual rate of 37% to 29.6%.
- Because of the continuing disparity between the corporate tax rate (21%) and the pass-through rate (29.6% or higher), an entity might consider converting from pass-through status to a corporation taxable at the 21% rate.
  - Note that this strategy is less helpful to the extent the corporation intends to pay dividends that will be subject to an additional tax to the shareholders.

Key Driver #3: Replacement of U.S. International Tax System

- Under prior law, active foreign earnings of foreign subsidiaries of U.S. corporations were subject to local tax in the foreign jurisdiction, but were not subject to immediate U.S. tax.
  - Some foreign jurisdictions, such as Ireland, have a low tax rate.
- The foreign earnings were subject to U.S. tax only when they were repatriated to the U.S corporation. The U.S. tax on repatriation was reduced by foreign tax credits for the tax paid to the foreign jurisdiction.
- In other words, the United States imposed tax on earnings around the world, but the tax on foreign earnings was deferred. It was a worldwide tax system with deferral.

Key Driver #3: Replacement of U.S. International Tax System (cont'd)

- Very few countries have a worldwide tax system. Most other countries have a system that does not impose tax on earnings from outside the country (an exemption system).
- The U.S. international tax system encouraged U.S. companies to move their income and activities offshore to lower-tax jurisdictions, and encouraged them to keep their foreign earnings offshore and not repatriate them to the United States.
  - At the end of 2017, U.S. multinationals had over $2 trillion in unrepatriated foreign earnings.
  - The Act includes a provision requiring an immediate tax on previously unrepatriated foreign earnings (at a 15.5% rate for foreign earnings held in cash, and at an 8% rate on foreign earnings held in other assets).
- The U.S. tax system also encouraged U.S. companies to emigrate by so-called inversions.

Key Driver #3: Replacement of the U.S. International Tax System (cont'd)

- The Act replaces the U.S. international tax system with a modified exemption system.
- In general, active foreign earnings of foreign subsidiaries of U.S. corporations are not subject to U.S. tax when earned. Furthermore, the earnings are not subject to tax when repatriated to the U.S. corporation. This result is accomplished by including the repatriated amounts in the U.S. corporation's income, and by providing an offsetting deduction for these amounts.
- It is a "modified" exemption system because of base erosion provisions, discussed next.

Key Driver #4: Base Erosion

- If there is no U.S. tax on active foreign earnings, either when earned or when repatriated to the United States, there is an an incentive to move activities and income offshore to lower-tax jurisdictions, as under old law.
- In fact, as compared to old law, under which active offshore earnings were subject to U.S. tax upon repatriation, under new law the active offshore earnings will never be subject to U.S. tax, which might increase the incentive to move activities and income offshore.
- On the other hand, the reduced U.S. corporate tax rate may offset any increased incentive to move income and activities offshore.
- In addition, despite the reduced U.S. corporate tax rate, there may still be an incentive for multinational companies to use techniques to reduce U.S. tax liability, for example by placing debt and interest deductions in U.S. members of the multinational group.

Key Driver #4: Base Erosion (cont'd)

- Because of concerns about erosion of the U.S. tax base, the Act includes various provisions to prevent it, including:
  - An immediate 10.5% tax on low-taxed offshore earnings - the tax on Global Intangible Low-Taxed Income (the GILTI tax);
  - An alternative tax calculation that adds back deductible payments by a U.S. corporation to a foreign related party - the Base Erosion and Anti-Abuse Tax (the BEAT);
  - Denial of deductions for interest or royalty payments that are excluded from income for foreign tax purposes, or that are paid by or to an entity that is treated as disregarded for U.S. tax purposes and not disregarded for foreign tax purposes (or vice versa); and
  - Denial of business interest deductions in excess of 30% of earnings before interest and depreciation deductions.

Key Driver #5: Encouragement of U.S. Business Activity

- The Act seeks to encourage activity in the United States rather than elsewhere.
- The Act includes a provision allowing a deduction that reduces the U.S. tax rate on foreign-derived income of a U.S. corporation - the deduction for Foreign-Derived Intangible Income (FDII).
- In effect, the deduction reduces the U.S. tax rate on the foreign income to 13.125%.

Effect of the 2017 Tax Act on the Business Community

- The business community favors the 21% corporate tax rate and the exemption for active foreign earnings.
- Other business provisions that are taxpayer-favorable include:
  - Expensing of new and used property (until it is gradually phased out starting in 2023); and
  - Repeal of the corporate alternative minimum tax.
- There are some business provisions that are taxpayer-unfavorable, such as:
  - The limitation on interest deductions;
  - The immediate tax on previously unrepatriated foreign earnings;
  - The GILTI tax;
  - The BEAT;
  - Limitations on the use of net operating loss carryovers; and
  - Required amortization of research and experimentation expenditures.

Effect of the 2017 Tax Act on the Business Community (cont'd)

- The 2017 Tax Act will also have financial statement impacts, some of which might not be favorable, such as:
  - The impact of the immediate tax on previously unrepatriated foreign earnings; and
  - The reduction in deferred tax assets as a result of the lowering of the corporate tax rate from 35% to 21%.
- The Act will have differing effects on different industries. In general, all types of industries should benefit, but the benefit will vary among industries and among businesses depending on their profiles.

Effect of the 2017 Tax Act on the Business Community (cont'd)

- What will U.S. companies do as a result of the 2017 Tax Act?
  - More capital investment?
  - More compensation to workers?
  - More dividends and stock buybacks?
  - More acquisitions? More cash acquisitions (because of limitations on interest deductions)? More asset acquisitions (because of expensing)?
  - All of the above? Some of the above?

What Policy Objectives Did the 2017 Tax Act Not Achieve?

- Two other important objectives of a tax reform bill would be (1) simplification, and (2) permanence.
- For many years policymakers and commentators have criticized the Internal Revenue Code for its complexity.
  - Other than the doubling of the standard deduction, which reduces the number of individual taxpayers itemizing their deductions, the 2017 Tax Act does not meaningfully simplify the Code.
- For many years policymakers and commentators have criticized the Internal Revenue Code for the instability caused by expiring provisions. Expiring provisions make it difficult for taxpayers to plan with certainty.
  - The 2017 Tax Act includes numerous expiring provisions, in particular most of the individual provisions will expire at the end of 2025.

How Will Other Countries React?

- Other countries will continue to compete for investment, including by lowering their corporate tax rates or providing other incentives.
- Other countries might respond by including income, denying deductions or otherwise increasing taxes on U.S. multinationals doing business in their countries.
- The World Trade Organization might challenge the FDII deduction as an illegal export subsidy.
- The European Commission will continue to pursue cases asserting that agreements between U.S. multinational companies and certain countries (such as Ireland) violate trade rules about unfair competition (the State Aid rules).

How Will the States React?

- It is not yet clear how the states will react to the 2017 Tax Act.
- States that impose a corporate income tax generally conform in some way to the Internal Revenue Code, either automatically, periodically or as to selective provisions.
- The corporate tax base for states will expand as a result of conformity, generally leading to higher state corporate tax revenues because states have their own tax rates.
- For example, will states adopt expensing? How will the limitation on interest deductions apply at the state level? How will the new international tax provisions affect the states?

How Will the States React? (cont'd)

- How will states react to the new limitation on the deductibility of state and local taxes?
- For example, New York State has enacted an optional employer payroll tax for which employees would receive a personal income tax credit against their New York State income tax liability.
- New York State has also enacted a charitable contribution regime under which individuals may contribute to certain state or local charitable funds and receive a tax credit against their New York State income taxes or real property taxes and (hopefully) receive a federal charitable contribution deduction.

What are the Chances of Federal Legislation?

- The 2017 Act has various glitches and ambiguities. The chances of technical corrections or other correcting legislation are slim in the near future.
- In the absence of reconciliation legislation, changes to the Act will require 60 votes to avoid a filibuster in the Senate. It is unlikely that Democrats will vote for changes to the 2017 Act without significant concessions by Republicans.
- The pending 2018 Congressional elections are another factor that will discourage enactment of legislation.

Administrative Guidance

- Responsibility has been passed to Treasury's Office of Tax Policy and the IRS to provide administrative guidance to clarify and interpret the Act.
  - The guidance will be in the form of notices, as well as proposed, temporary and final regulations.
  - Because it will take some time for the government to issue guidance, there will be a period of time when taxpayers and their advisors will need to interpret the Act without guidance.
- On April 12 the Treasury Department and OMB (Office of Management and Budget) entered into a Memorandum of Agreement increasing the role of OMB in the promulgation of tax regulations.
  - It is unclear what effect the MOA will have on the substance of regulations and the speed of issuance.

Factors to Consider in Selecting the Type of Guidance

- Notice and comment
- Speed
- Scope of coverage
- Final rules

Guidance Priorities

- Section 965 (deemed repatriation of offshore earnings)
- GILTI (Section 951A and Section 250)
- BEAT (Section 59A)
- FDII (Section 250)
- Section 163(j) (limitation on interest deductions)
- Section 199A (deduction for qualifying pass-through or sole proprietorship business income)
- Other 2017 Act projects?
- In the next year or so, it is unlikely that Treasury and the IRS will focus much attention on projects not relating to the 2017 Act, other than urgent projects.

IRS Administration and Enforcement

- The IRS will have to administer and enforce the new law.
- The IRS will need to revise dozens and forms and publications.
- The IRS will need to modify its computer systems.
- IRS enforcement levels are low and the new law will add to enforcement challenges.

Budget Outlook

- The federal long-term budget outlook is challenging.
- Federal debt rose from 35% of GDP in 2007 to 76% in 2017, in part because of the Great Recession.
- According to the Congressional Budget Office (CBO), Federal debt is projected to rise to about 96% of GDP in 2028, in particular because of Medicare, Medicaid and Social Security spending.
- Interest costs will also rise because of accumulating debt.
- CBO estimates that, by FY2019, the federal deficit will rise to about $980 billion and will grow steadily thereafter ($1.5 trillion in 2028).
- Federal revenues will not offset higher entitlement spending and interest costs.

Budget Outlook (cont'd)

- Many provisions of the 2017 Act, particularly the individual provisions, are scheduled to expire in 2025.
- The CBO projections on the previous slide are based on the 2017 Tax Act as enacted, including the scheduled expiration of many provisions.
- Making the Act's expiring provisions permanent would significantly increase the federal debt and deficits.

Potential Solutions to Budget Challenges

- How will the federal government address increasing debt and deficits? Spending reform, such as reducing entitlement programs? Increased taxes? Both?
- Are we done with tax reform?
- At some point in the future, will we need new taxes, such as a value-added tax or a carbon tax?

The End

Unanticipated Pitfalls

In Dealing with Texas Tax Laws

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I. SUCCESSOR LIABILITY

A. Successor Tax Liability Upon Transfers Of Businesses.

1. Successor liability provisions – in general. Most states have some variation of the requirement that a purchaser has a responsibility and/or potential liability for unpaid tax liability on the part of the selling entity if certain steps are not taken to satisfy that liability. Some provisions apply only to sales tax liability; others pertain to other taxes as well.

a. The taxing authority typically requires that there be some notification that the transfer of the business has occurred. This reporting requirement is usually within a short period of time of the transfer.

b. The acquirer is often required to either get some evidence of no tax due by the selling entity, or withhold and/or pay over to the taxing authority those amounts if an assurance of no tax due is not received.

c. If the acquirer has not followed the prescribed requirements, and there is some tax amount due, the acquirer is usually made liable for unpaid taxes owed by the seller (up to the amount of the purchase price) as a successor in interest. The successor cannot challenge the underlying propriety of the tax liability. This is true even when the tax liability was not assessed until after the acquisition. *See Agri-Plex Heating and Cooling, LLC v. Hegar*, No. 03-15-00813-CV (Tex.App.—Austin 2017, no pet.) (memorandum opinion).

d. It is not unusual for an acquirer not to request tax clearance information from the taxing authorities in connection with an acquisition. This usually happens either because (i) there is insufficient time before closing to obtain the necessary information from the taxing authority, or (ii) there is a (valid) fear that an audit will be triggered by such a notification or request.

e. **CAVEAT**: If an acquirer does not receive the necessary clearance from the taxing authorities, the purchaser should obtain an indemnification from the seller with respect to any tax, penalty and/or interest that is ultimately asserted against the acquirer pertaining to such prior liabilities. Further, the acquirer should have a high comfort level that the seller/indemnitor is capable of, and will perform on the indemnification if necessary. Failure to protect itself can easily result in the acquirer being liable for a debt that does not properly belong to the acquirer.

B. Tax Collection on Termination of Business - Successor Liability in Texas State Taxes.

1. There is a potential withholding requirement on the part of successor in interest to the owner of a business (per TEX. TAX CODE ("Tax Code") § 111.020) unless and until the seller provides a receipt from the Texas Comptroller of Public Accounts ("Comptroller") showing either that tax amounts have been paid or no tax is due.

2. In general, a purchaser of a business or stock of goods who (or which) fails to withhold an amount of purchase price is liable for the amount required to be withheld to the extent of the value of the purchase price. Tax Code § 111.020(b). In situations involving fraud, however, the successor can be held liable for tax in excess of the purchase price. See Tax Code § 111.024.

3. There must be consideration transferred in order for there to be a purchase price. Unless there is consideration in a transaction, there should be no successor liability. See Comptroller Decision No. 32,202 (1995) where a repossession of inventory by the prior seller of a business was not deemed to be consideration for successor liability purposes.

4. When determining if a "business" has been sold, the Comptroller will examine the transaction to determine what the parties to the transaction intended to buy and sell. 34 TEX. ADMIN. CODE ("Rule") § 3.7(d).

5. A purchaser may request that the Comptroller issue a certificate stating that no tax is due or issue a statement of the amount required to be paid before a certificate may be issued.

a. The Comptroller is required to issue a certificate or statement within 60 days after receiving the request or within 60 days after the day on which records of former owner made available for audit (whichever date is later), but in no event more than 90 days after receiving the request. Tax Code § 111.020(c).

b. If the Comptroller fails to mail the certificate or statement within the applicable period, the purchaser is released from the obligation to withhold the purchase price. Tax Code § 111.020(c).

> Where purchaser of business requested a certificate of no tax due and Comptroller provided results of audit more than 90 days after request was received, Comptroller was

barred from collecting tax from purchaser. Comptroller Decision Nos. 14,609, 16,093 (1985).

c. The seller is required to inform the Comptroller in writing of the name and address of purchaser and must file a final report immediately after the sale of the business. Rule 3.7(f).

d. The taxing authority (i.e., the Comptroller) has the initial burden of making a *prima facie* case that there has been a successor liability event. See Comptroller Decision Nos. 107,836 (2014); 44,506-44,507 (2006); 42,071 (2005); 33,110 (1995). Once a *prima facie* case has been established, the burden of proving by a preponderance of the evidence that there has not been a sale shifts to the purchaser. Comptroller Decision No. 39,257 (2001).

e. If the Comptroller staff does not establish a *prima facie case* that there has been a successor liability event no such liability passes to the purchaser. Thus, when it clear that taxpayer had acquired a floor-covering business from predecessor, Comptroller staff did not demonstrate when an asserted successor liability was made against the purchaser, when the assessment against Predecessor was final, and that an unpaid balance of tax was actually due from Predecessor. Comptroller staff failed to meet its *prima facie* burden, and as a result the successor liability assessment issue against the taxpayer was dismissed. Comptroller Decision No. 109,480 (2017).

f. Provisions in a sale contract between seller and buyer as to which party has resulting tax obligations have no binding effect on the Comptroller. Consequently, where the parties to a sale transaction agreed that the buyer of that business would not be liable for the debts of the seller, the buyer was still subject to successor liability provisions with respect to the seller's unpaid taxes. Comptroller Decision No. 10,316 (1979).

6. Per Comptroller Rule, a seller may be deemed to have sold a business even when few assets are transferred. *E.g.*, the following may be deemed "business" sales (a non-exclusive listing) if the owner sells:

a. A building, land, furniture, fixtures, inventory and the right to use the seller's trade name, or

b. All the capital assets of a business, or

c. The name and goodwill of a business, or

d. All the inventory of a business, or

e. Fixed assets and realty necessary to operate a similar business as the seller at the same location. Rule 3.7(d).

f. Example: The Comptroller has ruled even though no physical assets were transferred, establishing a new business utilizing predecessor corporation's trade name, phone number and goodwill was sufficient to result in successor liability . Comptroller Decision Bi, 111,329 (2017). See also Comptroller Decision No. 108,899 (2016).

7. Sole proprietor with tax obligation incorporated and transferred business to new corporation. The prior tax liability of the sole proprietor follows and becomes a liability of new corporation. Comptroller Decision No. 35,696 (1998).

8. Purchaser acquired a business from an unrelated seller several months after the seller had shut down business operations. Purchaser used a different name for the business, but located it in an office suite next to where the seller had previously operated the business. The purchaser acknowledged he hoped to garner the benefit of the defunct business based on operating the acquired business with many of the same assets in close proximity to the previous business. Result – Purchaser's acquisition of assets was considered to be a sale. Comptroller Decision No. 44,506 (2003).

9. Successor Liability Considerations – Foreclosure and Bankruptcy. Tax Code § 111.020

a. Exception for sale by bankruptcy trustee or estate - not a sale by a vendor or former owner for purposes of Tax Code § 111.020 successor liability provisions and the purchaser will not incur liability thereunder.

b. The conclusion in several Comptroller decisions is that successor liability per Tax Code § 111.020 should not flow through a mortgagee to a purchaser with respect to foreclosures because the mortgagee was not itself a purchaser of the property. See Comptroller Decision Nos. 22,978; 24,563-24,569 (1989).

c. For contrary results with respect to a similar statute (Tax Code §§ 351.0041 and 351.002(a)) dealing with the Texas municipal hotel occupancy tax, see *City of Amarillo v. Ray Berney Enterprises, Inc.*, 764 S.W.2d 861 (Tex. App.–Amarillo 1989, no writ).

d. The sale of assets by a seller who took an installment note back from the purchaser ultimately resulted in a default by the purchaser. The original owner took back the business, and forgave the remaining debt owed by purchaser. The seller/reacquiror reasoned there was no consideration paid upon reacquisition of the business assets and therefore no sale occurred. Upon refund claim denial hearing, the auditor asserted failure to report the reacquisition of the business assets as a sale indicated a fraudulent transfer or sham transaction (pursuant to Tax Code § 111.0335). ALJ concluded that the original seller/reacquiror had not engaged in a fraudulent transfer – but concluded the transfer of the business assets back to the original seller/reacquiror did constitute a sale. As a result, the original seller/reacquiror was held liable for delinquent taxes to the extent of the purchase price of the business – that being the amount of debt forgiven by the original seller/reacquiror. The deemed purchase price of the business exceeded the original seller/reacquiror's refund claim amount and the claim was therefore denied. Comptroller Decision No. 110,931 (2015).

e. The language of Tax Code § 111.020 describes the responsible party (i.e., the successor) as a "purchaser;" and not (for example) as one who acquires a business in any manner – such as through repossession resulting from a failed transaction. Case law holds that any doubt as to legal authority for the reach or application of the tax is to be resolved in favor of the taxpayer. It is a so-called "imposition" tax.

f. If a foreclosure is not conducted with the proper formalities, a purchaser may still have tax liability as a successor. That was the result in a hearing where the Comptroller tax division argued that the transaction at issue was a failed foreclosure, the result of which would have been successor liability for the purchaser. The administrative law judge ("ALJ") concluded there was not sufficient proof that the foreclosure was improper, or in fact, that a foreclosure had actually occurred. Furthermore, the Tax Division had not proved up consideration passed from buyer to seller. Result – buyer was not deemed to have purchased assets from the seller whose property was (allegedly) foreclosed – no successor liability. Comptroller Decision No. 29,568 (1994).

g. A taxpayer who bought a restaurant that was in financial difficulty and had been subject to a Small Business Administration ("SBA") lien was liable for sales tax owed by preceding owner. Taxpayer argued this type of sale was analogous to a foreclosure sale, in which case the exception to successor liability provision applied. A review of the facts revealed the sale did not formally involve the SBA – and the foreclosure exception to successor liability did not apply. Comptroller Decision No. 29,559 (1994).

10. Successor liability provisions apply to all taxes in Chapters 2 and 3 of the Texas Tax Code (*i.e.* all taxes except for property tax). Rule 3.7(a). As discussed in more detail below, however, there are also property tax successor liability provisions that can be applicable. See Tax Code § 31.081.

11. Successor liability provisions vary by state. Consult the applicable successor tax liability provisions for the specific state(s) at issue. CAVEAT: When in doubt, be sure to get assistance of local counsel to assure compliance with the provisions, or to assure an understanding of what liability for failure to so comply will be. **DO NOT ASSUME THE SUCCESSOR LIABILITY PROVISIONS ARE THE SAME FROM STATE TO STATE. CONSULT LOCAL COUNSEL FOR FURTHER ADVICE.**

12. Additional Successor Liability Rulings and other Determinations

a. Successor not liable even though taxpayer began business at same location of previous owner, where there was no evidence of any purchases by or transfers to taxpayer, nor evidence of consideration given by taxpayer for purchase. Comptroller Decision No. 30,262 (1994).

b. The purchase of the name of the prior business and use of an existing telephone number at the same location of the selling entity was not deemed to be the purchase of an existing business. The buyer entered into a new lease with the landlord, provided new inventory, and basically started a new business. Consequently there was no successor liability resulting from the acquisition of the name and telephone number. Comptroller Decision No. 33,110 (1995).

c. Provision in sales contract that buyer of business was not responsible for seller's debts did not alter buyer's liability as successor for seller's delinquent taxes. Comptroller Decision No. 10,316 (1979).

d. The Comptroller considers whether there was intent to sell a business in determining whether there has been such a transfer. In a transaction where the purchase agreement provided the acquiring taxpayer was conveyed the right, title and interest in a business, and the items purchased included the leasehold, furniture and fixtures, inventory, the business name and a clientele list, the Comptroller ruled there was a business transfer. Successor liability was incurred. Comptroller Decision No. 35,441 (1997).

e. The purchaser of a going concern was deemed liable for the unpaid sales tax of its predecessor where a change in the method used to generate business was held to not change the nature of the business purchased. The purchaser (an outside sales office supply business) acquired a retail office supply business at the same location as the selling entity. The purchaser was still held to be operating a continuing office supply business – and successor liability attached. Comptroller Decision No. 24,762 (1989).

f. Shutting down an operating business in one type of entity and reopening essentially the same business in another legal entity will typically not avoid successor liability for any taxes owed by the transferor. Thus, for example, incorporating a sole proprietorship with tax liabilities will result in the corporate entity incurring transferee liability with those unpaid. See Comptroller Decision No. 35,696 (1998). The same result is likely to occur if corporate entity A ceases operations and newco Corporation B starts a "new" business in a new corporate (or LLC or partnership or…) entity.

C. Fraudulent Transfer Successor Liability Considerations. Tax Code Statutory Provisions § 111.024.

1. A person who acquires a business or the assets of a business from a taxpayer through a fraudulent transfer or a sham transaction is liable for any tax, penalty and interest owed by the taxpayer. Tax Code § 111.024(a). A fraudulent transferee can therefore be liable for a tax amount that exceeds the purchase price paid.

2. A transfer of a business or the assets of a business is considered to be a fraudulent transfer or a sham transaction if the taxpayer made the transfer or undertook the transaction:

a. With intent to evade, hinder, delay or prevent the collection of any tax, penalty or interest owed under this title; or

b. Without receiving a reasonably equivalent value in exchange for the business or business assets subject to the transfer or transaction.

(Tax Code § 111.024(b))

3. In determining intent of the taxpayer (as to evade, hinder or delay payment of tax) consideration may be given, among other factors, to whether:

a. The transfer was to a current or former business insider, associate or employee of the taxpayer or to a person related to the taxpayer within the third degree of consanguinity by blood or marriage;

b. The transfer was to a third party who subsequently transferred the business or assets of the business to a current or former business insider, associate, or employee of the taxpayer or to a person related to the taxpayer within the third degree of consanguinity by blood or marriage;

c. The taxpayer retained possession or control of the business or the assets of the business after the transfer or transaction;

d. The taxpayer's business and the transferee's business are essentially operated as a single business entity at the same location;

e. Before the transfer or the transaction occurred, the taxpayer had either been subjected to or apprised of impending collection action by the Comptroller or by the attorney general;

f. The transfer or transaction was concealed

g. The taxpayer was insolvent at the time of the transfer or became insolvent not later than the 31st day after the date the transfer or transaction occurred; or

h. The transfer or transaction involved all or substantially all of the taxpayer's assets.

(Tax Code § 111.024(c))

4. The fraudulent conveyance provisions do not apply to a transfer of a business or the assets of a business:

a. Through a court order on dissolution or a marriage; or

b. By descent and distribution or testate succession on the death of a taxpayer.

(Tax Code § 111.024(d))

5. The interplay of the successor liability provisions of Tax Code § 111.020 and the fraudulent conveyance liability provisions of Tax Code § 111.024 serve to

keep a taxpayer who owns one business from shutting down or abandoning that enterprise and subsequently starting up a new business with some or all of the old business assets. Doing so will very likely result in successor liability from the old business attaching to the newly established enterprise.

6. A convenience store company assessed liability for unreported taxable sales was also deemed to have successor liability for taxes owed by the former owner of the convenience store. The owner of the predecessor entity was the brother of an officer of the new entity which acquired the assets of the prior entity. Those facts, coupled with non-disclosures on the sales tax application, were deemed *prima facie* that the fraudulent transfer provisions of the Tax Code § 111.024 applied. Comptroller Decision No. 104,533 (2012).

7. Fraudulent transfer / sham transaction provisions of Tax Code § 111.024 were also applicable in the following hearings:

a. During the course of a mixed beverage gross receipts tax audit of a night club business the company sold assets of the business to a third party. The acquiring entity was assessed tax pursuant to the fraudulent transfer provisions of Tax Code § 111.024. The successor argued for insolvency relief. The insolvency claim was denied with the notation that insolvency relief is denied in cases involving fraudulent transfers. Comptroller Decision No. 47,837 (2012).

b. A refrigerator and repair business that acquired the assets of a predecessor entity was subject to fraudulent transfer provisions. The acquirer had previously operated under five different taxpayer ID numbers, but was determined to be essentially the same business. Several factors deemed to be indicators of a sham transaction / fraudulent transfer pursuant to Tax Code § 111.024 were deemed present, including: transfer to a current or former business insider ((c)(1)); taxpayer retained possession of the business ((c)(3)); taxpayer's business was essentially operated as a single business entity at the same location ((c)(4)); taxpayer was subject to or knew about pending collection action at the time of the transfer ((c)(5)); and the transferor was insolvent (or became insolvent) at a time within 31 days of the transfer ((c)(7)). Comptroller Decision No. 101,355 (2013).

c. The sole proprietor of a computer consulting and repair business who transferred the assets of the business to a newly formed sole member LLC at a time when the individual was insolvent and when tax collection actions were impending was deemed to be *prima facie* evidence that fraudulent transfer / sham transaction had occurred. Comptroller Decision No. 106,447 (2012).

d. When some of the same individuals were involved the sale and purchase, for nominal consideration, of what was deemed to be a business which had previously been assessed a tax liability, such transfer was treated as a sham transaction entered into to evade tax. The transferee entity was subject to a 50% § 111.024 fraud penalty. Note: The "sale" consisted of a transfer of only a trade name and operations by acquirer at the same location as seller. Comptroller Decision No. 110,329 (2015).

8. Taxpayer deemed not to be a fraudulent transferee. Merely establishing that tax was collected but not remitted does not, by itself, establish a *prima facie* case that the fraudulent transfer provisions of Tax Code § 111.024 apply. Nor does merely operating the same business at the same location before or after the transfer without further factors present indicate intent to evade taxes. There needed to be some pending or threatened collection action the transferor knew about before the fraudulent transfer provisions applied. The Tax Division failed to carry its burden of proof and the case claiming a fraudulent transfer was dismissed. Comptroller Decision No. 104,681 (2012).

D. Property tax successor liability – withholding required on purchase of a business or inventory.

1. Persons who make such a purchase are required to make withholding payments on business personal property, or face personal liability. Tax Code § 31.081(a).

2. Purchaser is required to hold from purchase price an amount sufficient to pay all taxes imposed on personal property of a business (plus penalty and interest) until seller provides purchaser with:

a. A receipt from appropriate tax collector showing taxes, penalty or interest have been paid, or

b. A tax certificate from the collector from each taxing unit stating no taxes, penalty or interest is due the taxing unit. Tax Code §§ 31.08; 31.081(b). The tax certificate may be requested by the purchaser. Tax Code § 31.081(d).

3. A purchaser who (or which) fails to withhold or obtain a required tax certificate is liable to the taxing

unit to the extent of the purchase price. Tax Code § 31.081(c).

> Successor liability for property taxes occurs upon the acquisition of a business. Thus a taxpayer that purchased business after the first of the year was liable for entire year's ad valorem tax rather than only having liability for a pro rata share of the acquisition year's tax. Tax Code § 31.081. *Dan's Big & Tall Shop, Inc. v. County of Dallas,* 160 S.W.3d 307 (Tex. App.–Dallas 2005, pet. denied).

4. An action under Tax Code § 31.081(a) does not release the seller of the business or inventory taxes imposed. Tax Code § 31.081(f).

5. For purposes of Tax Code § 31.081, a person is considered to have purchased:

a. A business, if the person purchases the name or goodwill of the business, and

b. The inventory of the business, if the person purchases inventory of a business which is at least 50% of the value of the total inventory of the business on the date of the purchase. Tax Code § 31.081(g).

> Comptroller held that taxpayer neither 1) purchased "the business", since he did not acquire the name, business location, or any goodwill associated therewith, or 2) its "stock of goods", since he only purchased 20% of inventory. See Comptroller Decision No. 12,822 (1983).

c. At issue in a property tax successor liability withholding case was whether there was, in fact, transfer of inventory that would result in liability to acquirer pursuant to Tax Code § 31.081. A tax delinquency proceeding was instituted against acquirer of business with substantial inventory. Acquirer asserted tax delinquencies were claimed due with respect to multiple appraisals of a property and property that did not exist, and filed a motion with the appraisal district pursuant to Tax Code § 25.25(c) to correct such errors in the appraisal rolls. Acquirer argued that the tax delinquency proceedings should be abated pending the determination of the Tax Code § 25.25(c) motion. When the trial court refused to do so, acquirer filed an appeal asserting that failure to abate the tax delinquency proceeding pending the outcome of the Tax Code § 25.25(c) motion was an abuse of discretion. The appellate court concluded otherwise, noting that: i) acquirer had failed to pay uncontested amount of property tax due (in violation of Tax Code § 42.08), and ii) if acquirer ultimately prevailed in its § 25.25(c) motion, it could file a claim for refund with the appraisal district. *TVMAX Holdings, Inc. v. Spring Indep. Sch. Dist.*, No. 01-14-00304-CV, 2015 WL 1967596 (Tex. App.–Houston [1st Dist.] April 30, 2015, no pet.) (not reported). In practice the question of whether a pending tax delinquency case will be abated pending the outcome of a Tax Code § 25.25(c) motion is often a discretionary determination on the part of plaintiff taxing authorities.

> Observation: Not allowing a Tax Code § 25.25(c) motion proceeding to be completed that might otherwise resolve a tax controversy without costly litigation raises the question of whether this was good use of the resources of the court and the taxpayer.

E. Successor liability – Hotel Occupancy Tax Considerations

1. A hotel tax is imposed on persons on use or possession of hotel type business (when stay is less than 30 days). See Tax Code Chapter 156.

2. A successor/acquirer of hotel is required to withhold an amount of the purchase price sufficient to pay any tax amount due state unless a certificate of no tax due is obtained from Comptroller. Tax Code § 156.204(a).

a. A taxpayer that purchased real property at a foreclosure sale that was subject to hotel occupancy tax incurred successor liability for taxes owed by the mortgagor foreclosed upon. In this transaction title never vested in the creditor – it passed directly from mortgagor to the purchaser at the foreclosure sale. Comptroller Hearing No. 22,292 (1989). A purchaser of property in a properly conducted foreclosure would not be liable as a successor because the purchaser would not be buying the property directly from the seller. As evidenced by the result in Comptroller Hearing No. 22,292, that does not mean, however, that the seller and/or a third party in a foreclosure could not still have a successor tax liability resulting from the transaction.

b. City was entitled to pursue collection of unpaid hotel occupancy taxes from prior owner of hotel, who was required to collect this tax in the first place, as well as from lender who purchased hotel at foreclosure sale and failed to withhold amount of occupancy taxes due from purchase price. Obligation of prior owner to pay occupancy tax is not extinguished by foreclosure. *Calstar Properties, L.L.C. v. City of Fort Worth*, 139 S.W.3d 433 (Tex. App.–Fort Worth 2004, no pet.).

c. Sale of a hotel property doesn't relieve seller of hotel tax liability – irrespective of whether the successor/purchaser was liable for the tax. In addition, seller's attempt to use current documentation to support claims for earlier periods was also rejected. Note: Commentary by the ALJ suggests that if Petitioner/taxpayer had shown there was no significant change in operations from the period in which the tax liability arose and the time of hearing, there might have been a different outcome. Comptroller Decision No. 22,447 (1998).

3. The procedure for requesting and obtaining a certificate of no tax due for state hotel tax purposes and consequences for failure to do so are similar to analogous provisions pertaining to general Comptroller successor liability. See Tax Code § 156.204(b)-(e).

4. Successor liability for hotel purchases – local taxing authorities.

a. Similar to state taxing authority successor liability provision, but at local level.

b. Requests for no tax due/clearance certificate are to be directed to person designated by municipality in which hotel located (including extra territorial jurisdiction). See Tax Code §§ 351.001, 351.002, et seq.

F. Employment Tax – Business Transfer Considerations

1. Texas unemployment compensation provisions administered by Texas Work Force Commission ("TWC"). TEX. LABOR CODE ("Labor Code") §§ 201.001 et seq.

2. Texas Unemployment Compensation. Texas imposes a payroll/ unemployment tax on employees based upon an experience rating of unemployment claims that have been filed and sustained against employees in the state. Labor Code § 201.001, et seq.

3. Under the Texas Unemployment Compensation Act, an employing unit that acquires all of the business of an employer and continues that business of an employer and continues that business also acquires the predecessor's compensation experience if there is a connection between the acquirer and acquiree, *e.g.*, a common shareholder, officer or other owner of a legal or equitable interest. Labor Code § 204.083.

4. Conversely, the acquirer can be a new employer, without the predecessor's experience, where there are not related shareholders, directors or officers of the acquiring or selling business. Labor Code § 204.081 et. seq.

5. There may be situations where only a part of the business is sold, and the acquirer wants to retain the experience rating of the predecessor business that would otherwise not occur. In such a case, the successor and predecessor employers may apply to the Texas Workforce Commission to transfer the attributable compensation experience, which may be approved upon a showing of the following factors: Labor Code § 204.084.

a. Immediately after the acquisition, the successor employer continues operation of substantially the same business or the part of the business or organization acquired;

b. The predecessor employer waives, in writing, all rights to an experience rating computed on the compensation experience attributable to the part of the business acquired by the successor employer, unless the acquisition results from the predecessor's death;

c. A definitely identifiable and segregable part of the predecessor's compensation experience is attributable to the part of the business acquired; and

d. The successor employer was not an employer within the terms of the Act at the time of the acquisition, but elects to become such an employer on the date of the acquisition or otherwise becomes an employer during the year in which the acquisition occurs. *See State v. Williams & Mettle Co.*, 888 S.W.2d 162 (Tex. App.–Austin 1994, writ denied).

e. There are limitations on the ability to utilize the compensation experience rating of a predecessor employee if TWC determines that the transfer of the experience rating was accomplished solely for the purpose of obtaining a lower contribution rate. See, e.g., Labor Code §§ 204.083(d), 204.0861.

II. PERSONAL LIABILITY FOR TEXAS TAXES

A. State Of Texas Imposes A Trust Fund Liability on Responsible Persons.

The State of Texas imposes a trust fund liability tax on responsible persons pursuant to the dictates of Tax Code § 111.016. It is similar in scope and purpose to Internal Revenue Code § 6672 responsible person provisions (the 100% penalty tax). Specific requirements of the trust fund tax are as follows:

1. Tax Held in Trust. Any person who receives or collects a tax or any money represented to be a tax from another person is deemed to hold the amount so collected in trust for the benefit of the state and is liable to the state for the full amount collected plus any accrued penalties and interest. Tax Code § 111.016(a).

2. Who is a "responsible individual" for purposes of the trust fund tax? An individual who controls or supervises the collection of tax or money from another person, or an individual who controls or supervises the accounting or paying over of the tax or money, and who willfully fails to pay or cause to be paid the tax or money is considered to be a responsible individual. Tax Code § 111.016(b).

3. By statute, a "responsible individual" includes (but is not limited to) an officer, manager, director, or employee of a corporation, association, or limited liability company or a member of a partnership who (in such capacity) is under a duty to perform an act with respect to the collection, accounting, or payment of a tax or money subject to the provisions of Tax Code § 111.016(a). Tax Code § 111.016(d).

4. "Tax" is defined to include penalty and interest responsible person purposes. Tax Code § 111.016(d)(2). The essence of Tax Code § 111.016 is discussed later in this outline.

5. Responsible person – selected Tax Code § 111.016 statutory provisions.

a. Any person who receives or collects a tax or any money represented to be a tax from another person holds the amount so collected in trust for the benefit of the state and is liable to the state of the full amount collected plus any accrued penalties and interest on the amount collected. Tax Code § 111.016(a).

b. A person is presumed to have received or collected a tax or money represented to be a tax for the purpose of this section if the person files, or causes to be filed, a tax return or report with the Comptroller showing tax due. A person may rebut this presumption by providing satisfactory documentation to the Comptroller that the tax on a transaction or series of transactions was not collected. Tax Code § 111.016(a-1). *See Alon USA, LP v. State*, 222 S.W.3d 19 (Tex. App.–Austin 005, writ denied).

c. An individual who controls or supervises the collection of tax or money from another person, or an individual who controls or supervises the accounting for and paying over the tax or money, and who willfully fails to pay or cause to be paid the tax or money is liable as a responsible individual for an amount equal to the tax or money not paid or caused to be paid. The dissolution of a corporation, association, limited liability company, or partnership does not affect a responsible individual's liability. Furthermore, an individual may be help personally liable for a trust fund tax even if not affiliated with the business entity to which the tax relates. Tax Code § 111.016(b).

6. If the tax liability of the legal entity with which the responsible individual was employed or associated has either not become final, is subject to tolling of limitations or is the subject of a federal bankruptcy proceeding, the statute of limitations relating to the period during which the individual may be personally assessed by the Comptroller is stayed until the first anniversary of the date the liability becomes final or the date the bankruptcy proceedings is closed or dismissed. Tax Code § 111.016(b-1).

7. The district courts of Travis County have exclusive, original jurisdiction of a suit dealing with responsible person litigation. Tax Code § 111.016(c).

8. For purposes of § 111.016 providing that a "responsible" person can be held liable for a company's collected but unremitted state sales tax if he "willfully" fails to pay the tax, "willfully" encompasses both actual knowledge and a responsible individual's reckless disregard of the risk that taxes may not be remitted.

a. Where a corporation performed jobs that were both subject to and not subject to sales tax, the corporation's bookkeeper incorrectly marked the jobs at issue as non-taxable in the corporation's monthly sales tax returns and payments. Upon audit, the taxable transactions were treated as taxes collected and not remitted. Evidence brought forward was sufficient to establish that corporation's officers did not "knowingly" fail to remit the collected taxes, for purposes of determining whether officer's acted "willfully." The officers were therefore not personally liable for unremitted taxes. *State v Crawford,* 262 S.W.3d 532 (Tex. App.–Austin 2008, no pet.).

b. In a situation where there was an inability to access funds due to be paid to the Comptroller because such funds were in possession of a bankruptcy trustee, corporate officers against whom the Comptroller asserted responsible person statute (with corresponding personal liability) argued they should not be liable for the unremitted taxes. The Comptroller did not agree, essentially holding that sales tax amounts should have been submitted to the Comptroller before there ever was a bankruptcy proceeding. Comptroller Decision No. 109,848 (2015).

9. Responsible Person Determinations

a. Corporate president and director could be held jointly and severally liable with corporation for conversion of gasoline and diesel fuel taxes collected by corporation on State's behalf, given his actions in instigating, aiding or abetting corporation in spending of State's tax money for corporate purposes. The corporate president/director argued he could not be held liable for spending fuel tax amounts collected from customers on corporate expenses. He was unclear on the concept – and did not prevail in his argument. Those who have the ability to direct payment of trust fund taxes and do not make sure the state is paid are at risk. See *Dixon v. State,* 808 S.W.2d 721 (Tex. App.–Austin 1991, no writ).

b. A liquidation trustee appointed under debtor's confirmed bankruptcy plan who "willfully" failed to remit state sales taxes from debtor's restaurants to the Texas Comptroller was held personally responsible for his professional conduct. Trustee admitted that he knew that the sales taxes were due to the Comptroller but used the money to pay other creditors, including suppliers and staff. This was the result notwithstanding the trustee's "good intentions" of maximizing the estate's value. Tax Code § 111.016 (b). *In Re Texas Pig Stands, Inc.,* 610 F.3d 937 (5th Cir. 2010).

c. By definition, responsible individual includes an officer, manager, director, or employee of corporation, association, or limited liability company, or a member of the partnership who, as an officer, manager, director, employee or member, is under a duty to perform an act with respect to the collection, accounting, or payment of a tax money subject to the provisions of Tax Code § 111.016(a).

d. If corporate taxpayer's officer and director can be held individually liable under provision of Tax Code imposing individual liability on any person who receives or collects a tax, State must still prove actual amount officer received or collected. The individual liability is limited to amount collected absent a showing of a fraudulent transfer. See Tax Code § 111.016(a).

e. For one to be held individually liable under § 111.016, the State must 1) prove the actual amount he received or collected, and 2) prove his liability is limited to the "amount collected." Proof, by means of comptroller's certifications, of the full amount of corporate tax liability is insufficient. The State failed to carry its burden – taxpayer prevailed. See *N.S. Sportswear, Inc. v. State,* 819 S.W.2d 230 (Tex. App.–Austin 1991, no writ).

f. In order to recover a corporation's delinquent sales tax from an individual, the State must show: 1) that the tax is due; 2) that the individual was responsible for the delinquency; and 3) the amount of tax actually collected by the individual. The State must affirmatively prove the specific amount of tax actually collected by the individual. The Comptroller's certificate does not meet this burden. *Herrera v. State,* No. 03-01-00101-CV, 2002 WL 185476 (Tex. App.–Austin Feb. 7, 2002, no pet.) (unpublished opinion).

g. Where there are no facts establishing an individual's liability and the only documentation provided by the Tax Division in the administrative process was a certification of tax liability from the Comptroller, the State was unable to meet its evidentiary burden of proving the amount of money actually collected by the target individual and not remitted. This was the result even though the individual in question admitted he had collected some amount of tax and failed to remit same to the Comptroller. The State's failure to prove up the amount of tax collected and not remitted resulted in a decision that no amount was due from the asserted responsible person. *Herrera v. State,* 2002 WL 185476. See also *Parker v. State,* 36 S.W.3d 616 (Tex. App.–Austin 2000, no pet.).

h. When the reason for the Comptroller's inability to present documentation in support of the asserted tax liability is due to taxpayer's lack (or inadequacy) of records, the taxing authority is given more leeway to press its claim that responsible person liability applies.

i. Where the Comptroller's auditors asserted liability based on only two categories of items sold at a convenience store (beer and cigarettes) and relied on cash register tapes and vendor records of beer sales to support their claim of taxes collected and not remitted, the court agreed that such an approach was reasonable and sufficient. The two audited items were selected because of the presumption (accepted by the court) that all sales of those items were subject to sales tax. The result was responsible person liability for the person who was in charge of the operations. See *Khan v. State,* No. 03-09-00708-CV, 2011 WL 3890394 (Tex. App.–Austin, Aug. 31, 2011, no pet.). To the same affect is Comptroller Decision No. 404,689 (2013).

B. Forfeiture of Corporate Privileges, Charter or Certificate of Authority.

1. Forfeiture of Corporate Privileges. Pursuant to Tax Code § 171.251, a corporation's corporate privileges are required to be forfeited by the Comptroller if the corporation:

a. Does not file within 45 days after the date notice of forfeiture is mailed a required franchise tax report.

b. Does not pay, within 45 days after the date of notice of forfeiture is filed, tax or penalty under the franchise statute.

c. Does not permit the Comptroller to examine the corporation's records.

2. Result of Forfeiture of Corporate Privileges. If corporate privileges are forfeited, the corporation is not entitled to the use of the state's courts to sue or defend. Further, each director or officer of the corporation is liable for debts of the corporation from the date of the forfeiture. Tax Code §§ 171.252, 171.255. If the corporate privileges are so forfeited, each director or officer of the corporation is liable for each debt of the corporation that is created after the date such report, tax or penalty is due (including any taxes that become due). Liabilities determined to be due as result of forfeiture are joint and several with respect to officers and directors that do not have a valid defense. Thus an argument by a one third member/owner that he should be liable for only one third of the personal liability found to be due was rejected. See Comptroller Decision No. 111,897 (2017).

a. An individual defendant could be held liable for corporation's unpaid franchise taxes and penalties only if they became due and payable after corporate privileges were forfeited. When the franchise tax due date occurred before corporate privileges were forfeited, the subsequent jeopardy determination could not be retroactively applied to create director or officer liability where it did not otherwise exist. See *Davis v. State*, 846 S.W.2d 564 (Tex. App.–Austin 1993, no writ).

b. Officers and directors are not required to have personally participated in transactions resulting in corporate debt to have liability exposure; rather, it is the director's or officer's consent to and approval of corporate debts that leads to their personal liability. Tax Code § 171.255. See *In re Trammell*, 246 S.W.3d 815 (Tex. App.–Dallas 2008, no pet.).

3. Exceptions that Preclude Forfeiture. A director or officer will not be personally liable for the corporation's debts if it can be shown that the debt was created or incurred over the director's objections, or without the director's knowledge and that the exercise of reasonable diligence to become acquainted with the affairs of the corporation would not have revealed the intention to create the debt. Tax Code § 171.255(c).

a. A plaintiff who was injured on condominium premises sued builder's corporate offices seeking to hold them personally liable. The Court of Appeals held that Tax Code § 171.255, holding directors and officers liable for debts of a corporation whose corporate privileges are forfeited for failure to pay its franchise taxes, did not apply to debts arising out of tort judgments predicated on negligence liability. Tort judgments are deemed to have arisen involuntarily, and are therefore not within the scope of Tax Code § 171.255. See *Williams v. Adams*, 74 S.W.3d 437 (Tex. App.–Corpus Christi 2002, pet. denied).

b. Former directors were not liable for debts corporation allegedly owed to financial corporation that had hired accounting corporation to collect certain delinquent accounts. It is the act of creating or incurring a debt when the franchise report is delinquent that triggers personal liability once the corporate privileges are forfeited; if no debts are created or incurred after delinquency there is no liability. Tax Code § 171.255(a). In addition, officers and directors that resigned their positions prior to the time the debt was incurred are not liable pursuant to the provisions of Tax Code § 171.255. See *Paccar Financial Corp v. Potter*, 239 S.W.3d 879 (Tex. App.–Dallas 2007, pet. denied).

c. Personal liability was asserted due from the officer of a company that had forfeited its corporate privileges. The officer argued 1) there was not a franchise tax liability at the company level, and 2) even if there was such a liability he shouldn't be held liable because he didn't know the tax obligation existed. The ALJ rejected both arguments in holding: 1)an officer or director of a corporation may not challenge the underlying corporate liability that is administratively final (citing Comptroller Hearing No. 42,791); and 2) the Petitioner officer's affidavit testimony asserting lack of knowledge was insufficient to support a finding that the company tax debt was created or incurred over his objection or without his knowledge. Comptroller Decision No. 112,712 (2017).

4. Window of Liability. Even if corporate privileges are ultimately revived, the personal liability of the officers and directors who are liable by reason of the forfeiture is not affected by the revival of the charter or certificate of authority. That exposure remains in place. Tax Code § 171.255(d).

5. Forfeiture of Corporate Charter or Certificate of Authority. If the corporation does not pay the amount of taxes and penalties it owes within 120 days from the forfeiture of corporate privileges, the Comptroller can request the Attorney General to bring suit to cause the forfeiture of the charter or certificate of authority. Tax Code §§ 171.301-303. Alternatively, the Comptroller can certify the name of the defaulting corporation to the Secretary of State, who has the power to forfeit the charter or certificate of authority without court proceedings. Tax Code § 171.301.

6. Applicability of Forfeiture Provisions. Substantial additional case law exists interpreting the applicability of the forfeiture of corporate privileges/charter provisions, including the following authority:

a. An officer of a corporation whose charter had been revoked for nonpayment of franchise tax was individually liable to pay for stock which had been ordered through the corporation by an individual who was not an employee; the court concluded the officer could have discovered the debt with reasonable diligence. *Skrepnek v. Shearson Lehman Bros., Inc.*, 889 S.W.2d 578 (Tex. App.–Houston [14th Dist] 1994, no writ).

b. Forfeiture of corporate privileges exposes officers and directors to liability that extends beyond just deficiencies. Taxpayer argued that the personal liability provisions only applied to such tax deficiencies, and that a successor liability tax obligation that existed prior to the forfeiture date would not be a personal liability of the successor. The Court disagreed, stating the plain language of Tax Code § 171.255(d) specified that officer and directors are liable for "each debt" incurred after the forfeiture date – not just tax debts arising after forfeiture. *Bosch v. Cirro Group, Inc.*, No. 05–11–01625–CV, 2012 WL 5949481 (Tex. App.–Dallas Nov. 28, 2012, pet. denied).

c. While debts incurred pursuant to Tax Code § 171.255(a) by a corporate entity after forfeiture of corporate privileges extend beyond just tax obligations, courts have ruled that such liability does not extend to tort judgment predicated on negligence liability. *Suntide Sandpit, Inc. v. H & H Sand & Gravel, Inc.*, No. 13-11-00323-CV, 2012 WL 2929605 (Tex. App.–Corpus Christi July 19, 2012, pet. denied) (citing *Williams v. Adams*, 74 S.W.3d 437, 442 (Tex. App.–Corpus Christi 2012, pet. denied)).

d. Officer's and director's statutory liability for corporate "debt" upon the corporation's forfeiture of its corporate privileges for failing to pay franchise taxes, encompassed the corporation's obligation to pay contributions to the Unemployment Compensation Fund. *Wilburn v. State*, 824 S.W.2d 755 (Tex. App.–Austin, 1992, no writ).

e. Tax Code § 171.255 must be strictly and narrowly construed to protect individuals against whom liability is sought because the resulting personal obligation is penal in nature. Tax Code § 171.255 does not create a basis for asserting personal jurisdiction (as opposed to liability) over a nonresident officer or director of an entity that has (or had) corporate privileges in Texas. *ACS Partners, LLC v. Allen Gross*, No. 01-11-00245-CV, 2012 WL 1655547 (Tex. App.–Houston [1st Dist] May 4, 2012, no pet.).

7. Relation Back Considerations

a. Officers or employees of a corporation whose corporate privileges have been forfeited need not take a specific action creating corporate debt after corporate privileges have been forfeited for the officer to be liable for the corporate debt. If the determination of liability occurred after forfeiture, even though the binding agreement arose prior to forfeiture, the tax/penalty amounts did not "relate back" to the initiation of the contract. *Serna v. State*, 877 S.W.2d 516 (Tex. App.–Austin 1994, writ denied).

b. The relation back doctrine did not apply to preclude imposition of personal liability on automobile dealership corporation's director and officer for a corporation's breach of dealership agreement in which the corporation's privileges were revoked for failure to file a required franchise tax report after entry into dealership agreement but before breach of the agreement. The debt was deemed to be "created or incurred" at the time of the breach. See *Taylor v. First Community Credit Union*, 316 S.W.3d 863 (Tex. App.–Houston [14th Dist] 2010, no pet.).

c. Where a lease was entered into prior to the time there was a forfeiture of corporate privileges, but the breach of the lease contract didn't occur until after the forfeiture, at issue was when the debt asserted due by plaintiff was considered to have occurred. The Court held the obligation arose at the time of the execution of the lease – not when the breach occurred. As a result the debt obligation related back to a time prior to the forfeiture and there was no personal liability imposed pursuant to Tax Code § 171.255. *River Oaks Shopping Center v. Pagan*, 712 S.W.2d 190 (Tex. App.–Houston [14th Dist.] 1986, writ ref'd n.r.e.).

d. When an order from the Texas Railroad Commission assessing penalty for failing to plug abandoned oil wells was issued after the date the corporation's franchise taxes were due, but not paid, officers and directors of the corporation were individually liable for penalty. The debt was deemed to be "created or incurred" on the date the Texas Railroad Commission entered an order directing the corporation to pay – not four years earlier when the violations actually occurred. *Jonnet v. State*, 877 S.W.2d 520 (Tex. App.–Austin 1994, writ denied).

e. Where taxpayer's tax delinquency amount is a portion of the sales tax delinquency amount that was at issue in an administrative redetermination, the tolling of three-year statute of limitations of Tax Code § 111.207 applies only to the "issues that were contested" in that administrative redetermination. The question in the case was whether the three year statute of limitations period to bring an action to collect a tax (per Tax Code § 111.202) was tolled by an administrative proceeding relating to the corporate entity – as opposed to the individual from whom the Comptroller was asserting to be a responsible person. Taxpayer argued that a prior Comptroller hearing decision supported his position – which it did. The court declined to follow the prior Comptroller decision, however, stating that the plain language of the statute authorized tolling of the limitations period. Consequently, the statute of limitations was extended as to the individual as a result of the pendency of the corporate administrative hearing. As a result, the taxpayer was determined to be a responsible person per Tax Code § 171.255. See *Wilson v. State*, 272 S.W.3d 686 (Tex. App.–Austin 2008, pet. denied).

f. A homebuilder LLC entered into a contract to build a house for homebuyers prior to the time there was a forfeiture of corporate privileges by the LLC. Purchaser homebuyers discovered defects after the forfeiture occurred and subsequently sued the sole manager of the LLC (when the LLC couldn't pay). Homeowners asserted personal liability against the sole manager of about $2 million. The court held all events establishing a debt obligation of the plaintiff homeowners had occurred pre-forfeiture, even though liquidated damages claim wasn't determined until post-forfeiture. The court analysis noted the penal nature of the statute (rather than punishment), which required (to the extent of any ambiguity in the statute) reading the entire statute in a way that benefits the party facing the possibility of a penalty if a fair reading so permits. The court reasoned that the purpose of Tax Code § 171.255 was to protect the potentially liable corporate officer or director – not to aid litigants recover damages. <u>Result</u>: No tax liability for LLC manager. *Hovel v. Batzri*, 490 S.W.3d 132 (Tex. App.–Houston [1st Dist.] 2016, pet. filed).

8. Comptroller may use the same procedure and rationale of forfeiture of corporate authority or certificate of authority for forfeiture of certificate or registration of any taxable entity (e.g., partnership, LLCs, etc.). Tax Code § 171.302.

C. Personal Liability for Actions Considered to be Fraudulent Tax Evasion – Additional 50% Fraud Penalty.

1. Any officer, manager or director of a corporation, association or LLC, partner of a general partnership or managing general partner of a limited partnership or LLP who in such capacity engaged in fraudulent tax evasion activities is personally liable for the tax. Tax Code § 111.0611(a). This is distinct from the 50% fraud penalty that can be asserted against a "person" engages in fraudulent activity per Tax Code § 111.061(a) (failure to pay tax or alteration of records). For purposes of Tax Code § 111.061(a), a "person" could be a legal entity such as a corporation or LLC. By contrast, Tax Code § 111.0611(a) applies specifically to individuals.

2. An additional 50% is penalty added to tax due to an individual engaged in fraudulent activity. Tax Code § 111.0611(a).

3. Per statute, actions indicating of fraudulent tax evasion include:

a. filing or causing to be filed a fraudulent business tax return or report;

b. intentional failure to file required tax return, report or document on behalf of business entity;

c. filing or causing to be filed a tax return or report containing an intentionally false statement resulting in understating tax by 25% or more;

d. altering, destroying or concealing any record, document or thing presented to the Comptroller or other conduct utilized with the intent to fraudulently affect the outcome of a Comptroller investigation, audit, hearing or other such matter.

(Tax Code § 111.0611(b))

4. Personal liability limited to an amount by which excess otherwise personal liability obligation exceeds unencumbered assets of the corporation. Tax Code § 111.0611(c).

5. Comptroller administrative hearing decisions dealing with the personal liability for fraudulent tax evasion including the following pursuant to Tax Code § 111.0611(a):

a. Personal liability for fraudulent tax evasion was assessed against a taxpayer associated with a limited liability company (LLC) that has an unpaid tax liability dismissed when Comptroller representatives failed to present a *prima facie* case for personal liability. No public records were used to confirm the target individual's role with the company. The only relevant evidentiary documentation was the references to the taxpayer as president in the audit documents. No facts were established regarding the identity of the person who was involved in the day-to-day operation of business, who completed the returns and what records were used. As liability for the penalty pursuant to Tax Code § 111.0611 hinges on the target individual being an officer, manager or director of the entity, failure to prove that link resulted in a ruling for the taxpayer and against the Comptroller. See Comptroller Decision No. 103,918 (2011).

b. Whether the president of a corporate entity reporting greatly understated taxable transaction amounts in filing returns or causing them to be filed, constitutes grounds for personal liability was the focus of Comptroller hearing dealing with applicability (or lack thereof) of Tax Code § 111.0611. Petitioner's involvement in the day-to-day operations of corporate activity plus the gross underreporting of tax (46.57% error rate), was considered sufficient by a clear and convincing evidence standard to warrant imposition of the 50% fraud penalty against the corporation. The consequent conclusion was that the corporate president filed the sales and use tax returns as part of a fraudulent scheme or plan to evade payment of taxes, and was personally liable for the 50% fraud penalty. See Comptroller Decision No. 104,433 (2011).

6. In a redetermination proceeding the taxing authority's representatives bear the burden of proving clear and convincing evidence that the assessment of personal liability is warranted under Tax Code § 111.0611.

a. Factual assertions in Staff's pleadings about audit findings and the Petitioner's actions in its pleadings do not qualify as evidence. Such evidence must be clear and convincing to establish that Petitioner took an action or participated in a fraudulent scheme or fraudulent plan to evade the payment of taxes due under § 111.0611. The ALJ was clear in opining that audit findings are not "evidence." The conclusion was the taxpayer was not liable for the 50% fraud penalty due, even though it was apparent there had been under reporting of tax. The unanswered question was who was responsible for such under reporting. See Comptroller Decision No. 104,430 (2011).

b. In a mixed beverage gross receipts audit, a fraud penalty was asserted against an officer/director because he signed certain tax reports and some checks. Taxpayer argued he shouldn't be held liable because he held no stock, was uncompensated and wasn't involved in day to day operations. The ALJ, in a withering opinion, determined the Comptroller Tax Division did not prove up a *prima facie* case because there was not a conclusive showing the Comptroller's Decision was final, and didn't conclusively provide the amount due. As a result, the ALJ concluded one of the literal requirements of Tax Code § 111.0611(a) – proving the amount due – which imposed the fraud penalty on taxes and any penalty and interest due had not been met. The ALJ concluded Tax Code § 111.0611 fraud penalty could not properly be imposed on the officer/director. Comptroller Decision No. 109,061 (2015).

c. Comptroller representatives audited a liquor store business and issued an assessment asserting a sales tax liability with respect to the company. At the same time the auditor asserted a 50% fraud penalty (per Tax Code 111.0611) with respect to Petitioners (husband and wife) based on their capacity as officers, involvement in day to day operations and preparation of company sales tax reports. Although the company was determined to be liable for underreported sales tax Petitioners argued they should not be held personally liable based upon information considered in the proceeding against the company. There was no documentation in the record regarding either Petitioner's involvement in the administration and/or operation of the business. Referring just to the company assessment and the supporting evidence in that matter, Comptroller Staff did not provide any audit documents or other supporting documentation indicating Petitioners' involvement in tax reporting. The ALJ concluded and held the record did not establish by clear and convincing evidence that Petitioners took actions or participated in a fraudulent scheme or plan to evade payment of taxes. Consequently personal liability assessments against Petitioners were dismissed. Comptroller Decision No. 112,225 (2017).

7. Once Comptroller representatives have presented facts indicating a *prima facie* case supporting a finding of fraud or evasion, the burden of proof shifts to the taxpayer to prove by a preponderance of the evidence that liability should not be imposed and that the assessment should be dismissed. Tax Code § 111.0611.

> Where Comptroller representatives submitted copies of receipts for delivery of liquor to bar which taxpayer had signed, the taxpayer was determined to have been involved in the day-to-day operations of the bar. The gross underreporting of tax (at a rate of 82.67%), sufficed as clear and convincing evidence so as to establish personal liability for the fraud penalty. The Comptroller had established *prima facie* evidence that taxpayer acted in a fraudulent manner, and that assertion was not rebutted by the taxpayer. See Comptroller Decision No. 105,113 (2011). Note: This is one of several decisions dealing with convenience stores resulting in similar outcomes.

8. Additional instances where the taxpayer was found to have acted in a fraudulent manner such that the 50% fraud penalty of Tax Code § 111.0611 include:

a. The under reporting of taxable transactions by 36% plus the involvement of a key employee, the lack of records and no explanation as to the reason for the under reported tax amounts was sufficient for the Comptroller to determine the 50% fraud penalty was warranted. Comptroller Decision No. 103,683 (2011). Note: The ALJ's proposed decision was changed to a substantial degree by the Comptroller. The Comptroller rejected that finding of fact (as well as several findings of law) in determining the penalty was proper.

b. Filing, or causing to be filed, fraudulent tax returns or reports. Comptroller Decision No. 103,204 (2012).

c. Taxpayer president of company signed all tax returns, audits of which showed receipts underreported by more than 25%. Taxpayer did not specifically contest the 50% penalty and provided no evidence showing why the 50% fraud penalty should not be imposed. Comptroller Decision Nos. 105,282 (2012), 105,289 (2012). Once a *prima facie* case has been made, the burden is on the taxpayer to show why the fraud penalty should be abated. The fraud penalty was upheld. See also Comptroller Decision Nos. 104,617 (2012) and 106,244 (2012) for similar results.

d. Taxpayer was president of the general partner of a company that failed to report 87% of taxes found to be due on audit. Taxpayer managed the company's store, ordered its inventory and oversaw day to day operations. The liability could not be contested by a successor entity. Comptroller Decision No. 107,234 (2013).

e. While not involved in day to day operations of three convenience stores, reviewing a store's activities and records thoroughly and being aware of purchases of taxable inventory and receipts indicates the individual was aware or should have been aware of significant underreporting. The 50% fraud penalty was upheld. Comptroller Decision No. 104,445 (2012).

9. Once a tax amount has been assessed, how long does the Comptroller have to collect the tax deficiency? Per Tax Code § 111.202 at any time within three years after a deficiency or jeopardy determination has become due and payable or within three years after <u>the last recording of a lien</u> (emphasis added) the Comptroller may bring a court action to collect the delinquent taxes (as well as related penalty and interest). In a case where a Comptroller's Certificate had been issued and the Comptroller sought to collect the tax due, taxpayer raised limitations as an affirmative defense, asserting that the State must record a lien within the three year limitations period for filing suit – which had not happened. Taxpayer further

asserted that not requiring a lien to be recorded within the three year period would give the state an indefinite period of time to file suit. The court disagreed. In a technical statutory construction analysis, the court essentially concluded that so long as a lien was initially recorded within three years of the time a deficiency because due and payable, any subsequent recording of a lien would give the Comptroller three years after the recording of such lien to file a collection suit action. That could be, and in this case, was well beyond even six years (i.e., assuming a lien is recorded on the last of the 3 year period when tax became "due and payable") since the earliest tax deficiency (pertaining to a 2004 Texas franchise report) had become due and payable (May 15, 2005) and the time the lien was recorded on which the Comptroller relied (April 15, 2013). Because the collection action was filed within three years of the April 15, 2013 date, the court concluded the limitations period had not expired – and the collection action was therefore not barred. *Jeff Kaiser, P.C. v. State,* No. 03-15-00019-CV, 2016 WL 1639731 (Tex. App.–Austin Apr 20, 2016, pet. denied).

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NORTON ROSE FULBRIGHT

South Dakota v. Wayfair: Do you have what you need?

Jay Chadha
Senior Counsel
Norton Rose Fulbright US LLP

September Date

OVERVIEW

Nominal Issue: Can a state require an out-of-state retailer with no physical presence in a state to collect use tax on sales to in-state buyers?

Underlying Issue: What does it mean to have nexus with a state for Commerce Clause purposes?

Background

- Commerce Clause - Article I, Section 8 of the US Constitution grants Congress the power "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian tribes."
  - "Dormant" Commerce Clause prohibits a state from passing legislation that improperly discriminates against interstate commerce.
- *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977)
  - Supreme Court's four-part test to determine whether a state tax on an interstate business violates the Commerce Clause:
    - Is applied to an activity with a substantial nexus with the taxing State,
    - fairly apportioned,
    - does not discriminate against interstate commerce, and
    - is fairly related to the services provided by the State.

Background

- *National Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 360 U.S. 753 (1967)
  - Supreme Court held that claims under the Due Process Clause and the Commerce Clause are "closely related".
  - Court said that if Illinois could requires sales tax collection, then every other state could as well, resulting in:
    - Many variations in rates of tax, in allowable exemptions, and in administrative and recordkeeping requirements.
    - Could entangle Taxpayer's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose "a fair share of the cost of the local government."
- Established physical presence requirement, but Court not clear for what purpose.

Background

- *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992)
  - U.S. Supreme Court determined that “due process” nexus and “commerce clause” nexus required separate analysis.
  - Court overturned the physical presence rule for Due Process Clause holding, but upheld the physical presence requirement for substantial nexus under the Commerce Clause.
  - Commerce Clause “substantial nexus” requirement demanded physical presence in a state before a state could require the seller to collect a use tax on sales to in-state purchasers.
    - continuing value of a bright-line physical presence rule
    - Stare decisis

Background

- *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124 (2015)
  - Justice Kennedy concurrence - "separate statement concerning what may well be a serious, continuing injustice faced by Colorado and many other States."
    - There is a powerful case to be made that a retailer doing extensive business within a State has sufficiently "substantial nexus" to justify imposing some minor tax-collection duty, even if that business is done through mail or the Internet.
    - "Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court's holding in Quill. A case questionable even when decided, Quill now harms States to a degree far greater than could have been anticipated earlier."

South Dakota v. Wayfair, Inc. et al., 585 U.S. ____ (2018)

- South Dakota Senate Bill 106
  - Provides that a seller that does not have a physical presence in South Dakota will be required to collect and remit South Dakota sales tax *as if the seller had a physical presence within the state*, if the seller meets either of the following criteria:
    - The seller's gross revenue from the sale of tangible personal property, any product transferred electronically, or services delivered into South Dakota exceeds $100,000.
    - The seller sold tangible personal property, any product transferred electronically, or services for delivery into South Dakota in 200 or more separate transactions
  - Amounts are based on the previous calendar year or the current calendar year.
  - Applied prospectively only
- South Dakota sought declaratory judgment that were valid and applicable to certain online retailers. Online retails sought summary judgment that the law was unconstitutional under *Quill*.

South Dakota v. Wayfair

- In a 5-4 decision, Court overruled the physical presence requirement for substantial nexus under Quill.
  - Majority – Kennedy, Thomas, Ginsburg, Alito and Gorsuch
  - Dissent – Roberts, Breyer, Sotomayor and Kagan.
- Both majority and dissent agree that physical presence to create a collection obligation for an remote seller was a bad decision, but differed on best way to remedy issue.
- Court affirmed that the four part *Complete Auto* test must be satisfied for a state tax to be valid under Commerce Clause.
  - Court did not rule that South Dakota's economic nexus standard is valid, but remanded the case to the lower court to examine the law without Quill's physical presence nexus requirement.

South Dakota v. Wayfair

- Complete repudiation of *Quill*
  - –Physical presence rule is not a necessary interpretation of the substantial nexus requirement.
    - –Cites Due Process cases, including National Bellas Hess, to hold that while Due Process and Commerce Clause standards may not be identical, there are significant parallels.
  - –Quill creates market distortions
    - –Bright line test imposes arbitrary, formalistic distinction that modern Commerce Clause precedents disavow.
  - –Physical presence rule of *Quill* is unsound and incorrect.
  - –Stare Decisis
    - –Can no longer support Court’s prohibition of a valid exercise of the States’ sovereign powers.
    - –The Internet’s prevalence and power have changes the dynamics of the national economy.

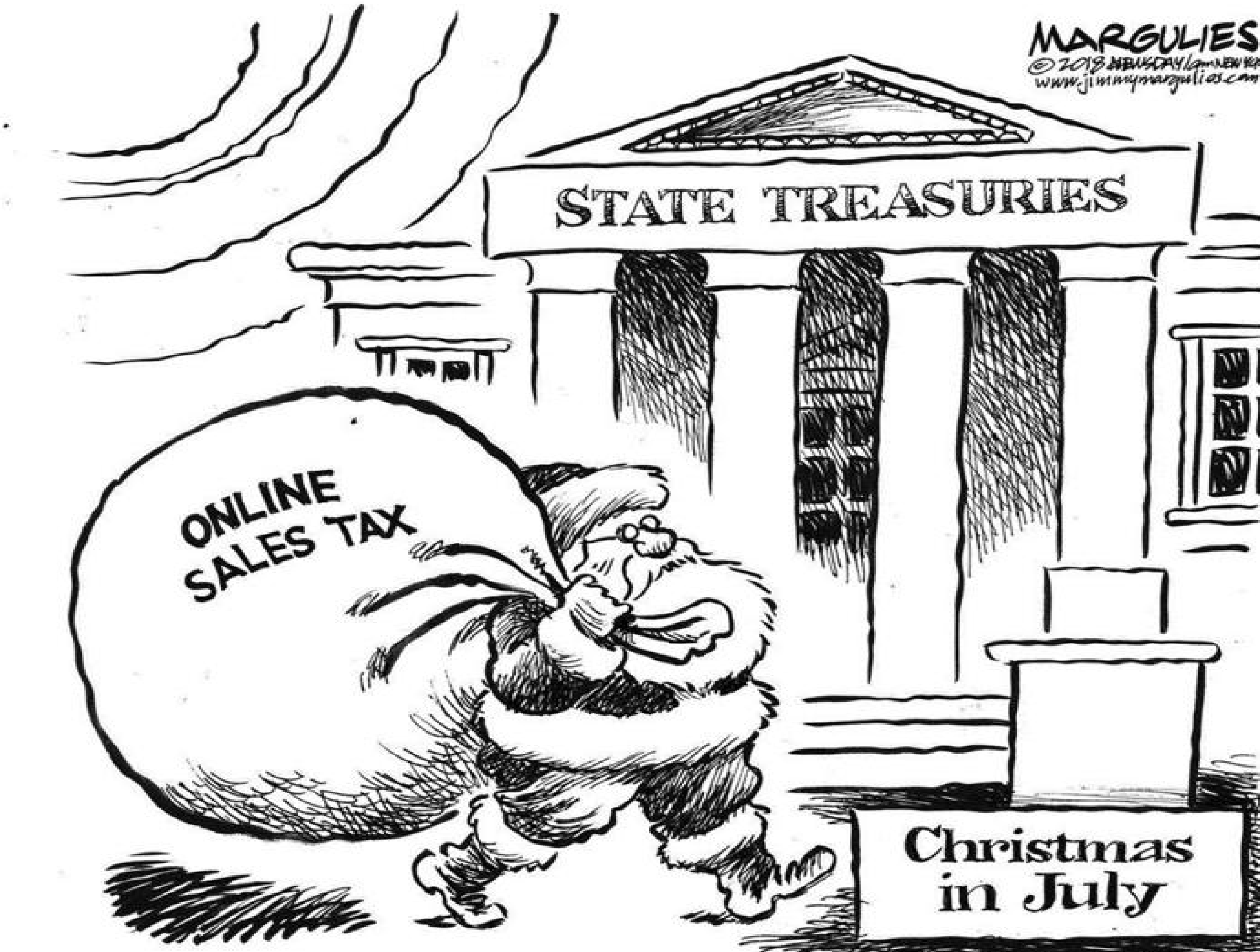
South Dakota v. Wayfair

- Other aspects of SB 106:
  - –Safe harbor provision with specific threshold amounts for those with limited business transactions in the state
  - –No obligation to remit the sales tax may be applied retroactively.
  - –South Dakota is a member of the Streamlined Sales and Use Tax Agreement.
  - –South Dakota provides access to sales tax administration software paid by the state.
  - –Sellers who use such software are immune from audit liability.
- Court indicated that South Dakota's safeguards appear designed to prevent discrimination against or undue burdens upon interstate commerce.

South Dakota v. Wayfair

- Dissent:
  - Court should not act on this important question of economic policy.
  - Overturning a half century of precedent is an "exceptional action" demanding "special justification".
  - Congress may be better qualified to resolve and Congress has the ultimate power to resolve.
  - Disputes some of the economic effects cited by majority (amounts to be collected, costs of compliance)

States' reactions to *Wayfair*



States' reactions to *Wayfair*

- Other states
  - Economic Nexus – Several states have adopted South Dakota's economic nexus standard($100,000 gross receipts/200 transaction).
    - 24 of the 45 states with a sales tax are in various stages of requiring out-of-state retailers to collect.
  - Click-through nexus – New York's Amazon-type law
  - Cookie Nexus - Massachusetts "cookie nexus"
  - Reporting Requirements – Colorado
  - New Hampshire – Live Free or Die

WWTD – What will Texas do?

- Texas Comptroller issued initial guidance June 27, 2018
  - Comptroller would review rules, but stressed that there would be no retroactive application of the new law to remote sellers that have no physical presence in Texas.
  - Early 2019 is the target effective date for rule amendments.
  - State will likely relieve some out-of-state sellers from collection responsibilities in order to avoid imposing an undue burden on interstate commerce.
- Draft Amendment to Comptroller Rule § 3.286, Seller's and Purchaser's Responsibilities.
  - Amends definition of "engaged in business" by deleting any references to physical presence and inserts "engaged in business" activities in Tex. Tax Code § 151.107.
  - Comptroller will not enforce permit requirements on a remote seller whose total revenue is less than $500,000.
  - Compliance to begin October 1, 2019.

WWTD – What will Texas do?

- Proposed Legislative measures:
  - Amend definition of “seller” and “retailer” in Tex. Tax Code 151.008 to include “marketplace platforms” used by third parties to facilitate a sale.
  - Amend Tex. Tax Code 151.059 to allow nonresident remote sellers to remit local sales taxes at a weighted average local tax rate instead of actual rates.

TTARA Webcast September 13, 2018.

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Congressional Response

- Hearing:
  - House Judiciary Committee held a meeting on July 24, 2018.

- Proposed Legislative measures
  - H.R. 6824, Online Sales Simplicity and Small Business Relief Act of 2018 – would ban states from retroactively imposing sales tax collection duties on remote online sellers; require all states to push back economic nexus implementation dates to Jan. 1, 2019; and establish a small seller exemption, meaning a remote seller with gross annual receipts below $10 million in the U.S. isn't required to collect and remit sales tax.

  - H.R. 6724, Protecting Businesses from Burdensome Compliance Cost Act of 2018, limits States' authority to require remote sellers to collect taxes and fees owed by purchasers of goods and services

  - S. 3180, Stop Taxing Our Potential (STOP) Act - bill would legislatively overrule *Wayfair* and prevent a state from imposing tax collection or information reporting obligations on sellers with no physical presence in a state.

Unanswered Questions

- How do you determine when you meet economic nexus standards?

- Sufficiency test – combination of Due Process and Commerce Clause?

- Does physical presence matter anymore?

- Foreign retailers?

- How much money does this really raise?

- Implications to taxes other than sales tax collection obligations?

Steps to consider

- Review current business activities to determine if economic nexus threshold exceeded.
- Review and consider technology needs
- Analyze taxability of products/service in any jurisdictions where business is subject to tax
- Consider overall business implications
- Develop a plan for registration and tax compliance.
- Monitor tax updates

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TAX SECTION
State Bar of Texas

October 1, 2018

By First Class Mail & Electically to:

Via Federal eRulemaking Portal
at www.regulations.gov

Internal Revenue Service
CC:PA:LPD:PR (REG-107892-18)

Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: *Comments on Proposed Regulations Concerning the Deduction for Qualified Business Income under Section 199A of the Internal Revenue Code*

Dear Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury ("Treasury") and Internal Revenue Service (the "IRS" or "Service") in the Notice of Proposed Rulemaking (REG-107892-18, RIN 1545-B071) issued on August 16, 2018 (the "Proposed Regulations"). The Proposed Regulations provide guidance regarding the application of Section 199A of the Internal Revenue Code of 1986, as amended (the "Code") that was enacted on December 22, 2017 by Section 11011 of "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Public Law 115-117 commonly referred to as the Tax Cuts and Jobs Act of 2017 (the "TCJA"), and was amended on March 23, 2018, retroactively to January 1, 2018, by Section 101 of Division T of the Consolidated Appropriations Act, 2018, Public Law 115-141.

1414 Colorado Street, Austin, TX 78701
(512) 427-1463 or (800) 204-2222

October 1, 2018

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed comments on the Proposed Regulations.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend Treasury and the Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Catherine C. Scheid

Catherine C. Scheid, Chair
State Bar of Texas, Tax Section

October 1, 2018

COMMENTS ON PROPOSED REGULATIONS CONCERNING THE DEDUCTION FOR QUALIFIED BUSINESS INCOME UNDER SECTION 199A OF THE INTERNAL REVENUE CODE

These comments on the Proposed Regulations (the "Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Professor Bruce McGovern, Chair of the General Tax Committee, Chris M. Goodrich, Vice Chair of the General Tax Committee, Nathan Smithson, Chair of the Partnership and Real Estate Tax Committee, Preston “Trip” Dyer, Jr., Vice Chair of the Partnership and Real Estate Tax Committee, Will Becker, Argyrios Saccopoulos, and Vu Khoa, each a Member of the Partnership and Real Estate Tax Committee, Carol G. Warley, Co-Chair of the Estate and Gift Tax Committee, Laurel Stephenson, Co-Chair of the Estate and Gift Tax Committee, Celeste C. Lawton, Co-Chair of the Estate and Gift Tax Committee, Cindy Hull, Vice Chair of the Estate and Gift Tax Committee, Corey Junk, Vice Chair of the Estate and Gift Tax Committee, Jeffry M. Blair, Chair of the Corporate Tax Committee and Kelly Rubin, Vice Chair of the Corporate Tax Committee. William P. Bowers and Patrick O’Daniel reviewed the Comments and made substantive suggestions on behalf of the Partnership and Real Estate Tax Committee. Dan McCarthy reviewed the Comments and made substantive suggestions on behalf of the Estate and Gift Tax Committee. Henry Talavera reviewed the Comments and made substantive suggestions on behalf of the Committee on Government Submissions (“COGS”).

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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October 1, 2018

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Date: October 1, 2018

I. INTRODUCTION

These Comments are provided in response to Treasury's and the IRS's requests for comments on the Proposed Regulations concerning the deduction for qualified business income under Code Section 199A. Code Section 199A was enacted on December 22, 2017 as part of the TCJA. Code Section 199A provides a deduction generally equal to twenty percent (20%) of the qualified business income ("QBI") of an individual, partnership, S corporation, trust or estate (the "Section 199A Deduction"). The Section 199A Deduction may be taken by individuals and some estates and trusts. A Section 199A Deduction is not available for income from performing services as an employee or for business income earned through a C corporation. For taxpayers whose taxable income exceeds a statutorily-defined amount ("Threshold Amount"), Section 199A may limit the taxpayer's Section 199A Deduction based on (i) the type of trade or business engaged in by the taxpayer, (ii) the amount of W-2 wages paid with respect to the trade or business ("W-2 Wages") and/or (iii) the unadjusted basis immediately after acquisition ("UBIA") of qualified property held for use in the trade or business ("UBIA of Qualified Property").

The Proposed Regulations were issued to provide taxpayers with computational, definitional, and anti-avoidance guidance regarding the application of Code Section 199A. We commend Treasury and the IRS for its efforts in issuing the Proposed Regulations. We also appreciate the opportunity to comment on the Proposed Regulations.

In response to the requests from Treasury and the IRS, we respectfully offer the comments and suggestions described below.

II. OPERATIONAL RULES

A. Qualified Property Contributed to a Partnership or S Corporation should be its Pre-Contribution UBIA

Under Proposed Regulation Section 1.199A-2(c)(3), the UBIA of Qualified Property contributed to a partnership in a Code Section 721 transaction equals the partnership's tax basis as determined under Code Section 723, rather than the contributing partner's original UBIA in the property. Similarly, the UBIA of Qualified Property contributed to an S corporation in a Code Section 351 transaction equals the S corporation's tax basis as determined under Code Section 362. In both cases, we believe that this could result in an unwarranted step-down in the UBIA of Qualified Property used in a qualified trade or business immediately prior to the contribution due only to the fact that the owner or owners chose to continue to operate their existing qualified trade or business through a partnership or an S corporation.

We respectfully disagree with this result, and instead recommend that the UBIA of property contributed to a partnership under Code Section 721 or to an S corporation under Code Section 351 should retain its UBIA on the date it was first placed in service by the contributing partner or S corporation shareholder.

A fundamental principle underlying Code Section 721 is that a contribution of the assets of a business to a partnership is a mere change in form of conducting the contributed business or holding the assets of that business. To determine the UBIA of Qualified Property contributed to a partnership by reference to its tax basis as determined under Code Section 723 rather than its UBIA in the hands of the contributing partners ignores this principle.

This same fundamental principle underlies Code Section 351. Code Section 351 permits a taxpayer to choose to incorporate an existing business without recognizing gain or loss on the contribution of the business to the corporation. Requiring a step-down in the UBIA of Qualified Property contributed to the corporation by using the tax basis of the contributed property as determined under Code Section 362 places an unwarranted additional tax cost to taxpayers on the decision of whether to incorporate a qualified trade or business and make an S corporation election.

Further, it is clear from the language of Code Section 199A(b)(2)(B)(ii) that UBIA is determined immediately after the "acquisition" of qualified property. The contribution to a partnership or a corporation under Code Section 721 and 351, as the case may be, is not an acquisition for federal income tax purposes. As discussed above, the contribution is a continuation of the use of such property, and therefore there should be no UBIA redetermination event as a result of such transaction.

Code Section 199A(b)(2) provides that the deductible amount with respect to any qualified trade or business may be limited to, in part, 2.5 percent of the UBIA of Qualified Property. Therefore any reduction to UBIA could have a significant negative impact on a taxpayer's ability to use the deduction under Code Section 199A(b)(2) with respect to any property previously placed in service within a qualified trade or business that is contributed to a partnership, S corporation or other relevant pass-through entity ("RPE").

Example 1:

Individual A purchases a building through a limited liability company ("Company"), a disregarded entity for federal income tax purposes, for $100 and immediately places the building in service in a trade or business, which is not a specified service trade or business (a "SSTB"). The basis and UBIA of the building would be $100 at such time.

After six years, the basis of the building, as adjusted for depreciation deductions, would be $82 and its UBIA would remain $100. At such time, Individual A decides to raise funds to purchase another building by having Individual B make a $100 investment in Company in exchange for an interest in Company. Under Revenue Ruling 99-5, Individual A would be treated as contributing all of the assets of Company to a new partnership in exchange for a partnership interest under Code Section 721. Under the Proposed Regulations, the UBIA of the building in the Company's hands would be $82, its tax basis under Code Section 723, rather than Individual A's $100 UBIA immediately prior to the deemed contribution, notwithstanding the fact that Company continues to operate the same trade or business, just in in the form of a partnership for federal income tax purposes.

Example 2:

Partnership AB purchases a building for $100 and immediately places the building in service in a trade or business, which is not a SSTB. The basis and UBIA of the building would be $100 at such time.

After six years, Partnership AB's basis of the building, as adjusted for depreciation deductions, would be $82 and its UBIA would remain $100. Partnership CD is a newly formed fund that initially holds only cash. Partnership AB has agreed with Partnership CD that it will contribute its property to Partnership CD in exchange for an interest therein. As a result of the contribution of the building to Partnership CD, the UBIA of such building in the hands of Partnership CD would be adjusted to $82. If, however, Partnership AB functioned as the fund itself, and all investors contributed cash directly to Partnership AB in exchange for an interest therein, the UBIA of the original Partnership AB building would remain $100.

The examples above are exacerbated in the event the property is not a building, but instead a newly acquired piece of equipment that is subject to an immediate 100% deduction or expensing under Code Sections 168 or 179. The immediate deduction or expensing in such case would result in a $0 UBIA for the contributed asset, no matter the length of time such asset was held in the prior trade or business.

Although the Proposed Regulations do not recognize the principle that a contribution to a partnership or a contribution to an S corporation is a mere change in form of conducting a business in the context of determining UBIA, they do recognize this principle in the depreciable period of qualified property. Under Proposed Regulation Section 1.199A-2(c)(2)(iv), for purposes of determining the depreciable period of qualified property that is acquired in a Code Section 721 or a Code Section 351 transaction, if the transferee's unadjusted basis in the qualified property does not exceed the transferor's unadjusted basis in such property, the date the transferee (i.e., a partnership or corporation) first placed the qualified property into service is the date on which the transferor (i.e., the contributing partner) first placed such qualified property in service. Thus, the Proposed Regulations recognize that qualified property contributed to a partnership has already been placed in service by the contributing partner. It follows that the UBIA of qualified property should also be determined based on the date it was first placed in service, rather than by reference to the date acquired by the partnership in a Code Section 721 or by an S corporation in a Code Section 351 transaction.

Finally, within the UBIA discussion, the Preamble to the Proposed Regulations sets out a policy reason as to why adjustments under Section 734(b) or Section 743(b) would not be factored in to UBIA (as discussed further below). No similar argument had been made, however, to support the treatment of UBIA on a mere contribution of capital to a partnership or corporation and continuation of a trade or business.

The inherent unfairness of the UBIA rule set forth in Proposed Regulation Section 1.199A-2(c)(3) may result in (i) a reduction in partnership or S corporation formations involving a contribution of business property previously placed in service and (ii) a rise in sale and disguised sale transactions whereby taxpayers and their prospective partners seek to avoid a reduction to the UBIA of valuable property. Accordingly, we respectfully request that Treasury and the IRS consider altering the method by which UBIA will be determined to eliminate the negative impact, along with the potential for gaming of the rules, that may take place as a result. We respectfully suggest that the UBIA of qualified property should be determined based on the date such property was first placed in service by the contributing partner or contributing shareholder. We further respectfully suggest that utilizing a consistent standard to determine the placed-in-service-date for purposes of the determining the UBIA and depreciable period of qualified property would reduce taxpayer confusion, burden and administrative complexity with respect to the Section 199 Deduction.

B. Certain Basis Adjustments under Section 734 and Section 743 should be qualified property for purposes of determining UBIA

Proposed Regulation Section 1.199A-2(c)(1)(iii) provides that basis adjustments under Code Sections 734(b) and 743(b) are not treated as qualified property. Under this rule, a partnership would be required to use the partnerships UBIA of Qualified Property, excluding all Code Section 734(b) and 743(b) adjustments. This rule, specifically in the case of Code Section 743(b) adjustments, creates an incentive on the part of taxpayers to engage in creative tax planning and unnecessarily complex transactions, structured primarily to mitigate the impact of acquiring an interest in a partnership with appreciated Qualified Property.

The preamble to the Proposed Regulation provides that "[t]reating partnership special basis adjustments as qualified property could result in inappropriate duplication of UBIA of qualified property (if, for example, the fair market value of the property has not increased and its depreciable period has not ended)." To the extent the fair market value of the qualified property does not exceed the UBIA of such property, we agree that treating a special basis adjustment as qualified property could result in duplication of UBIA. However, to the extent that the fair market value of the qualified property exceeds its UBIA at the time of the special basis adjustment, it would be appropriate to treat such excess as qualified property. Such treatment would eliminate the mismatch in economically equivalent transaction described above.

Further, the negative impact of Proposed Regulation Section 1.199A-2(c)(1)(iii) would be exacerbated by the treatment currently set forth in Proposed Regulation Section 1.199A-2(c)(3) wherein the UBIA for qualified property contributed to a partnership in a Code Section 721 transaction would be its basis under Code Section 723. Under such circumstance, a person acquiring a partnership interest where a fully depreciated business asset had previously been contributed might see a zero dollar UBIA for a full price partnership interest acquisition.

Finally, this treatment does not accord with other provisions of the Code and Regulations, including the recently issued Notice of Proposed Rulemaking (REG-104397-18, RIN 1545-B074) issued on August 8, 2018 with respect to Code Section 168(k) (the "Section 168(k) Proposed Regulations"). Among other things, the Section 168(k) Proposed Regulations provide parties buying a partnership interest to avail themselves of the Code Section 168(k) special allowance when a 754 election has been made. Not permitting the same partner to treat the increased value of qualified property as UBIA is contradictory to the Section 168(k) Proposed Regulations.

Accordingly, we respectfully recommend that basis adjustments under Code Section 734(b) and 743(b) should be treated as qualified property to the extent that the fair market value of the qualified property to which the adjustments relate exceeds the UBIA of such property immediately before the applicable Code Section 734(b) or 743(b) adjustment.

III. QBI, QUALIFIED REIT DIVIDENDS, QUALIFIED PTP INCOME

A. The Proposed Regulations excluding QBI for 707(a) payments received for services may unfairly impact partners who would otherwise have QBI from a valid trade or business

Code Section 199A(c)(4)(C) states that QBI shall not include, to the extent provided in regulations, any payment described in Code Section 707(a) to a partner for services rendered with respect to the trade or business. Section 1.199A-3(b)(2)(ii)(J) of the Proposed Regulations creates a blanket policy that excludes from QBI any Code Section 707(a) payment received by a partner for services rendered with respect to the trade or business. We believe that such wholesale exclusion would negatively impact many taxpayers who are engaged in a qualified trade or business and such income would otherwise have been QBI to such taxpayers but for the fact that is was received from a partnership.

The preamble states that the principle behind the guaranteed payment rule is to exclude from QBI income that "does not flow from the specific economic value provided by a qualifying trade or business." By applying the Proposed Regulations as drafted, however, any RPE that is engaged in a trade or business of providing services (other than an SSTB) would see its QBI eliminated with respect to 707(a) income received from any partnership in which it owns an interest, no matter how small the interest. Today's business world has many examples of equity ownership opportunities for partnerships, whether or not a person is actively involved in the business of the partnership. The following example illustrates this point.

Example:

Corp, an S corporation, operates a bicycle repair business, and is not engaged in an SSTB.

Partnership sells bicycles and, pursuant to a sale, provides the first repair service on such bike free of additional charge. Partnership contracts with Corp to provide all of such bicycle repair servicing for $10,000 per year. Presumably, such fee would also qualify as QBI based on the bicycle repair trade or business of Corp.

After 1 year, Partnership's partners are so pleased with the program that Corp is offered the opportunity to invest in Partnership for a 1% equity interest, as a limited partner. Thereafter, the first $10,000 in gross profit is distributed to Corp, and every dollar of net income from Partnership is allocated 1% to Corp and 99% to the other partners. The structure results in a payment under Code Section 707(a), but turns all of Corp's QBI from services provided to the Partnership into non-QBI.

The unintended impact of the second structure is that by becoming a small investor in Partnership, all payments received by Corp from Partnership for its bicycle repair services would be treated as payments under Code Section 707(a). This would turn all of Corp's QBI from services provided to the Partnership into non-QBI.

Although we believe that Code Section 199A(c)(4)(C) should exclude Code Section 707(a) payments from QBI where the payments are from partners with significant interests in the partnership receiving the payment or where the partners providing the services are not providing similar services for other unrelated third parties, we believe that by including the phrase "except as provided in regulations" Congress was indicating that there are times that income from Code Section 707(a) payments should be included in QBI. By excluding all such income from QBI, the Proposed Regulations effectively eliminate the need for Congress to have included the phrase "to the extent provided in regulations" in the text of Code Section 199A(c)(4).

Accordingly, we respectfully request that the application of Proposed Regulation Section 1.199A-3(b)(2)(ii)(J) be limited only to individuals and RPEs that are either (i) not otherwise engaged in a trade or business of providing such services to other consumers or (ii) exceed a de minimis ownership amount.

Further, we respectfully request that the language in Proposed Regulations Section 1.199A-3(b)(2)(ii)(J) be clarified so that (i) the "trade or business" to which this section is intended to relate is the trade or business of the partnership, and not the trade or business of the partner providing the service and (ii) such provision is only effective with respect to 707(a) income to a partner that is unrelated to such partner's trade or business.

B. Guaranteed Payments Under Section 707(c) for the Use of Capital Should Not Be Excluded from QBI

Code Section 199A(c)(4)(B) states that "[q]ualified business income shall not include any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business." Similarly, Code Sections 199A(c)(4)(A) and (C) eliminate certain payments of compensation for services from the QBI of a taxpayer's qualified trade or business. Based on the language of Code Section 199A(c)(4), Congress clearly intended to limit QBI treatment for certain compensation and guaranteed payments paid by a partnership to one of its partners for services. No mention was made, however, with respect to guaranteed payments for capital. Despite this, Proposed Regulations Section 1.199A-3(b)(ii) eliminates from QBI payments attributable to a guaranteed payment for the use of capital. We believe that the application of the limitation in the Proposed Regulations to guaranteed payments for capital is an overextension of Congressional intent and such limitation should be removed for the following reasons:

- The limitation would negatively impact common business transactions. For instance, a taxpayer that provides capital to a partnership accompanied by an "equity kicker" would see what may be QBI automatically converted into non-QBI, regardless of the scope of ownership such partner may have in a partnership.

- To this day there remains a significant amount of confusion as to what sort of payments would and would not be treated as a guaranteed payment for capital under the Code and existing Regulations. We would welcome any clarification in the final Regulations that would shed additional light on the sorts of payments that would (i) constitute a guaranteed payment for capital and (ii) be prohibited from QBI inclusion under the Proposed Regulations, as drafted.

- This rule is unfair as compared to other RPEs, such as S corporations, that do not have a similar rule.

- If the relevant payor partnership is engaged in a trade or business for purposes of Code Section 162 (and therefore for purposes of Code Section 199A), then the guaranteed payment should be includible in the QBI calculation as income for the recipient partner. Section III.A(ii) of the Preamble to the Proposed Regulations indicates that the rationale for this rule is because "guaranteed payments for the use of capital under Code Section 707(c) are determined without regard to the income of the partnership…such payments are not considered attributable to a trade or business, and thus do not constitute QBI." As noted above, guaranteed payments for the use of capital are a common aspect of partnership business; such guaranteed payments are taxed to the recipient partner as a distributive share from the partnership and included in the income of the recipient partner under Code Section 706(a).

- From a policy perspective, a guaranteed payment for the use of capital (as distinguished from a guaranteed payment for services that is akin to employee compensation) should be treated similarly with respect to the determination of income and expenses. This is not the case as currently drafted, however, as the Proposed Regulations affirmatively treat such guaranteed payments as attributable to a trade or business only for purposes of constituting an item of expense in calculating QBI and specifically do not treat such guaranteed payments as attributable to a trade or business for purposes of constituting an item of income in calculating QBI.

- The Preamble to the Proposed Regulations specifically mentions that guaranteed payments for capital are not at risk in the same way as other forms of income. In reality, however, there is often discounting with respect to use of capital when equity is issued at the same time, which inherently includes an element of risk for the provider of such capital by virtue of holding a partnership interest that is subordinated to other indebtedness.

Accordingly, for the reasons stated above, we respectfully recommend that guaranteed payments for capital under Code Section 707(c) should not be excluded from QBI.

IV. SPECIFIED SERVICE TRADE OR BUSINESS AND THE TRADE OR BUSINESS OF PERFORMING SERVICES AS AN EMPLOYEE

Request for Additional Guidance as to the Meaning of Services Performed in the Field of Health

For purposes of the Section 199A Deduction, the term "qualified trade or business" excludes any trade or business involving the performance of services in the field of health. *See* Code Sections 199A(d)(1)(A), (2)(A). Proposed Regulation Section 1.199A-5(b)(2)(ii) defines the "performance of services in the field of health" as being limited to only "the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologist and other similar healthcare professionals performing services in their capacity as such who provide medical services directly to a patient (service recipient)." This section of the Proposed Regulations goes on to provide that "[t]he performance of services in the field of health does not include the provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient." In addition, the Propose Regulations list the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or research, testing, and manufacture and/or sales of pharmaceuticals or medical devices as examples of the performance of services that are not treated as the performance of services in the field of health for purposes of the Section 199A Deduction. We generally commend Treasury and the IRS for narrowing the definition of the performance of services in the field of health as described in the Proposed Regulations.

Given the vast number of businesses and industries affected, however, it would be helpful for Treasury and the IRS to provide further elaboration, by way of examples or otherwise, as to what constitutes "performance of services in the field of health" for purposes of the Section 199A Deduction and whether two separate activities would generally be viewed separately in determining whether or not an activity should be properly viewed as the "performance of services in the field of health." This is especially the case with respect to healthcare facilitators that provide improved real estate and equipment in the healthcare industry (i.e., healthcare facilities), such as free-standing emergency centers (which are separate from acute care hospitals), urgent care centers, or surgical centers. These healthcare facilitators do not themselves directly provide treatment and diagnostic care to service recipients. Instead, the healthcare facilities offered by the healthcare facilitators are rented by physicians, or are effective "rented" by service recipients being treated directly by physicians at the healthcare facilities. Such health care facilitators may also provide the healthcare facilities and independently contract with physicians to be "on staff" at those healthcare facilities provide direct treatment and diagnostic care to service recipients, with the physicians charging separately for their services due state law prohibitions against the "corporate practice of medicine." In these situations, it would be helpful for taxpayers to have a clearer statement that these healthcare facilitators will not be treated as being in a trade or business of performing services in the field of health, especially when one or more of the owners also perform medical services in the facilities.

There is precedent under Code Sections 469 for distinguishing between (i) providing direct treatment and diagnostic care to service recipients by licensed health care professionals ("Direct Care") versus (ii) companies which engage in the business of providing services or facilities ancillary to the Direct Care, even where physicians own a minority interest in the entity owning the facilities.

For purposes of the passive activity loss rules under Code Section 469, the Tax Court and the IRS have each held that a physician's activities should not be grouped with the activities of a separate LLC that owned the facilities where the physician performed his medical services where the physician only had a minority interest in and exercised no management over the LLC's operations. *See Stephen P. Hardy, et. ux. v. Commissioner,* T.C. Memo 2017-16 (2017) (holding that physician's wholly owned medical practice should not be grouped with his minority interest in an LLC owning a surgery center for purposes of the passive loss rules); T.A.M. 2016-34-022 (Apr. 5, 2016) (holding that an LLC owning a surgery center did not have to be grouped with a physician medical practice where surgery center performed different medical services and the physician had different ownership and control of the LLC compared with his medical practice). Although we understand that Treasury and the IRS are not adopting the Code Section 469 grouping rules as the means by which taxpayers can aggregate trades and businesses for purposes of applying Code Section 199A, we respectfully still believe that the reasoning of this precedent for purposes of determining whether an activity should be treated as separate for purposes of whether the activity should constitute the performance of services in the field of health.

Accordingly, we respectfully request that Treasury and the IRS provide additional clarification in the form of examples or otherwise to clarify its treatment of whether healthcare facilitators (or similar entities) that are not directly involved with the provision of healthcare services will be treated as performing services in the field of health, especially when one or more of the owners of the healthcare facilitators also performs medical services in the facilities owned by the facilitators.

V. LOOK-THROUGH OF SALES OF US PARTNERSHIP INTERESTS

Regulatory clarification requested in determining QBI under Code Section 864(c)(8) upon a sale of a partnership interest

We request clarification within the Proposed Regulations as to whether, notwithstanding Code Section 199A(c)(3)(A)(i), a partnership interest must be owned by a trade or business (within the meaning of section 199A) for Code Section 751 gain to be tested as QBI under Code Section 864(c)(8).

Proposed Treasury Regulation Section 1.199A-3(b)(1)(i) provides that with respect to a partnership "gain or loss attributable to assets of the partnership giving rise to ordinary income under section 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and is taken into account for purposes of computing QBI." According to Section III.A(i) of the Preamble of the Proposed Regulations, gain attributable to the assets of a partnership giving rise to ordinary income under Section 751(a) or (b) is QBI of that partnership only if "the other requirements of Code Section 199A and Prop. Reg. 1.199A-3 are satisfied." One such requirement involves the look-through provision of Code Section 199A(c)(A)(i) which requires that items of income, gain, deduction, and loss be effectively connected with the conduct of a trade or business within the United States (within the meaning of Code Section 864(c), determined by substituting "qualified trade or business (within the meaning of section 199A)" for nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears. Therefore, in order to determine whether the ordinary income recognized by a partnership under Code Sections 751(a) or (b) is QBI pursuant to Code Section 199A(c)(3)(A)(i) and Proposed Regulation Section 1.199A-3(b)(2)(i)(A), we must substitute "trade or business (within the meaning of section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears) in Code Section 864(c).

Newly enacted Code Section 864(c)(8) determines whether and to what extent the gain or loss from the sale of a partnership is effectively connected income when held by a nonresident alien or a foreign corporation. Unfortunately, it is not clear how to interpret Code Section 864(c)(8) after the substitution of terms as required by Code Section 199A(c)(3)(A)(i) and Proposed Regulation Section 199A-3(b)(2)(i)(A). When the required substitution of these terms is made, Code Section 864(c)(8)(A) reads as follows:

> Notwithstanding any other provision of this subtitle, if a **~~nonresident alien individual or foreign corporation~~** **trade or business (within the meaning of section 199A)** owns, directly or indirectly, an interest in a partnership which is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or any portion of) such interest shall be treated as effectively connected with the conduct of such trade or business to the extent such gain or loss does not exceed the amount determined under subparagraph (B).

This presents several issues. First, the concept of a trade or business "owning" an interest in a partnership is unclear. Ownership is something done by persons and business entities, and a "trade or business" is not precisely the same thing as a person or a business entity – it is a collection of assets that are owned. A reasonable interpretation of this version of Code Section

864(c)(8) is that a business entity conducting a trade or business (within the meaning of Code Section 199A) must own an interest in a partnership—i.e., a lower-tier partnership—in order for Code Sections 199A(c)(3)(A)(i) and 864(c)(8) to literally apply to treat amounts on the sale of the lower-tier partnership as effectively connected income ("ECI") that may qualify as QBI.

This seems counterintuitive to the intent of both the statute and the Proposed Regulations that a two-tier structure should be required to obtain the benefits of Code Section 199A with respect to Code Section 751 ordinary income. Furthermore, we do not believe this was the intent of the statute or the Proposed Regulations. If the qualified trade or business is conducted in a one-tier partnership structure, and a sale of that one-tier partnership interest by its owner produces Code Section 751 ordinary income, then we believe that the logic of Code Section 864(c)(8) should be applied to that sale to determine how much of the Code Section 751 ordinary income would be ECI (and therefore QBI), irrespective of whether the partnership could somehow be considered to be owned by a trade or business (within the meaning of Code Section 199A).

Accordingly, we respectfully request that Treasury and the IRS clarify the Proposed Regulations to explain that, notwithstanding Code Section 199A(c)(3)(A)(i), a partnership interest need not be owned by a trade or business (within the meaning of Code Section 199A) for Code Section 751 gain to be tested as QBI under the rule of Code Section 864(c)(8). This would be consistent with the approach taken by the IRS in Rev. Rul. 91-32, 1991-1 C.B. 107, the reasoning of which was rendered suspect by the decision in *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (2017) (the decision that prompted the promulgation of Code Section 864(c)(8)). If this clarification is not made, taxpayers face uncertainty as to whether the IRS may take the position that *Grecian Magnesite* does not permit gain on the sale of a partnership interest to be treated as ECI or QBI if neither Code 864(c)(8) itself (requiring a foreign seller), nor the as-substituted version of Code Section 864(c)(8) required by Code Section 199A (apparently requiring a two-tier structure in which a trade or business itself owns a lower-tier partnership interest), literally applies.

VI. RULES AFFECTING NON-GRANTOR TRUSTS

A. Comments Regarding Proposed Regulation Section 1.643(f)-1; Treatment of Multiple Trusts

We agree with the IRS that the issuance of Proposed Regulation Section 1.643(f)-1 is necessary to prevent taxpayers from undermining the intended effect of the "threshold amount" via a division of assets among multiple trusts so that each may then claim its own separate threshold amount. However, we request that the IRS provide additional clarity regarding its intended application of Proposed Regulation Section 1.643(f)-1 in the manner outlined below so that we and other tax advisors can properly counsel taxpayers on their available options for lifetime and testamentary trust planning.

1. Definition of Primary Beneficiary

It would be helpful if the IRS would provide a definition of "primary beneficiary." It is unclear whether that term refers only to a beneficiary currently entitled or permitted to receive distributions from a trust or whether the term is to be defined more broadly to include a beneficiary entitled to trust distributions upon the current beneficiary's death or, possibly, a beneficiary with an even more remote interest.

2. Determination of Whether Trusts Have "Substantially the Same Primary Beneficiary or Beneficiaries"

It would be helpful if the IRS would provide additional guidance as to how it will assess whether multiple trusts have "substantially the same primary beneficiary or beneficiaries," which is the first of two criteria (the "First Prong"; a principal purpose of the trusts being the avoidance of federal income tax, the "Second Prong") that if both met result in an aggregation of the trusts pursuant to the Multiple Trust Rules. Each of the examples in Proposed Regulation Section 1.643(f)-1(c) involves trusts with different stated beneficiaries, and notably the beneficiaries in Example (2) have significantly different rights under the separate trusts. However, the IRS appears to conclude in both instances that the trusts have substantially the same primary beneficiaries, necessarily in Example (1) due to the directed aggregation of the trusts and implicitly in Example (2) given the IRS's indication that the trusts are not to be aggregated absent evidence that they were created with a principal purpose of avoiding income taxes.

We understand that a literal application of the "substantially the same primary beneficiary or beneficiaries" standard would lend itself to taxpayer abuses that would render the Multiple Trust Rules meaningless. However, it would be helpful if the IRS would explain the basis for what appears to be its implicit assessment that the Example (2) trusts have substantially the same primary beneficiaries despite the notable differences in their beneficial interests.

It would also be helpful if the IRS would further illustrate situations in which it believes that trusts that ostensibly provide for different primary beneficiaries with different beneficial interests should be considered as having or not having "substantially the same primary beneficiary or beneficiaries" for purposes of Proposed Regulation Section 1.643(f)-1.

For example, it is common for parents to create separate trusts for children and their family groups with virtually identical dispositive terms and provide for each child and his/her descendants to be contingent beneficiaries of the trusts for a sibling and his/her descendants in the event that sibling's family group has no surviving member. Separate trusts are typically created in that event to accommodate each child's desire to be the sole trustee of his or her share of the gifted wealth and thereby manage his or her trust in a manner that aligns with his or her personal distribution and investment philosophies. This avoids the tensions and estrangements that can develop when siblings' financial affairs become too entangled.

We believe those objectives are "significant non-tax (or non-income tax)" purposes that could not be achieved without the creation of the separate trusts, and thus in our opinion the planning safely avoids failing the Second Prong. However, we are mindful of the case law mandating a need to more closely scrutinize stated non-tax reasons for intra-family planning.

In light of that history, we request additional clarity regarding the structure of trusts that avoid failing the First Prong so that taxpayers and the IRS can avoid protracted disagreements as to whether the selected planning avoids failing the Second Prong. Based upon the examples provided, we are concerned that the conventional multi-trust planning outlined above typically adopted by parents to transition ownership of a "qualified trade or business" to descendants might not be respected by the IRS under the Multiple Trust Rules. Specifically, the examples suggest that the IRS might be inclined to discount what we believe to be true differences in beneficiary status and beneficial interests in contexts it views as being principally driven by an income tax avoidance objective, thereby arguably ignoring the First Prong.

3. Impact of Modifications of and Additional Contributions to Pre-Effective Date Trusts

The Preamble suggests that the rules of Proposed Regulation Section 1.643(f)-1(d) apply not only to trusts entered into or modified on or after August 16, 2018 but also apply to trusts previously entered into or modified prior to that date based upon those rules being generally reflective of Congress' intent in enacting Code Section 643(f). Given that, we would appreciate clarity as to the specific trusts the IRS considers subject to the Multiple Trust Rules, which presumably would exclude irrevocable trusts created prior to March 1, 1984 unless later becoming subject to the Multiple Trust Rules due to a modification or additional contributions.

It would also be helpful if the IRS would explain the types of modifications to exempt trusts that would cause them to become subject to the Multiple Trust Rules and those that could be safely pursued. For example, we welcome confirmation that modifications that are administrative in nature (e.g., eliminating the requirement of a corporate trustee) will not cause an exempt trust to become subject to the Multiple Trust Rules.

Presumably, a trust division could be considered a type of modification that would subject an exempt trust to the Multiple Trust Rules. If so, it would be helpful if the IRS would explain the types of divisions of exempt trusts that could be safely pursued in that regard. For example, it is common for a trust to be divided into separate trusts for non-income tax reasons, whether via a qualified severance pursuant to Code Section 2642 designed to separate its GST exempt and nonexempt portions into separate trusts or via a division of a trust created for all of the grantor's descendants designed to provide the children and their family groups with separate trusts for the previously noted reasons. Consequently, we welcome the IRS's confirmation that trust divisions for those purposes in particular will not subject the resulting separate trusts to the Multiple Trust Rules if the original trust was an exempt trust.

Lastly, we welcome guidance from the IRS as to whether post-effective date contributions to exempt trusts will result in the entirety of those trusts being aggregated and treated as a single trust pursuant to the Multiple Trust Rules or whether only the post-effective date contributed portion of each trust will be aggregated into a deemed single trust for that purpose. We believe the latter result is most consistent with the intent of the Multiple Trust Rules.

B. Comments Regarding Proposed Regulation Section 1.199A-6: Trusts and Estates

We appreciate the guidance provided by the IRS regarding the application of Code Section 199A to trusts and estates. However, we request that the IRS provide additional clarity regarding its intended application of Proposed Regulation Section 1.199A-6 in the manner outlined below so that we and other tax advisors can properly ensure that our clients remain in compliance with IRS requirements.

1. The Distribution Deduction Should Be Considered in Determining Whether the Taxable Income of Trusts and Estates Exceeds the Threshold Amount

The proposed regulations confirm that the taxable income threshold amount for a trust is \$157,500. The proposed regulations also provide that the threshold amount be determined at the trust level without taking into account any distribution deductions presumably based on a concern that the threshold amount could be subject to manipulation. We note that this position is inconsistent with the application of Code Section 1411 to trusts, which permits a distribution deduction in determining the various thresholds and the application of the net investment income tax that theoretically could be subject to manipulation. We appreciate the concern regarding potential manipulation. However, trustees owe fiduciary duties to beneficiaries and utilizing distributions to manipulate the Code Section 199A threshold is inconsistent with those duties (as described below).

We appreciate the IRS's concern that a trustee could manipulate the taxable income of a trust to stay below the threshold by distributing at least the excess amount of taxable income to its beneficiaries in return for a deduction pursuant to Code Section 651 or 661, as applicable. We think it is important to note that the IRS is apparently assuming that the "strategic" distributions will not cause a recipient to have taxable income after the distribution in excess of the threshold amount, which would be a situation that does not entail the overall manipulation of eligibility for the Code Section 199A deduction that the IRS is ostensibly attempting to address.

We believe the IRS's concerns that trustees will manipulate distributions solely for purposes of reducing the taxable income of trusts to the threshold amount ignores the impact of the various fiduciary duties imposed upon trustees. Specifically, we ask the IRS to consider that a trustee's duty of loyalty requires the trustee to act in a manner that is fair and impartial to all trust beneficiaries, not just those currently entitled to distributions (as discussed in more detail below).

A trustee may (but does not always) have the ability under a trust instrument to consider the income tax implications of a discretionary distribution to a current beneficiary. However, the trustee generally must always be mindful of the impact of a discretionary distribution on the interests of the remainder beneficiaries, as well as the current beneficiary if the distributed funds are not actually "needed." Distributed funds will lose the trust-provided creditor, "divorcing-spouse," and generation-skipping transfer tax protections, which could otherwise be preserved by the trustee retaining the funds for a future distribution to the current beneficiary when truly needed.

We urge the IRS to consider whether the failure to take into account the distribution deduction will penalize trusts and their beneficiaries when viewed collectively by attributing taxable income actually distributed to beneficiaries to both those beneficiaries and the trust for purposes of determining threshold-related limitations (i.e., double-counting taxable income). We believe the resulting overstatement of the taxable income of trusts is inappropriate and inconsistent with the legislative purpose of Code Section 199A. Therefore, we respectfully request that the IRS consider permitting a trust to calculate its taxable income for purposes of the threshold by taking the deduction pursuant to Code Section 651 or 661, as applicable.

As a caveat, we appreciate the IRS's concern that a trustee could take steps to manipulate the taxable income of a trust to stay below the threshold via a division of the trust into multiple trusts solely undertaken so that each could have its own threshold amount. We believe that trustees are far less restricted by their fiduciary duties in such attempts to circumvent the taxable income threshold when compared to a distribution designed to achieve the same result, given that a division of a trust into multiple trusts with identical terms is less likely to be challenged by a beneficiary on a breach of fiduciary duty basis. We accordingly appreciate the need for the anti-abuse provision of Proposed Regulation Section 1.199A-6(d)(3)(v).

2. Negative QBI Should Not Be Allocated to an Estate or Trust Beneficiary Based on Its Relative Proportion of DNI

Except in the year of termination of an estate or trust, as provided under Code Section 642(h), losses are not distributed to beneficiaries. Losses incurred by an estate or trust are retained at the entity level. It appears that distributing QBI net losses to a beneficiary is contrary to the existing framework of the taxation of trusts, estates, and their beneficiaries. We propose that if a trust or estate has a QBI net loss that the loss carryover be retained at the entity level.

3. Taxable Beneficiaries of Charitable Remainder Trusts and Other Split-Interest Trusts Should Be Eligible for Code Section 199A Deduction

The IRS has requested comments with respect to whether taxable beneficiaries of charitable remainder trusts and other split-interest trusts should be eligible for the Code Section 199A deduction to the extent each receives distributed value that may give rise to the deduction. The IRS has also requested that such comments include explanations of how amounts that may give rise to the Code Section 199A deduction would be identified and reported in the various classes of trust income received by the beneficiaries and how the excise tax rules in Code Section 664(c) would apply.

The legislative history of Code Section 199A indicates that it was enacted to provide a deduction for taxpayers other than a corporation (including trusts) based on QBI. Thus charitable remainder trusts, charitable lead trusts, and their beneficiaries should be eligible for the Code Section 199A deduction. We believe it would be unusual to have QBI in a split-interest trust due to the adverse tax consequences related thereto. The fact that this would not be a common situation should not be a reason to disallow a Code Section 199A deduction.

Charitable remainder trusts have a tier system of classifying items of income and deductions based on the tax character of those items (i.e. ordinary income, capital gains, and tax-exempt income). Under this system, required trust distributions are treated as being allocated first to the ordinary income tier and then to the other tiers. QBI would be allocated to the ordinary income tier.

Charitable remainder trusts are not subject to income tax and thus taxable income is not calculated at the trust level. This treatment effectively prohibits a trust from taking a Code Section 199A deduction because there is no taxable income. This treatment also prohibits the allocation of QBI, W-2 wages, and UBIA based on DNI since a charitable remainder trust does not have DNI. We recommend that the IRS consider an allocation of QBI, W-2 wages, and UBIA to the beneficiary that is based on the percentage of the ordinary income tier distributed to the beneficiary and that the QBI allocated to the trust remain a tier one item that could be distributed in future years (with the associated W-2 wages and UBIA being allocated at that time to the non-charitable beneficiary).

Non-grantor charitable lead trusts are subject to the same tax treatment as non-grantor, non-charitable trusts except that the charitable lead trust typically only has charitable beneficiaries during the lead term. Distributions to those beneficiaries generally qualify for a Code Section 642(c) deduction except as modified when the trust has unrelated business taxable income. We recommend that the allocation of QBI, W-2 wages, and UBIA be based on the allocation of DNI as per the proposed regulations. This allocation will typically result in the Code Section 199A deduction calculation being made at the trust level subject to the taxable income limitation calculated after the charitable deduction. The threshold amount should be the same as other trusts i.e. $157,500 calculated after the allowance of the charitable deduction.

A charitable remainder trust with unrelated business taxable income ("UBTI") is subject to an excise tax equal to 100% of the amount of UBTI per Code Section 664(c). The tax deduction allowed under Code Section 199A should not be allowed as a deduction when calculating UBTI because it is not a deduction directly connected with the carrying on of such trade or business. Additionally, pursuant to Code Section 199A(f)(3), the Code Section 199A deduction is allowed only for purposes of Chapter 1 of the Code. Pursuant to Code Section 664(c)(2)(B), the UBTI excise tax is deemed imposed pursuant to Chapter 42.

We appreciate the opportunity to provide these comments and suggestions on the Proposed Regulations. Thank you for your consideration.

STATEMENT OF DIRECTION

To: The 2018-2019 Council Members, Committee Chairs, and Vice Chairs of the State Bar of Texas Tax Section

From: The 2018-2019 Officers of the State Bar of Texas Tax Section

Date: August 24, 2018

* * * * *

Set forth below is an overview of our goals, and plans for the future.

<u>OUR ASSETS</u>

The assets of the Section are its members. Its members are vested with:

- Knowledge
- Experience
- Relationships
- Limited time

<u>OUR GOALS</u>

The Council should effectively use Section members to carry out the Section goals of:

- *Education* – The Section will provide world-class education to its members through accessible and relevant CLE.
- *Better Laws* – The Section will seek to improve the substance and administration of state and federal tax laws.
- *Pro Bono* – The Section will deliver the knowledge and experience of its members to those people who cannot afford the services of tax lawyers.
- *Enhanced Profile* – The Section will enhance the profile of its members within the tax community, including Treasury, the Internal Revenue Service, the Comptroller, and practitioners. The enhanced profile will benefit Section members by furthering the national respect for, and credibility of, Texas tax lawyers.
- *Future Leaders* – The Section will develop future leaders of the Tax Section through its Leadership Academy.
- *Outreach* – The Section will engage in our student scholarship program and regularly contact students through presentations at law schools and through other

communications to promote the practice of tax law. Section contacts should also include targeted communications to rural and small firm practitioners.

- *Having Fun* – The practice of law is difficult enough. This stuff we do with the Section should be fun.

BACKGROUND INFORMATION

Committee Analysis

We have two types of Committees:

Facilitator Committees: The Facilitator Committees set forth below help with coordinating projects and resources, removing barriers, monitoring tasks, soliciting participation, studying needs, and communicating with members.

- Continuing Legal Education (CLE)
- Government Submissions (COGS)
- Pro Bono
- Solo Practitioner and Small Firm
- Communications (*Texas Tax Lawyer* and Website)
- Leadership Academy
- Annual Meeting
- Law School Outreach (Coming Soon)

Substantive Committees: The Substantive Committees set forth below have responsibility for particular areas of taxation.

- Corporate Tax
- Employee Benefits
- Energy and Natural Resources
- Estate and Gift Tax
- General Tax
- International Tax
- Partnership and Real Estate Tax
- Property Tax

- State and Local Tax
- Tax Controversy
- Tax-Exempt Finance
- Tax-Exempt Organizations

<u>Law School Liason Task Force – Soon to be a Committee</u>

In addition to Committees, the Section has a Law School Liaison Tax Force. This Task Force has the responsibility for providing outreach to law schools as an effective membership development program and for administering the Section's scholarship program. Council Members Audrey Morris, Abbey Garber, and Stephen Long lead this Task Force.

<u>Annual Meeting</u>

The Annual Meeting Committee has the responsibility for planning and organizing all aspects of the annual meeting of the Section, including the CLE program and the Legends lunch. This Task Force is responsible for coordinating with the State Bar. The State Bar contact is Tracy Nuckols at 800-204-2222 ext. 1710 or tracy.nuckols@texasbar.com. It will be a team effort to put on the Annual Meeting this year with Dan Baucum as the Master of Ceremonies.

<u>COGS</u>

The most important way in which the Section seeks to improve the substance and administration of state and federal tax laws is through the COGS process. The COGS process is also the most effective way in which the Section can work towards the goals of enhancing the profile of its members within the tax community and furthering the national reputation of the Texas tax bar. In order to do this, every COGS project must be of the highest quality. We strongly encourage leaders of each COGS project to present their positions and recommendations in testimony before the applicable agencies in the appropriate forums.

Appointed Council members Henry Talavera, Jeffry Blair, Ira Lipstet and Jason Freeman are responsible for COGS. Sam Megally is a Vice Chair of COGS this year.

<u>CLE</u>

The Section provides world-class education to its members through accessible and relevant CLE, including in-person CLE programs, and the 24/7 library of free Webcast programs. Appointed Council members Dan Baucum, Michael Threet, Lora Davis and Amanda Traphagan are responsible for CLE.

The Section sponsors and conducts in-person CLE programs, including the annual Property Tax program, the annual International Tax programs, and State and Local Tax committee events. In addition, the Section co-sponsors various in-person CLE programs, including the Advanced Tax Law Program conducted by Texas Bar CLE. There will be a definite do over of the Targeted Advanced offering of Governmental Speakers in the Spring with Dan Baucum at the helm. We intend to continue Tax Law in a Day this year and collaborate with the State Bar and Dallas Bar

Solo and Small Firm to add a twist to the day. The Section takes advantage of other co-sponsorship opportunities presented to it, such as the Texas Society of CPAs Free CPE Day.

The Section has implemented a 24/7 library of free CLE Webcast programs (audio and video) accessible at any time to Section members through the Section's website. Each Webcast is approximately one-hour long. These Webcasts include "Basic Practice Skills" of the type that are expected to remain relevant for several years and "Advanced Practice Webcasts" covering a hot and/or advanced matter in a substantive area. Presentations from the Dallas and Houston Bar Associations are also added to the 24/7 free CLE library. In addition, in-person CLE programs are added to the 24/7 free CLE library as permitted. In all cases, the topics for Webcasts must be approved by the Chair of the CLE Committee. Except in certain circumstances where approved by the Chair of the CLE Committee, the Section intends for Webcasts to have a shelf life of no more than two years.

Pro Bono

The Section will continue its Pro Bono efforts. These include building upon and expanding the Section's program to assist pro se taxpayers during Tax Court calendar calls in Dallas, Houston, Lubbock, El Paso, and San Antonio, as well as providing support to appropriate charitable and governmental programs such as Texas C-Bar and VITA. Juan Vasquez and Rachael Rubenstein are the appointed Council Members responsible for Pro Bono. Elizabeth Copeland a former Chair of the Pro Bono Committee has committed to producing a teaching video for the Pro Bono Program in the near future.

Communications

The Section will continue to improve its communications with members and to market the Section's CLE programs. Catherine Scheid, Chair of the Section, will send an e-mail to the Section members at least once a month informing the members of upcoming CLE programs, the Section's 24/7 library of free CLE Webcast programs, COGS projects, Pro Bono initiatives, and other programs and activities of the Section. The messages will invite participation and suggestions and will generally promote the activities of the Section.

The Section publishes three issues of *The Texas Tax Lawyer* each year, which are distributed to members and other recipients electronically and, upon request, in hardcopy. Each Committee is expected to produce at least two submissions for *The Texas Tax Lawyer,* which may include substantive outlines from Committee Webcasts, COGS submissions, articles, or annotated forms. Michelle Spiegel is the appointed Council Member responsible for the T*exas Tax Lawyer*.

Another means of communicating with the Section includes the Section's website. As previously approved by the Council, the Section is undertaking efforts this year to implement a new website. Each officer, Council Member, and Committee chair is responsible for keeping the website current for programs, events, and materials under such person's responsibility by sending updates to the Tax Section Administrator, Anne Schwartz at anneschwartz@gmail.com.

Leadership Academy

This Committee has the responsibility for developing and implementing the Leadership Academy. Rob Morris, Chair of the Leadership Academy Committee and an appointed Council

Member is the Leadership Academy Program Director. There is a Leadership Academy video on the Tax Section's website.

<u>SUBSTANTIVE COMMITTEE TASKS</u>

Each Substantive Committee will implement the goals of the Section by accomplishing each of the following tasks this fiscal year:

- Identify and execute at least one COGS comment project and, if appropriate, present it in testimony before the applicable agency.

- Produce the content for, and acquire the speakers to present, one or more Basic Skills Webcast or Advanced Practice Webcast from the Committee's substantive area. All Webcast topics and titles must be approved in advance by the CLE Chair.

- Review the Webcasts in the Section's 24/7 free CLE library from the Committee's substantive area, identify those Webcasts that are no longer relevant or otherwise need to be removed or replaced, and suggest replacement or additional Webcasts, as appropriate. Unless otherwise approved by the CLE Chair, the Section intends for Webcasts to have a shelf life of no more than two years.

- Produce at least two submissions (in total) for *The Texas Tax Lawyer*, which will be issued in October 2018, February 2019, and June 2019. Submissions may be in the form of substantive outlines from Committee Webcasts, COGS submissions, articles, or annotated forms.

- Review and update your committee's page on the Tax Section website and provide any updates to the Tax Section Administrator, Anne Schwartz at anneschwartz@gmail.com.

- Maintain a list of Committee Members and communicate regularly with them (at least once a month except the month of the Quarterly Committee Call where the call is the Communication) through the Committee's Outlook mailing lists regarding the following:

    - New webcasts in the Section's 24/7 free CLE library relevant to the Committee

    - Solicitation of Webcast speakers

    - Upcoming in-person CLEs relevant to the Committee

    - Solicitation of COGS ideas and volunteers

    - Distribution of recently completed COGS projects

    - Requests for *Texas Tax Lawyer* submissions

  - Important updates or other items of interest
- Recruit at least five new Committee Members
- Quarterly Committee Call.

TAX SECTION OF
THE STATE BAR OF TEXAS

2018 – 2019 CALENDAR

June 2018	
Thur - Fri 06/21/18 – 06/22/18	**SBOT Annual Meeting** Marriott Marquis Hotel 1777 Walker Street Houston, Texas 77010 (713) 654-1777
Thursday 06/21/18	**Tax Section Council Planning Retreat** Marriott Marquis Houston, Texas 1:00 p.m. - 4:00 p.m.
Thursday 06/21/18	**2018 Tax Section Annual Meeting Speaker's Dinner** Grappino's 2817 W. Dallas Street Houston, Texas (713) 528-7002
Thursday 06/21/18	**Presentation of Outstanding Texas Tax Lawyer** Award Presentation at State Bar Annual Meeting, Speakers' Dinner Grappino's 2817 W. Dallas Street Houston, Texas (713) 528-7002
Friday 06/22/18	**2018 Tax Section Annual Meeting Program** Marriott Marquis Hotel 1777 Walker Street Houston, Texas 77010 (713) 654-1777
Friday 06/22/18	**Presentation of 2018 Tax Legend Award** Award Presentation During Tax Section Annual Meeting Program Marriott Marquis Hotel 1777 Walker Street Houston, Texas 77010 (713) 654-1777
July 2018	
Wednesday 07/04/18	**July 4th Holiday**
Fri - Sun 07/13/18 - 07/15/18	**Officer's Retreat** Granbury, Texas 76048

Tuesday 07/17/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00 a.m.
Thur - Sat 07/19/18 – 07/21/18	**Texas Bar College** Summer School Moody Gardens Hotel, Spa & Convention Center Seven Hope Boulevard Galveston, TX 77554
?	**Tax Section Budget Deadline** (Budget must be submitted to State Bar of Texas)
Monday 07/23/18	**SBOT Chair and Treasurer Training** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
August 2018	
Thur – Tues 08/02/18 – 08/07/18	**American Bar Association Annual Meeting** Hyatt Regency Chicago, Chicago, Illinois
Tuesday 08/07/18	**Officer's Call** 4:00 p.m.
Thur – Fri 08/09/18 – 08/10/18	**Advanced Tax Law Course** Cityplace Events, Dallas, Texas
Tuesday 08/21/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00 a.m.
Friday 08/24/18	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 (48th Floor) 10:30 a.m. – 12:30 p.m. w/lunch Dial In: 866-203-7023 Conference Code: 713-651-5591# Security Passcode: None – at the prompt press *
Sept 2018	
?	**Deadline for Submissions to State Bar of Texas Board of Directors Meeting Agenda**

Monday 09/03/18	**Labor Day Holiday**
Tuesday 09/04/18	**Officer's Call** 4:00 p.m.
Sun - Tues 09/09/18 – 09/11/18	**Rosh Hashanah (Religious Holiday)**
Friday 09/14/18	**Submission Deadline – Texas Tax Lawyer (Fall Edition)** Submit to TTL Editor: Michelle Spiegel michelle.spiegel@nortonrosefulbright.com
Monday 09/17/18	**Tax Court Pro Bono Calendar Call-Lubbock**
Monday 09/17/18	**Outreach to Law Schools/Texas Tech School of Law**
Tuesday 09/18/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00 a.m.
Tues - Weds 09/18/18 – 09/19/18	**Yom Kippur (Religious Holiday)**
Thursday 09/20/18	**Deadline for Appointment of Tax Section Nominating Committee**
Sun - Sun 09/23/18 – 09/30/18	**Sukkot (Religious Holiday)**
Oct 2018	
Monday 10/01/18	**Tax Court Pro Bono Calendar Call - Dallas & San Antonio**
Tuesday 10/02/18	**Officer's Call** 4:00 p.m.
Thurs - Sat 10/4/18 – 10/6/18	**American Bar Association Section of Taxation Joint Fall CLE Meeting** Hyatt Regency, Atlanta, Georgia
Monday 10/08/18	**Columbus Day Holiday**
Monday 10/15/18	**Tax Court Pro Bono Calendar Call - Houston**

Tuesday 10/16/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00 a.m.
Tues - Fri 10/23/18 – 10/26/18	**Council on State Taxation (COST) 49th Annual Meeting** Arizona Grand Resort & Spa, Phoenix, Arizona
Friday 10/26/18	**Council of Chairs Meeting** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
?	**National Association of State Bar Tax Sections ("NASBTS") Annual Meeting**
Tuesday 10/30/18	**COST Regional Meeting** Austin, Texas
Wednesday 10/31/18	**Insurance Renewal is Due Note Premium Paid by Big Bar!**
Nov 2018	
Monday 11/05/18	**Tax Court Pro Bono Calendar Call-Dallas**
Tuesday 11/06/18	**Officer's Call** 4:00 p.m.
Thurs - Fri 11/08/18 – 11/09/18	**20th Annual International Tax Symposium** Crowne Plaza Houston River Oaks 2712 Southwest Freeway Houston, TX 77098
Thurs - Fri 11/08/18 – 11/09/18	**Austin Chapter CPA Annual Tax Conference** Norris Conference Center, Austin, Texas
Friday 11/09/18	**Meeting of Council** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 (48th Floor) 10:30 a.m. – 12:30 p.m. w/lunch Dial In: 866-203-7023 Conference Code: 713-651-5591# Security Passcode: None – at the prompt press *

Monday 11/12/18	**Veterans Day Holiday**
Monday 11/12/18	**Annual Meeting Deadline for submitting to SBOT date and time preferences for CLE programs, section meetings, council meetings, socials and special events**
Tuesday 11/13/18	**Comptroller Annual Meeting Briefing**
Wed - Thurs 11/14/18 – 11/15/18	**UT Law 66th Annual Taxation Conference** AT&T Conference Center, Austin, Texas
Tuesday 11/20/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00 a.m.
Thursday 11/22/18	**Thanksgiving Day Holiday**
Dec. 2018	
Sun - Mon 12/02/18 – 12/10/18	**Hanukkah (Other Holiday)**
Tuesday 12/04/18	**Officer's Call** 4:00 p.m.
Monday 12/10/18	**Tax Court Pro Bono Calendar Call-Dallas**
Monday 12/17/18	**Tax Court Pro Bono Calendar Call-Houston**
Tuesday 12/18/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00 a.m.
Tuesday 12/25/18	**Christmas (Other Holiday)**
Jan. 2019	
Tuesday 01/01/19	**New Year's Day Holiday**
?	**Nomination Period Opens for 2019 Outstanding Texas Tax Lawyer Award** • Nominations due April 1, 2019 • Nomination forms to be posted on website • Submit nomination forms to Tax Section Secretary: Christi Mondrik

Wednesday 01/02/19	**Officer's Call** 4:00 p.m.
?	**Deadline for receipt of information for SBOT Board of Director's Meeting Agenda**
Monday 01/07/19	**Annual Meeting Deadline: Submit programming for the registration brochure, CLE topics, speakers, and speaker contact information and firms**
Monday 01/7/19	**Pro Bono Tax Court Calendar Calls – San Antonio**
Friday 01/11/19	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 (48th Floor) 10:30 a.m. – 12:30 p.m. w/lunch Dial In: 866-203-7023 Conference Code: 713-651-5591# Security Passcode: None – at the prompt press *
Friday 01/11/19	**Leadership Academy application due for the 2019-2020 class**
Tuesday 01/15/19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00 a.m.
Thur - Sat 01/17/19 – 01/19/19	**American Bar Association Section of Taxation Midyear Meeting** Hyatt New Orleans, New Orleans LA
Monday 01/21/19	**Martin Luther King Jr. Day (Holiday)**
?	**Application Period Opens for Law Student Scholarship Program**
Friday 01/25/19	**Submission Deadline – Texas Tax Lawyer (Winter Edition)** Submit to TTL Editor: Michelle Spiegel michelle.spiegel@nortonrosefulbright.com
Friday 01/25/19	**Tax Law in a Day CLE**
Monday 01/28/2018	**Pro Bono Tax Court Calendar Calls – El Paso**
Thursday 01/31/2019	**Pro Bono Tax Court Calendar Calls – Lubbock**

Feb. 2019	
Friday 02/01/19	**Register and make guest room reservations for Annual Meeting (www.texasbar.com/annualmeeting)**
?	**Leadership Academy Class of 2019-2020 Announced**
Monday 02/4/19	**Pro Bono Tax Court Calendar Call – Houston**
Tuesday 02/05/19	**Officer's Call** 4:00 p.m.
Monday 02/18/19	**George Washington's Birthday (Holiday)**
Tuesday 02/19/19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00 a.m.
?	**International Fiscal Association Oil & Gas Meeting**
Thur - Fri 02/21/19 – 02/22/19	**International Fiscal Association Annual Conference** Washington, D.C.
Friday 02/22/19	**Council of Chairs Meeting and Section Representative Election** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
Monday 02/25/2019	**Pro Bono Tax Court Calendar Calls – Dallas**
March 2019	
Friday 03/01/19	**Nomination Deadline for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members**
Monday 03/04/19	**Annual Meeting Deadline: Order special awards, council and chair plaques, food and beverage and audio visuals**
Tuesday 03/05/19	**Officer's Call** 4:00 p.m.
Monday 03/18/19	**Pro Bono Tax Court Calendar Calls – Dallas**

Tuesday 03/19/19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00 a.m.
Thur - Fri 03/21/19 – 03/22/19	**Leadership Academy Dallas Session**
Friday 03/22/19	**SBOT Tax Section Deep Dive Tax Workshop – Dallas** Belo Mansion 2101 Ross Ave Dallas, TX 75201
Sun - Wed 03/24/19 – 03/27/19	**Annual Meeting of Unclaimed Property Professionals Organization (UPPO)** Tampa, Florida
Monday 03/25/19	**Pro Bono Tax Court Calendar Calls – Houston**
?	**2019 State Bar of Texas Property Tax Committee Meeting & Legal Seminar**
April 2019	
Monday 04/01/19	**Nominations for Outstanding Texas Tax Lawyer Due to Christi Mondrik** Email**:** (cmondrik@mondriklaw.com)
Monday 04/01/19	**Nominating Committee Report Due to Council**
Wednesday 04/02/19	**Officer's Call** 4:00 p.m.
?	**Law Student Scholarship Application Deadline**
Friday 04/05/19	**Meeting of Council** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 (48th Floor) 10:30 a.m. – 12:30 p.m. w/lunch Dial In: 866-203-7023 Conference code: 713-651-5591# Security passcode: None - at the prompt press * **Note: Council Vote and Selection of Recipient of 2019 Outstanding Texas Tax Lawyer Award**
Friday 04/12/19	**Submission Deadline – Texas Tax Lawyer (Spring Edition)** Submit to TTL Editor: Michelle Spiegel michelle.spiegel@nortonrosefulbright.com

?	**Tax Court Pro Bono Calendar Call**
Tuesday 04/16/19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00 a.m.
Fri – Sun 04/19/19 – 04/21/19	**Good Friday, Passover, Easter Sunday (Religious Holiday)**
Monday 04/15/19	**Annual Meeting Deadline: course materials for app; CLE articles, PowerPoints, speaker bios and photos**
Monday 04/22/19	**Annual Meeting Deadline: submit any final programming changes for onsite event guide; CLE topic titles, speakers, speaker contact information and firm**
May 2019	
Tuesday 05/07/19	**Officer's Call** 4:00 p.m.
Thur - Sat 05/09/19 – 05/11/19	**American Bar Association Section of Taxation May Meeting** Grand Hyatt, Washington, DC
Monday 05/13/19	**Last Day of Early Bird Registration for Annual Meeting**
Monday 05/20/19	**Deadline to make guest room reservations for Annual Meeting at discounted rate (www.texasbar.com/annualmeeting)**
Tuesday 05/21/19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00 a.m.
Monday 05/27/19	**Memorial Day Holiday**
June 2019	
Tuesday 06/04/19	**Officer's Call** 4:00 p.m.
Wed – Fri 06/12/19 – 06/14/19	**Annual Texas Federal Tax Institute** La Cantera Resort, San Antonio, Texas
Wed - Fri 06/12/19 – 06/14/19	**Leadership Academy Austin Session (with Annual Meeting)**

Thur – Fri 06/13/19 – 06/14/19	**SBOT Annual Meeting** JW Marriot, Austin, Texas
Thursday 06/13/19	**Tax Section Council Planning Retreat** JW Marriott Austin, Texas
Thursday 06/13/19	**2019 Tax Section Annual Meeting Speaker's Dinner**
Thursday 06/13/19	**Presentation of Outstanding Texas Tax Lawyer** Award Presentation at State Bar Annual Meeting, Speakers' Dinner
Friday 06/14/19	**2019 Tax Section Annual Meeting Program**
Friday 06/14/19	**Presentation of 2019 Tax Legend Award** Award Presentation During Tax Section Annual Meeting Program
Tuesday 06/18/19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00 a.m.

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LEADERSHIP ROSTER

2018-2019

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TAX SECTION
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2018-2019

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1.	**Annual Meeting**	**[Pending]**	N/A (Planning Committee)
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***New Committee – Amendment to Bylaws in process to add Law School Outreach and Scholarship Committee.**