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TAX SECTION
STATE BAR OF TEXAS

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Dear Fellow Tax Section Members:

Somehow we are halfway through our 2018-2019 fiscal year. There is still a chill in the air, but the hope of Spring is on the horizon. The Tax Section is as busy as ever.

Pro Bono Committee

There is nothing bigger than the heart of a Texas tax lawyer helping others. The VITA Adopt-a-Base program has been going strong with **Rachael Rubenstein**, and **Charlotte Noel** devoted to training at Fort Hood, Fort Smith, Fort Sam, Lachland, and Good Fellow. Further, the volunteers for the Tax Court calendar call assisted taxpayers in Houston, Dallas, and San Antonio.

International Tax Symposium

The **21st Annual International Tax Symposium** took place November 9th in Houston. The event continues to be a success each year. There were 52 attendees and, for the first time, the Symposium was recorded as a webcast that was also broadcast on November 9th. Also, on November 8th, we presented a separate four-hour webinar focused on the Nuts and Bolts of International Tax. The Tax Section received positive comments from attendees on the quality of speakers and topics. Thank you, **John Strohmeyer**, **Vu Le**, **T. L. Fahring**, and **Samuel Denton**!

Tax Law in a Day

The Tax Section held its annual **Tax Law in a Day** program on Friday, January 25, 2019 in Dallas at the Belo Mansion. The CLE program focused on the effects of the new tax laws. This CLE program was started several years ago as a means of providing basic level tax continuing education and is available to both CPAs and attorneys. Many thanks to **Lora Davis**, **Renesha Fountain**, **David Gair**, **Tiffany Hamil**, and everyone else who helped make the program a success.

First Wednesday Tax Update

The Tax Section continues its wildly popular free webcast series, "**First Wednesday Tax Update**." The webcasts are offered the first Wednesday of each month, focus on recent developments in federal income taxation, and are presented by **Bruce McGovern**, Professor of Law and Director, Tax Clinic, South Texas College of Law Houston (and may occasionally include other guest speakers). We hope you will make plans to watch the webcast each month, but if you miss it, check the Tax Section's 24/7 online library after a few weeks.

Deep Dive Tax Workshop – 2019

The 2019 Deep Dive will be into the world of state and local tax and is titled, "A Post-*Wayfair* Deep Dive into Nexus." It is being held on March 22, 2019 at the Belo Mansion in Dallas. The following is an overview of the program:

- **Overview of Substantial Nexus and Issues to Consider for Litigation Exposure**
  Cindy Ohlenforst — K&L Gates
  David Colmenero — Meadows, Collier, Reed, Cousins, Crouch & Ungerman
  Jimmy Martens — Martens, Todd, Leonard & Alrich

- **Legislative Update - State and Federal**
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  Chris Blackwell Deloitte

- **Tax Administrators Roundtable: Thoughts on Wayfair from Inside the DORs**
  Nancy Prosser Texas Comptroller's Office
  Tim Jennrich Washington Department of Revenue
  Michael Fatale Massachusetts Department of Revenue
  Joe Garrett Alabama Department of Finance

- **The Role of Marketplace Providers**
  Kirk Lyda Jones Day
  Sam Megally K&L Gates
  William Lasher Ebay

- **To Streamline or Not to Streamline: Removing Undue Burden from Remote Sellers**
  Helen Hecht Multistate Tax Commission
  Nancy Prosser Texas Comptroller's Office
  Doug Lindholm Council on State Taxation

- **International Commerce: What does the Future Hold for International Sellers?**
  Charolette Noel Workshop Program Committee
  John Baker Louisiana State University Law School
  Sue Haffiled PriceWaterhouseCoopers

- **Migration and Mitigation: A Practical Roadmap for Businesses Operating in Multiple States or Serving a Multistate Customer Base**
  Christi Mondrik Mondrik & Associates,
  Ira Lipstet Dubois Bryant & Campbell
  Karen Currie Ernst& Young
  Shirley Sicilian KPMG

Many thanks to **Dan Baucum**, **Charolette Noel**, and **Christi Mondrik** for their help in preparing a great program!

Leadership Academy

The applications for the 2019–2020 class have been submitted, reviewed, and accepted. The next Leadership Academy class will form this spring and we are delighted beyond words with the program and its participants. We look forward to the first session in Dallas in March. The Tax Section promotional video for the Leadership Academy is available on the Tax Section's website. Thank you, **Rob Morris** for all your hard work and dedication.

Committee on Governmental Submissions

The Committee on Governmental Submissions continues to produce fantastic work! Their most recent submission is an amazing comment on Code Section 1400Z-2, which permits the deferral of certain gains on the sale of property where such funds are invested in a qualified opportunity fund. The principal drafters were Chris Goodrich, Adam Harden, Nathan Smithson, Brandon S. Jones, and Jeffry M. Blair. Despite the government shutdown, the comment was accepted and **Chris Goodrich** with Crady, Jewett, McCulley & Houren, **and Adam Harden** with Norton Rose Fulbright testified in Washington, D.C..

Further, **Bob Probasco**, along with Jason Freeman, Juan Vasquez, Jr., Rachael Rubenstein, and Richard Hunn wrote a magnificent comment regarding the Tax Court Procedure Rules on entries of appearance. Thank you, **Henry Talavera**, **Jeffry Blair**, **Ira Lipstet**, and **Jason Freeman** for your continued work on this committee.

Property Tax Committee Meeting & Legal Seminar

The Property Tax Committee is once again putting together its CLE on Friday, March 29, 2019. The CLE is being held in its traditional location in Austin at the Thompson Conference Center at the University of Texas. The CLE will include an ad valorem tax case law update, an overview of delinquent tax matters, a chief appraiser's panel, and ethics, among other topics. Please make plans to attend. The Property Tax Section is chaired by **Braden Metcalf** and vice-chaired by **Daniel Richard Smith**.

Law School Outreach

The Tax Section's Law School Outreach initiative is well underway. The Tax Section has provided panel presentations to law students at Southern Methodist University and Texas Tech University. Remaining planned programs include events at St. Mary's School of Law, Thurgood Marshall School of Law, The University of Texas at Austin School of Law, Baylor Law, University of Houston Law Center, South Texas College of Law Houston, and Texas A&M University School of Law. Many thanks to **Audrey Morris** for her continued hard work and dedication to this program.

Law School Scholarship Applications

The application period for law school scholarships opened on January 16, 2019. Applications are available on our website. These scholarships are intended to assist students with their financial needs, facilitate and encourage students to enter the practice of tax law in Texas, and become active members of the State Bar Tax Section. Applications must be postmarked or received by April 6, 2019 and can be emailed to **Stephen Long** at stephen.long@bakermckenzie.com. The scholarships will be awarded at the State Bar Annual Meeting in Austin this June.

Section Representative to the State Bar of Texas Board of Directors

The Tax Section nominated **Judge Elizabeth A. Copeland** to serve as the Large Section Representative to the State Bar Board of Directors for the 2017 to 2020 term. Congratulations Judge Copeland!

Outstanding Texas Tax Lawyer Award

The nominations period for the annual Texas Tax Lawyer Award opened on January 1, 2019. Help us continue this long-standing tradition by nominating a candidate. Nomination forms are available on the Tax Section website. Nominations should be submitted to **Christi Mondrik**, Tax Section Secretary, at cmondrik@mondriklaw.com no later than April 1, 2019. The award will be presented at an awards dinner on Thursday, June 13 in Austin in conjunction with the 2019 Annual Meeting of the Tax Section.

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

The deadline for submitting articles for the Spring edition of the *Texas Tax Lawyer* is **April 15, 2019**. Any members interested in submitting articles should contact **Michelle Spiegel** at michelle.spiegel@nortonrosefulbright.com.

Sponsorships

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

Join a Committee

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

Any members interested in joining a committee can do so by visiting our website at www.texastaxsection.org. **Tax Lawyers are a lot of fun!**

Contact Information

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

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2019
CALL FOR NOMINATIONS FOR
OUTSTANDING TEXAS TAX LAWYER AWARD

The Council of the State Bar of Texas Tax Section is soliciting nominees for the Outstanding Texas Tax Lawyer Award. Please describe the nominee's qualifications using the form on the next page. Please attach additional sheets if needed.

Nominees must: (i) be a member in good standing of the State Bar of Texas or an inactive member thereof; (ii) a former full time professor of tax law who taught at an accredited Texas law school; or (iii) a full time professor of tax law who is currently teaching at an accredited Texas law school. In addition, nominees must have (1) devoted at least 75% of his or her law practice to taxation law, and (2) been licensed to practice law in Texas or another jurisdiction for at least ten years.[1] The award may be granted posthumously.

In selecting a winner, the Council will consider a nominee's reputation for expertise and professionalism within the community of tax professionals specifically and the broader legal community; authorship of scholarly works relating to taxation law; significant participation in the State Bar of Texas, American Bar Association, local bar associations, or legal fraternities or organizations; significant contributions to the general welfare of the community; significant pro bono activities; reputation for ethics; mentorship of other tax professionals; experience on the bench relating to taxation law; experience in academia relating to taxation law; and other significant contributions or experience relating to taxation law.

Nominations should be submitted to Christi Mondrik, Tax Section Secretary by email to cmondrik@mondriklaw.com no later than April 1, 2019. The award will be presented at the 2019 Annual Meeting of the Tax Section in Austin, Texas on June 13, 2019.

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[1] "Law practice" means work performed primarily for the purpose of rendering legal advice or providing legal representation, including: private client service; service as a judge of any court of record; corporate or government service if the work performed was legal in nature and primarily for the purpose of providing legal advice to, or legal representation of, the corporation or government agency or individuals connected therewith; and the activity of teaching at an accredited law school; and "Taxation law" means but is not limited to "Tax Law" as defined by the Texas Board of Legal Specialization's standards for attorney certification in Tax Law; tax controversy; employee benefits and executive compensation practice; criminal defense or prosecution relating to taxation; taxation practice in the public and private sectors, including the nonprofit sector; and teaching taxation law or related subjects at an accredited law school.

NOMINATION FOR 2019 OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name: ____

Nominee Mailing Address, Phone, and Email:

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Description of Nominee's Contributions/Experience Relating to Taxation Law (please attach additional sheets if needed):

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Nominator Name: ____

Nominator Mailing Address, Phone, and Email:

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Merging an S-Corporation into a C-Corporation For NOLs – Not So Fast!
A Section 382(b) Analysis

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This article is intended to examine some of the limitations to utilizing a C corporation's net operating losses against S corporation's built-in-gains. It is not intended as legal advice, but rather to illustrate some of the limitations imposed by Internal Revenue Code ("**IRC**") section 382(b). Attorneys should conduct a section 382(b) analysis early on, especially prior to major shifts in ownership interests. This may be of particular interest to those considering advising clients to favor mergers into c corporations due to the beneficial tax rate after the passage of the 2018 Tax Cuts and Jobs Act.

Suppose an S Corporation ("**S-Corp**"), owned by Client, holds real estate with unrealized built-in-gains ("**BIG**"). Client has other businesses and would like to merge the S-Corp into a C Corporation ("**C-Corp**"), which has excess net operating losses ("**NOL**"), in order to offset any realized BIG against the acquired NOL. Following the merger, C-Corp will be the survivor and S-Corp will either be absorbed into C-Corp, or become a C corporation subsidiary of C-Corp. This analysis assumes that Internal Revenue Code ("**Code**") [1] section 1374 is inapplicable because the target S-Corp has always been an S corporation and none of its assets were acquired from a C corporation. *See* IRC §1374.

Rather than hold the reader in suspense, the answer is that this is permissible. It is *narrowly* permissible because of the exceptions outlined in Rev. Rul. 66-214 to the application of section 382(b). In Rev. Rul. 66-214, the Service specifically ruled that section 382(b) was inapplicable because the transferor corporation and the acquiring corporation are owned by substantially the same persons in the same proportion. *See* Rev. Rul. 66-214, 1966-2 CB 98. Thus, the importance of timing ownership changes to avoid section 382(b) applicability. The section 382(b) analysis follows.

In a merger where a C corporation will acquire an S corporation, the acquired S corporation's tax history will carry over to the acquiring C corporation under IRC §381, subject to any limitations under sections 382–384. *See* IRC §1371(c)(2); §§381-384. Section 383 is inapplicable to the proposed transaction because it limits the use of certain excess credits. *See* IRC §383.

[1] All references to "section" shall refer to the Internal Revenue Code, unless otherwise noted.

Similarly, section 384 does not apply to the proposed transaction because it meets the controlled group exception. *See* IRC §384(b)(2). Section 384 will apply if a "gain corporation" is involved in a transaction where a corporation acquires control of another corporation or the assets of corporation are acquired by another corporation in a reorganization described in sections 368(a)(1)(A), 368(a)(1)(C), or 368(a)(1)(D). *See* IRC §384(a). A gain corporation is any corporation with a net unrealized built-in gain. *See* IRC §384(c)(4). However, the limitation under section 384 does not apply to the preacquisition loss of any corporation if such corporation and the gain corporation were members of the same controlled group at all times during the 5-year period ending on the acquisition date. *See* IRC §384(b). A "controlled group" includes a brother-sister controlled group where five or fewer persons own stock possessing more than 80% of the total combined voting power and value of all the classes of stock of each corporation. *See* IRC §384(b)(2). Thus, the section 384 limitation will not apply to the proposed merger as described above.

Section 382 imposes an annual limitation on the use of carryovers and other attributes if the transaction causes an "ownership change" and generally applies to: (i) stock transfers when the target is a loss corporation that joins in the filing of a consolidated return with the acquiring corporation after the transaction; and (ii) successor corporations in tax-free asset reorganizations. *See* IRC §382. However, tax benefits are not disallowed after an asset acquisition when the acquiring corporation or its shareholders control the corporation whose assets are acquired immediately before the transfer. *See* IRC §269(a)(2). For example, when a brother-sister profitable corporation and loss corporation merged, the loss corporation's NOLs were not lost and the carryover of pre-merger operating losses against post-merger income was allowed. *See* Rev. Rul. 66-214, 1966-2 CB 98; Rev. Rul. 67-202, 1967-1 CB 73 (ruling that §269 does not apply because of common control in the same proportion prior to and after merger of related entities); *Southland Corp v. Campbell Jr.*, 358 F2d 333 (5th Cir. 1966)(NOLs allowed even though parent purchased and transferred income-producing assets to taxpayer-subsidiary, since subsidiary assumed parent's liabilities on purchases, parent was only conduit for subsidiary's acquisition of assets, basis in assets was cost; transactions were integrated.).

In Rev. Rul. 66-214, the Service ruled that a corporation, which acquires the assets of another corporation pursuant to a merger of two commonly controlled corporations, may carry over and deduct its premerger net operating losses against its post-merger income. *See* Rev. Rul. 66-214, 1966-2 CB 98. In this Revenue Ruling, individuals A, B, and C each owned one third of corporations X and Y. The corporations entered into a Type A reorganization, and after the merger continued to own the stock of X equally. The Service specifically ruled that section 382(b) was inapplicable because "it is specifically made inapplicable if the transferor corporation and the acquiring corporation are owned by substantially the same persons in the same proportion." *See* Id. Thus, under the facts of the proposed transaction, Rev. Rul. 66-214 will prevent the applicability of the section 382 limitation as it applies to the use of NOLs post-merger.

The consequences to the applicability of section 382 can be severe in limiting the use of NOLs. When a "loss corporation" is a party to a merger, the section 382 limitation will apply. *See* IRC §382.[2] Section 382 applies to loss corporations that experience an ownership change. *See* IRC §382(g)(3). A loss corporation is a corporation that: (i) is entitled to use an NOL carryforward to the tax year in which an ownership change occurs; (ii) generates an NOL in a tax year that includes a testing date; (iii) has a net unrealized built-in loss. *See* IRC §382(k)(1); Treas. Reg. §1.382-2(a)(1)(i)(A)-(C). A loss corporation also includes a corporation that is entitled to use a capital loss carryover or has a net capital loss for the tax year that includes a testing date. *See* Treas. Reg. §1.382-2(a)(1)(i)(B).

Pursuant to IRC section 382(g), an acquisitive merger constitutes an ownership change. *See* IRC §382(g)(3). Specifically, an ownership change can be triggered by either an equity structure shift, or an owner shift. *See* Id. As it applies to the contemplated merger, an equity shift will occur on the merger of S-Corp and C-Corp. Generally, an equity structure shift is an acquisitive reorganization within the meaning of IRC section 368, excluding a reorganization described in IRC sections 368(a)(1)(D), 368(a)(1)(G), and 368(a)(1)(F). *See* Id.

When a loss corporation is a party to a merger, the surviving target will be considered the old loss corporation. *See* IRC §382(k)(3); Treas. Reg. §1.382-2T(f)(3)-(4). The surviving corporation or acquirer to the merger will be considered the new loss corporation. *See* Id. A new loss corporation can thus be a corporation that sustained an NOL or a corporation that succeeds to NOL carryovers in a carryover reorganization or liquidation under IRC section 381. *See* IRC §382(k)(3); Treas. Reg. §1.382-2T(f)(3). The new loss corporation can be the same as the old loss corporation. *See* Id. Further, if an old loss corporation has a net unrealized built-in loss ("**NUBIL**"), any built-in loss recognized in the five-year period beginning on the change date is subject to limitation as a pre-change loss, known as the "built-in loss rule", but only up to the amount of the loss corporation's NUBIL. *See* IRC §382(h)(7)(A); §382(h)(1)(B)(ii)(II). The term loss corporation also includes any successor or predecessor to a loss corporation. *See* Treas. Reg. §1.382-2(a)(1)(i)(C).

When a loss corporation merges into, or its assets are transferred to, another corporation in an acquisitive merger: (i) the merged loss corporation is treated as continuing its existence until its NOL or other attributes are absorbed or expired; (ii) the merged loss corporation's pre-change loss carryovers and built-in losses are tracked separately until they are fully absorbed or expire; and (iii) the stock of the acquiring corporation is treated as stock of the predecessor corporation after a IRC section 382 ownership change for determining whether there is a later ownership change. *See* Treas. Reg. §1.382-2(a)(1)(ii)(A)-(C). An entity and any predecessor or successor of that entity are treated as a single entity. *See* IRC §382(l)(8). Thus, the section 382 limitation on a target's loss carryforwards continues to apply to the successor parent or acquiring corporation. Further, treating the parent and the subsidiary as a single entity results in the parent becoming subject to the section 382 limitation that resulted from the original stock purchase.

[2] The section 382 limitation is an objective rate of return (the long-term tax-exempt rate) times the old loss corporation's equity value. *See* IRC §382(b).

In conclusion, attorneys should coordinate the section 382(b) analysis early on with their clients looking to take advantage of the new NOL carryforward period (indefinite) and the lower corporate tax rate.

New Tools for the Toolbox

Additional Considerations a Year after the TCJA

By Jeffry M. Blair and Alexander G. McGeoch[1]

Each year end, millions of people flock to stores to find the perfect holiday gift for their loved ones. For some, it is a LEGO Harry Potter Hogwarts Great Hall, an iPhone XR, or a Nintendo Switch. For others it might be a sterling silver bracelet from Tiffany, a belt from Hermès or new Asic's Gel Contend running shoes. Even our holiday entertainment is filled with stories of searches for that perfect present.[2]

People who like to work with their hands hope to receive a gift of new tools. Whether it is a new sander, saw or drill, handypeople greatly appreciate such gifts. Even a new tool, however, may have to remain in the toolbox until the proper application presents itself and requires the new tool to be set into action. Regardless of how perfect a new tool seems at the time, it may require some aging before its full benefits are realized.

On December 23, 2017, President Donald Trump signed into law the Tax Cuts and Jobs Act of 2017 (the "TCJA") providing several new tools for each tax practitioner's toolbox. Although there was great excitement over many of these new provisions, some of the Code Sections lacked clarity.[3] Now that the IRS has provided a stream of proposed regulations interpreting these new rules, let's take a closer look at a few of our new "tools" that didn't get as much publicity when the TCJA was first enacted. These tools are likely to be widely utilized in 2019 and beyond.

QUALIFIED OPPORTUNITY ZONE INVESTMENTS

The TCJA created tax incentives for investing in "qualified opportunity zones." In general, investments in "qualified opportunity zones" permit investors to (i) defer recognition of capital gains on property sold to the extent that the proceeds from the sale are reinvested in a "qualified opportunity fund," (ii) reduce the amount of the deferred gain by providing additional tax basis in the property previously sold; and (iii) exclude gain on qualified opportunity zone investments from tax.

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[1] Jeffry M. Blair and Alexander G. McGeoch are both partners in the Tax & ERISA group at Hunton Andrews Kurth LLP. This article presents the views of Messrs. Blair and McGeoch and does not necessarily reflect those of Hunton Andrews Kurth or its clients. The information presented is for general informational and educational purposes. No legal advice is intended to be conveyed; readers should consult with legal counsel with respect to any legal advice they require related to the subject matter of the article. Messrs. Blair and McGeoch may be reached at (214) 468-3306 or jblair@huntonak.com and 214 979-3041 or amcgeoch@huntonak.com, respectively.

[2] For Ralphie the perfect gift was a Red Ryder Carbine Action 200-shot Range Model air rifle. *See* A CHRISTMAS STORY (Metro-Goldwyn-Mayer 1983((Renee Dupont & Bob Clark (producers); Bob Clark (director)). For George Bailey it was getting a rare chance to look back and realize what a wonderful life he had. *See* IT'S A WONDERFUL LIFE (Liberty Films 1946) (Frank Kapra (producer); Frank Kapra (director)).

[3] All Section references are to the Internal Revenue Code of 1986, as amended (the "Code") unless otherwise indicated.

A "qualified opportunity zone" is a population census tract that is a low-income community designated by the Secretary of the Treasury as a qualified opportunity zone.[4] Within the 90 day period immediately following the enactment of the TCJA, the chief executive officer of each State (including possessions) nominated tracts of land for designation as qualified opportunity zones and notified the Internal Revenue Service ("IRS") in writing of the nominations.[5] The IRS reviewed and certified these nominations and designated which tracts should be treated as qualified opportunity zones. A list of designated qualified opportunity zones can be found in IRS Notice 2018-48 and at the Community Development Financial Institutions Fund website at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.[6]

Investors can invest in a qualified opportunity zone by acquiring an interest in a "qualified opportunity fund."[7] A qualified opportunity fund must hold at least ninety percent (90%) of its assets in qualified opportunity zone property.[8] A "qualified opportunity fund" is an investment vehicle organized either as a corporation or a partnership for the purpose of investing in "qualified opportunity zone property."[9] Property holdings are determined by the average of the percentage of qualified opportunity zone property held in the fund on the last day of the first 6-month period of the taxable year of the fund and on the last day of the taxable year of the fund.[10] Qualified opportunity zone property is defined to include the following three types of property:

1. Qualified Opportunity Zone Stock. Qualified opportunity zone stock is any stock in a domestic corporation that is acquired by a qualified opportunity fund after December 31, 2017 at its original issue from the corporation solely in exchange for cash. The corporation must be a qualified opportunity zone business at the time the stock is issued and throughout the qualified opportunity fund's holding period of the stock.[11]

2. Qualified Opportunity Zone Partnership Interest. A qualified opportunity zone partnership interest is any capital or profits interest in a domestic partnership that is acquired by a qualified opportunity fund after December 31, 2017 at its original issuance from the partnership solely in exchange for cash. The partnership must be a qualified opportunity zone business at the time the partnership interest is issued and throughout the qualified opportunity fund's holding period of the partnership interest.[12]

3. Qualified Opportunity Zone Business Property. Qualified opportunity zone business property is tangible property used in the trade or business of a qualified opportunity zone fund that is acquired by the qualified opportunity zone fund by purchase after December 31, 2017. The original use of the property in the qualified opportunity zone must commence with the qualified opportunity fund or the qualified opportunity fund must substantially improve the property. In addition, during substantially all of the qualified

[4] §1400Z-1(a).
[5] §1400Z-1(b)(1).
[6] Notice 2018-48, 2018-28 I.R.B. 9 (Jun. 20, 2018).
[7] §1400Z-2(d)(1).
[8] *Id.*
[9] §1400Z-2(d)(1).
[10] §§1400Z-2(d)(1)(A)-(B).
[11] §1400Z-2(d)(2)(B).
[12] §1400Z-2(d)(2)(C).

opportunity fund's holding period for such property, substantially all of the use of such property must be in a qualified opportunity zone.[13]

A qualified opportunity zone business is a trade or business: (i) in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property; (ii) that generates at least 50% of its gross income from the active conduct of such business; (iii) in which a substantial portion of the intangible property of such entity is used in the active conduct of such business; and (iv) has less than 5% of the average of the aggregate unadjusted bases of the property of such entity attributable to nonqualified financial property.[14] The business cannot be described in Code Section 144(c)(6)(B).[15]

There are three federal income tax incentives designed to encourage investment in qualified opportunity funds.

- First, an investor may elect to defer federal income tax on gains from the sale or exchange of capital assets to an unrelated person by reinvesting the amount of the gain into a qualified opportunity fund during the 180-day period beginning on the date of the sale or exchange.[16] The deferral is until the earlier of when the investor disposes of its investment in the qualified opportunity fund, or December 31, 2026.[17]

- Second, if the investment in the qualified opportunity fund is held for at least 5 years, the investor will receive an increase in the tax basis of the property sold in the deferred sale equal to ten percent (10%) of the deferred gain invested in the qualified opportunity fund.[18] This will result in only 90% of the deferred gain being subject to tax. If the investment in the qualified opportunity fund is held for an additional 2 years (i.e., a total of at least 7 years), the investor will receive an additional increase in tax basis equal to 5% of the original deferred gain invested in the qualified opportunity fund.[19] This

[13] §1400Z-2(d)(2)(D). Property is treated as substantially improved by the qualified opportunity fund only if during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the qualified opportunity fund exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the qualified opportunity fund. If the property is a building located on land wholly within a qualified opportunity zone, then the requirement that the original use of the tangible property in the qualified opportunity zone commence with the qualified opportunity fund is not applicable with respect to the land on which the building is located and the determination as to whether the property has been substantially improved is measured by the qualified opportunity zone additions to the adjusted basis of the building and do not require additional improvement to the land itself. Rev. Rul. 2018-29, 2018-45 I.R.B. 765.

[14] §§1400Z-2(d)(3)(A)(i)-(ii); Prop. Treas. Reg. §1.1400Z-2(d)(1). .

[15] §§1400Z-2(d)(3)(A)(iii); Prop. Treas. Reg. §1400Z-2(d)(6). The Proposed Regulations list the following businesses as businesses that cannot qualify as a qualified opportunity zone business: (i) any private or commercial golf course; (ii) country club; (iii) massage parlor; (iv) hot tub facility; (v) suntan facility; (vi) racetrack or other facility used for gambling; and (vii) any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

[16] §1400Z-2(a)(1)(A). Only gains treated as capital gains for federal income tax purposes are eligible for tax deferral. Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(2)(A). This should include both long and short-term capital gains and net Section 1231 gains treated as long-term capital gains but should not include depreciation recapture and other ordinary income realized in connection with the sale of property. This should also not include the portion of gain from the sale of a partnership interest that is recharacterized as ordinary income under §751. For purposes of §1400Z-2, persons are related to each other if such persons are described in §267(b) or §707(b)(1), determined by substituting 20% for 50% each place it occurs in such sections. §1400Z-2(e)(2).

[17] §1400Z-2(b)(1).

[18] §1400Z-2(b)(2)(A), (B)(iii).

[19] §1400Z-2(b)(2)(A), (B)(iv).

presents the opportunity to reduce the taxable amount of the original deferred gain to only 85% of its original amount.

- Third, if the investment in the qualified opportunity fund is held for at least 10 years, the investor is permitted to elect to step up the tax basis of the investment to the fair market value at the time that investment is sold.[20] This election can result in an investor not being taxed on any gain from the appreciation of the investment in the qualified opportunity fund. The expiration of a qualified opportunity zone's designation will not invalidate an investor's ability to make this election as long as the investment is sold on or before December 31, 2047.[21]

In general, these sections of the Internal Revenue Code remain effective until December 31, 2026. However, investors who desire to qualify for the full 15% increase in their tax basis in property they sell that is reinvested in a qualified opportunity fund will need to invest before the end of 2019 in order to have held the investment for at least 7 years prior to the last date that all unrecognized deferred gains must be recognized.

ELIGIBLE TERMINATED S CORPORATION

Among the new "tools" provided by the TCJA were provisions making it less costly for an S corporation to terminate its S corporation election and become a C corporation. These new S corporation provisions should be viewed in connection with the general reduction in the highest marginal federal corporate income tax rate applicable to C corporations. The TCJA reduced the highest marginal federal income tax rate applicable to C corporations from thirty-five percent (35%) to twenty-one percent (21%). This rate reduction made the highest marginal federal corporate income tax rate on undistributed C corporation taxable income much lower than the 37% rate on an individual's ordinary income under the TCJA. This rate also is lower than the effective federal income tax rate on qualified business income that is eligible for a 20% deduction, which is 29.6%.[22] Note that the benefit of this lower federal corporate income tax rate is greatly diminished or completely eliminated with respect to distributed C corporation taxable income that is subject to an overall effective tax rate of 36.8% when the recipient shareholder's tax on the dividend is taken into account.

These new rules apply to an "eligible terminated S corporation." An eligible terminated S corporation is any C corporation: (i) which was an S corporation on December 21, 2017, (ii) revoked its S corporation election during the two year period beginning on December 22, 2017, and (iii) the owners of the stock of the corporation on the date that the revocation is made, are the same owners (and in identical proportions) as on December 22, 2017.[23]

[20] §1400Z-2(c).

[21] §1.1400Z-2(c)(1)-1(b); *see* §1.1400Z-2(c) example 1 (taxpayer able to make a valid election to eliminate gain on the sale of investment in qualified opportunity fund sold in 2031 with respect to investment acquired in 2020 and with respect to which a valid election to defer the initial gain was made in 2020, despite the expiration of the qualified opportunity zone's designation at the end of 2028).

[22] For noncorporate holders who do not materially participate in the business, these marginal federal income tax rates may increase by another 3.8% for the net investment income tax, as applicable.

[23] §481(d)(2). The termination of the S corporation election must be by revocation for these rules to apply.

If an S corporation qualifies as an eligible terminated S corporation, these new rules do several things. First, these rules permit the corporation to take tax accounting method changes resulting from the change from an S corporation to a C corporation into account ratably over a period of 6 taxable years.[24] Without this exception, the corporation would be required to take

In addition, these new rules provide more favorable treatment of distributions. In general, distributions of money by a former S corporation during the first year after the termination of the corporation's S corporation election (the "Post-Termination Transition Period") are treated as first coming out of the corporation's undistributed S corporation accumulated adjustments account ("AAA").[25] These distributions generally will be treated first as a tax-free return of the shareholder's tax basis in their former S corporation stock. Distributions more than one year after the termination of the corporation's S corporation election, however, generally are treated as taxable dividends to the extent of the corporation's undistributed C corporation earnings and profits.[26] Under the new rules, distributions by an eligible terminated S corporation more than one year after the termination of its S corporation election are treated as part AAA and part undistributed C corporation earnings and profits, with the portion treated as AAA determined based on the same ratio as the amount of undistributed AAA to the total amount of all undistributed earnings and profits (i.e., both C corporation and S corporation).[27] Accordingly, if a former S corporation is not able to fully distribute its AAA during the first year following the termination of its S election, these new rules still will permit the corporation to continue to distribute at least part of its previously distributed earnings as AAA more than one year after the termination of its S corporation election.

As indicated above, this tool has certain limitations. The S corporation must be terminated by revocation which requires the consent of more than 50% of the outstanding shares of the S corporation.[28] Furthermore, the revocation must take place before December 23, 2019 and the shareholders at the time of the revocation must be the same (and in the same proportions) as they were on December 22, 2017.

[24] §481(d)(1).
[25] §1371(e).
[26] §§301(c), 316(a).
[27] §1371(f).
[28] §1362(d)(1).

OPPORTUNITY ZONES & SECTION 1400Z-2

I. INTRODUCTION

As a part of the Tax Cuts and Jobs Act (the "**2017 Act**") enacted last December, new tax benefits were enacted to incentivize taxpayers to invest in census tract areas (so-called "opportunity zones") which are regarded as having residents whose income is below average. These new tax benefits are contained in Code section 1400Z-2 ("**Section 1400Z-2**").

Section 1400Z-2, the U.S. Department of the Treasury ("**Treasury**") is authorized to issue regulations that may be necessary or appropriate to carry out the purposes of Code Section 1400Z-2, including those for certification of an OZ Fund.[1] The initial proposed regulations promulgated under Section 1400Z-2 (referred to herein as the "**Proposed Regs**") were issued on October 19, 2018.[2] The explanatory preamble to the Proposed Regs indicate that Treasury and the IRS are working on additional proposed regulations expected to be published in the near future (in respect to Section 1400Z-2).

II. BACKGROUND

Creating tax incentives to encourage investment in poorer areas is not new. Prior to 2018, the following Code sections already existed to provide various such incentives:

(i) the 39% "new market" tax credits (useable in installments over 7 years) under Code section 45D;

(ii) the tax benefits for Code section 1391 "empowerment zones";

(iii) the tax benefits for Code section 1397 "enterprise zones";

(iv) the tax benefits for Code section 1400F "renewal communities";

(v) the tax benefits for Code Section 1400N "gulf opportunity zones"; and

(vi) the low income housing tax credit under Code section 42.

However, none of these previous tax incentives have created as much interest as Section 1400Z-2. Moreover, it is worth noting that Section 1400Z-2 was designed to be largely compatible with the 39% "new market" tax credit under Code section 45D. In many States (including Texas), the same low income census tracts which were previously designated as being eligible for the new market tax credit also constitute the opportunity zones ("**OZs**") for purposes of Section 1400Z-2. The combination of qualifying an investment for both Code section 45D

[1] Code Section 1400Z-2(e)(4)(A).
[2] Fed Reg REG-115420-18, Proposed Reg Section 1.1400Z-2(a)-1, Proposed Reg Section 1.1400Z-2(c)-1, Proposed Reg Section 1.1400Z-2(d)-1, Proposed Reg Section 1.1400Z-2(e)-1; IR 2018-206, 10/19/2018.

and 1400Z-2 is impressive, but not a lot is written about combining the tax incentives of Code sections 1400Z-2 and 45D. In part, this may because the tax benefits of Section 1400Z-2 alone are considerable.

When the 2017 Act was initially enacted, many tax practitioners did not appreciate the significance of Section 1400Z-2 as compared to these previously enacted tax incentives. This may have been because these previously enacted tax incentives were frequently regarded by investors as not being sufficient to risk the investment needed to qualify for the tax incentives.[3] Over the last four months, though, Section 1400Z-2 has been receiving a lot of attention by real estate trade groups and others.

Many people are surprised to learn where many OZs are located, e.g., next to the Ritz Carlton in downtown Atlanta, Georgia, parts of Hollywood, California, the Los Angeles Arts District, and parts of Miami and Tampa, Florida, etc. Closer to Houston, there OZs (i) East of Pecan Grove in the Fort Bend area, (ii) along I-69, West of Rosenberg, (iii) between NRG Stadium and the Texas Medical Center, (iv) along the East side of Highway 288 inside the 610 Loop near the Texas Medical Center, and (v) East of Downtown Houston. To see other OZs, try looking at www.policymap.com/maps or www.cims.cdfifund.gov/preparation/?config=confignmtc.xml. (For this second link, you will have to adjust the visible layers on the mapping tool to show only the opportunity zones.)

In short, do not make the mistake of thinking all OZs are in impoverished areas. Often, the income levels of residents may be low but the location is favorable for commercial development. Indeed, the Governors of the various States were allowed to designate about 40% of their New Market census tracts as OZs. One would suspect that those Governors picked those tracts which were most ripe for development.

The location of OZs are crucial because the OZ Funds, and the companies in which they invest, must generally locate most of their tangible property in the OZs, although there is presently no requirement that the residents of the OZs have any relationship with the OZ Funds or the businesses in which the OZ Funds invest, either as customers, employees, tenants or otherwise. The Proposed Regs do not require employees of the OZ business to work in the OZ, and there does not appear to be any statutory verbiage which would support such a requirement.

III. THE TAX BENEFITS

A. **Tax Benefits From Invested Rollover Proceeds**. Section 1400Z-2 provides qualifying taxpayers with the following three tax benefits (i.e., deferral, reduction of existing gain and elimination of future gain):

[3] When the subject of OZs was brought up at the May 2018 ABA Tax Section meeting, most of the members of the real estate subcommittee had not heard of Section 1400Z-2.

1. Deferral Until 2026 on Rollover Gain. A temporary deferral of "any gain" (the "**rollover gain**") which is reinvested into a "qualified opportunity fund" (an "**OZ Fund**"), until the earlier of (i) the date the taxpayer's OZ Fund investment is sold or (ii) December 31, 2026;[4]

a. the existing gain can be derived from any source (e.g., the sale of securities, real estate, businesses, etc.);

b. under the Proposed Regs, the deferral applies to any "eligible gains," which generally include all gains which are:

(1) treated as capital gains for Federal income tax purposes (whether short term or long term),[5]

(2) would otherwise be recognized for Federal income tax purposes before January 1, 2027 (if Code section 1400Z-2(a)(1) did not apply), and

(3) do not arise from a sale or exchange with a "related person" (Code section 1400Z-2(e)(2) incorporates the related person definition as defined in Code sections 267(b) and 707(b)(1), but replacing "20%" with "50%" as the applicable percentage).

Special rules apply in the case of certain gains, e.g., (i) gains from "section 1256 contracts"[6] and (ii) gains from a position that is or has been part of an "offsetting-positions transaction" in which the taxpayer had diminished risk of loss by holding other positions (e.g., a straddle).[7]

c. Despite the fact that the statutory language of Section 1400Z-2 refers to "any gain", the Proposed Regs state that only gains treated as capital gains are eligible.[8] Consequently, Section 1400Z-2 benefits will not be available to asset

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[4] Code section 1400Z-2(b)(1).

[5] Gains under Code section 1231 (e.g., depreciable buildings used in a trade or business) presumably satisfy this requirement, but the Proposed Regs do not specifically address this point. Also, remember that 1231 gains are only treated as capital gains to the extent such 1231 gains exceed section 1231 losses for the pertinent tax year. Will eligibility for Section 1400Z-2 deferral really depend on the results of this "hotchpot" calculation? Hopefully, Treasury will provide additional guidance to clarify how 1231 gains will be treated for purposes of Section 1400Z-2.

[6] Proposed Reg Section 1.1400Z-2(a)-1(b)(2)(iii).

[7] Proposed Reg Section 1.1400Z-2(a)-1(b)(2)(iv).

[8] Proposed Reg Section 1.1400Z-2(a)-1(b)(2). The Committee Reports summarizing the Senate Amendment that provides for the OZ provisions refers to "capital gains" while the statute in Code Section 1400Z-2 refers to "gain" that is reinvested. For example, the Report states that "The provision provides for the temporary deferral of inclusion in gross income for **capital gains** reinvested in a qualified opportunity fund and the permanent exclusion of **capital gains** from the sale or exchange of an investment in the qualified opportunity fund." Further, the name of Code section 1400Z-2 is "Special rules for **capital gains** invested in opportunity zones." Although the text of the statute itself only refers to "gain", the title of Code Section 1400Z-2 and the legislative history seems to suggest these provisions only apply to capital gains. Although the verbiage of Code section 1400Z-2 was specifically

sale proceeds taxable as ordinary income, such as depreciation recapture, inventory and so-called dealer realty (e.g., residential subdivision lots, condominiums, etc.).

d. Note that, in order to achieve the Section 1400Z-2 tax deferral, the amount which needs to be reinvested is an amount equal to the rollover gain, and not the amount of the full amount of the proceeds giving rise to the rollover gain (which would also include the return of basis). This is different than what is required for like-kind exchanges under Code section 1031.

e. Treasury anticipates that taxpayers will make an election under Section 1400Z-2 to defer capital gains recognition on Form 8949, in the year in which the capital gain is realized. The benefits of Section 1400Z-2 will not be available unless this election is made.[9]

2. 10-15% Partial Exclusion on Rollover Gain. A permanent 10% reduction *in the rollover gain* if the taxpayer's holding period in their OZ Fund reaches 5 years, or a permanent 15% reduction in the rollover gain if the taxpayer's holding period in their OZ Fund reaches 7 years; and

a. December 31, 2021 Deadline. Note that, if a taxpayer fails to roll over into an OZ Fund by the December 31, 2021, that taxpayer will not be able to satisfy the 5-year holding period (and thereby receive a 10% reduction in gain) before the "drop dead" gain recognition date of December 31, 2026.

b. December 31, 2019 Deadline. Note that, if a taxpayer fails to roll over into an OZ Fund by the December 31, 2019, that taxpayer will not be able to satisfy the 7-year holding period (and thereby receive a 15% reduction in gain) before the "drop dead" gain recognition date of December 31, 2026. However, the taxpayer will still be eligible for the 10% reduction in gain.

3. Complete Exclusion of Gain in Excess of the Rollover Gain. If the taxpayer's holding period in his or her OZ Fund reaches 10 years, that taxpayer is entitled to a permanent exclusion of any new gain (i.e., the gain in excess of the rollover gain, as possibly reduced by 10% or 15%) generated from the growth of the investment in the OZ Fund. This is accomplished by a statutorily granted increase in the taxpayer's basis in the OZ Fund equal to the sale price for the OZ Fund, as of the date of sale.

a. OZs are only designated through the year 2028. Commentators had asked what happens when a OZ Fund invests in OZ Property in 2019 and the ten-year

changed to delete the reference to "capital" gain, this legislative history and statutory heading may just be regarded as holdovers from before the referenced to "capital" gain was eliminated.

[9] Proposed Reg Section 1.1400Z-2(c)-1(a).

holding period expires after 2028. The Proposed Regs provide that an investment in OZ Property will retain its status through December 31, 2047 despite the fact that a census tract ceases to be classified as an OZ.[10]

B. **Eligible Taxpayers**. Taxpayers eligible to rollover gain for Section 1400Z-2's tax benefits include individuals, partnerships, limited liability companies, S corporations, estates, trusts and C corporations, including (without limitation) regulated investment companies ("RICs") and real estate investment trusts ("REITs").[11]

1. Special Pass-Through Taxpayer Election. A partnership, S corporation, estate or trust (a "**Pass-Thru Taxpayer**") may make the election to defer all or part of a capital gain to the extent it makes an eligible investment in an OZ Fund. If the Pass-Thru Taxpayer makes the election, no part of the deferred gain is required to be included in the distributive share of the Pass-Thru Taxpayer's owners or beneficiaries (as reported on their respective Schedules K-1). The Pass-Thru Taxpayer's 180-day reinvestment period commences on the date of the sale or exchange of the Pass-Thru Taxpayer.[12]

2. Owner or Beneficiary Election. To the extent a Pass-Thru Taxpayer does not elect to defer its capital gain, the capital gain will be included in distributive share of capital gain passing through to the owners or beneficiaries of the Pass-Thru Taxpayer, and those owners or beneficiaries can each elect to defer their distributive share of such gain. The owner's or beneficiary's 180-day reinvestment period generally commences on the last day of the Pass-Thru Taxpayer's tax year.[13] Alternatively, an owner or beneficiary of a Pass-Thru Taxpayer may elect to use the Pass-Thru Taxpayer's 180-day reinvestment period, which presumably could only be done if that owner or beneficiary knew or receives information regarding the date of the Pass-Thru Taxpayer's gain and the Pass-Thru Taxpayer's decision not to defer the gain.[14]

3. Practice Tip: Perhaps the governing documents for a partnership or LLC should preclude the partnership or LLC from making a Section 1400Z-2 election unless the owners of the partnership or LLC unanimously approve the partnership or LLC doing so, that way the owners of the partnership or LLC can independently decide whether to make the election for their personal purposes.

4. Taxpayer Gain Cannot be Rolled Over in a non-OZ Fund Partnership. If a taxpayer realizes a capital gain and invests in a partnership which is not an OZ Fund, but that partnership in turn invests in an OZ Fund within the requisite 180-day period, the

[10] Proposed Reg Section 1.1400Z-2(c)-1(b).
[11] Proposed Reg Section 1.1400Z-2(c)-1(b)(1).
[12] Proposed Reg Section 1.1400Z-2(a)-1(c)(1)(i) and 1.1400Z-1(c)(3).
[13] Proposed Reg Sections 1.1400Z-2(a)-1(c)(2)(i), 1.1400Z-1(c)(2)(iii)(A) and 1.1400Z-1(c)(3).
[14] Proposed Reg Section 1.1400Z-2(a)-1(c)(2)(iii)(B) and 1.1400Z-2(a)-1(c)(3).

initial taxpayer's gain is not eligible for a Section 1400Z-2 rollover since, to be eligible for the rollover, the taxpayer must acquire an "eligible interest" (i.e., an equity interest in an OZ Fund). Instead, the taxpayer must invest the eligible gain directly in an OZ Fund in order to qualify for a Section 1400Z-2 rollover.

C. **Tax Attributes Preserved**. The rollover gain's tax attributes are preserved through the deferral period and are taken into account when the gain is later included in taxable income. For example, if (without the taxpayer's election to defer the gain under Section 1400Z-2) the gain would have been included in income as short term capital gain, when the taxpayer is later required to include the previously deferred gain in income, the gain will still be treated as short term capital gain.[15]

1. Passive Activity Losses. If a taxpayer elects, or a partnership or LLC in which the taxpayer owns an interest elects, to make a Section 1400Z-2 election, how will any suspended passive activity losses be treated? The activities of the prior partnership and LLC would seem to be different so it does not seem likely that those suspended losses would be carried over to an OZ Fund into which the taxpayer, partnership or LLC rolls over gain. Also, it seems unlikely that the suspended losses would be deductible on the termination of the first activity (i.e., the prior partnership's or LLC's activity) without any corresponding gain recognition resulting from that termination. Consequently, it seems more likely that the suspended losses would remain suspended until the taxpayer recognizes the roll over gain. In any event, additional Treasury guidance seems necessary.

D. **Pledges**. A taxpayer may pledge his or her equity interest in an OZ Fund as collateral as long as the taxpayer making the pledge is still treated as the owner of that equity interest.[16]

1. Leverage. As noted below at III.G.3., an OZ Fund's combining debt financing with equity investments of rollover gain will not cause the OZ Fund to become subject to the "mixed funds" rule discussed at III.G. Consequently, this rule allowing pledges of equity interests in an OZ Fund will help facilitate such debt financing.

E. **No Basis Rule**. As noted above, taxpayers may invest realized gains from the sale of property into a OZ Fund and thereby defer that gain. However, to ensure that this deferred gain is taxed at a later point, the taxpayer takes a zero basis in the deferred gain that is rolled over into the OZ Fund.[17] Taking a zero basis in the OZ Fund investment is consistent with not having paid any taxes on the amount of the gain invested in the OZ Fund.

[15] Proposed Reg Section 1.1400Z-2(a)-1(b)(5).
[16] Proposed Reg Section 1.1400Z-2(a)-1(b)(3)(ii).
[17] Code Section 1400Z-2(b)(2)(B).

1. Interaction with New Market Credit. A taxpayer cannot claim more "new market" tax credit (a "NM Credit") than that taxpayer's basis in the investment (and correspondingly, a taxpayer's basis in the investment is reduced by the amount of the NM Credit claimed). If the investment does not have basis, then the NM Credit cannot be claimed in that year.

F. **Multiple Equity Investments in an OZ Fund**. Where a taxpayer acquires equity interests in an OZ Fund on more than one occasion, the Proposed Regs generally provide for a FIFO regime for determining the tax consequences resulting from the sale of one of those equity interests.[18]

G. **"Mixed Funds" Investments**. It is entirely conceivable that an investment in an OZ Fund may require a taxpayer to invest more funds than just an amount of proceeds equal to the rollover gain. This investment of additional funds may come from after-tax cash, or from borrowed funds, or from the contribution of in-kind assets. Investments in OZ Funds which include property in addition to rollover gain are generally referred to as "mixed funds" investments.

1. Example. Consider an investment of $2,000,000, $1,000,000 of which is funded from deferred gain, $400,000 is funded from after-tax cash, and $600,000 is funded by debt.

2. Rule for Mixed Funds Investments. Under the OZ provisions, the same investment will be treated as two separate investments for income tax purposes (the "mixed funds" rule). Using the foregoing Example, the portion of the $2,000,000 investment funded from the $1,000,000 of rollover gain will be one investment (the "First Portion of the Investment"), and the balance of the $2,000,000 investment (funded by the after-tax cash and the debt) will be a second investment (the "Second Portion of the Investment").

a. Interaction with New Market Credit. Notice that, under the foregoing Example, only about $610,000 of basis would be available for depreciation expenses since (i) the 39% NM Credits reduce the $1,000,000 basis (by 39% of $1,000,000, or $390,000) and (ii) there is no basis attributable to the rollover gain. Also note that the 39% NM Credit (i.e., $390,000), which is claimed and used over a 7 year period would produce a $390,000 tax savings which more than offsets the $200,000 capital gain tax on the $1,000,000 of rollover gain. Thus, a careful structuring of an investment rollover into a 10-year OZ Fund can eliminate all capital gain, not only on the asset sold which generated the original rollover gain but also on the OZ Fund investment(s) when sold after 10 years.

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[18] Proposed Reg Sections 1.1400Z-2(a)-1(b)(6), 1.1400Z-2(a)-1(b)(7) and 1.1400Z-2(a)-1(b)(8), examples 4-7.

3. Leveraged Investments. To the extent a tax partnership has liabilities, each owner of the partnership is deemed to have contributed money to the partnership equal to that owner's share of those liabilities (as determined under Code section 752). So, where an OZ Fund is organized as a tax partnership, how does partnership debt interplay with the mixed funds rule? The Proposed Regs answer this question. Where a OZ Fund is organized as a tax partnership, a partner's "deemed contributions of money" does not result in the partnership having two investments under the "mixed funds" rule. Accordingly, debt does not dilute the benefit of deferral possible under Section 1400Z-2.[19]

a. Depreciation Planning. As noted above at III.E., the taxpayer will generally have no basis in the taxpayer's equity investment in an OZ Fund. However, since an OZ Fund's combining debt financing with equity investments of rollover gain will not cause the OZ Fund to become subject to the "mixed funds" rule discussed above, if that OZ Fund is organized as a partnership or LLC, the taxpayer can still obtain basis from the debt financing and thereby currently benefit from depreciation deductions.

IV. A MYRIAD OF DEFINED TERMS

A. **Initial Read**. An initial read of Code section 1400Z-2 will make your head swim due to the multitude of defined terms, most of which begin with "qualified opportunity zone" or "qualified opportunity", e.g., (i) "qualified opportunity fund," (ii) "qualified opportunity zone property," (iii) "qualified opportunity zone stock," (iv) "qualified opportunity zone partnership interest," (v) "qualified opportunity zone business," and (vi) "qualified opportunity zone business property."

1. Some of these terms are component parts of other terms. For example: (i) the term "qualified opportunity fund" depends on what constitutes "qualified opportunity zone property;" and (ii) the term "qualified opportunity property" is the sum of "qualified opportunity zone stock," "qualified opportunity zone partnership interest" or "qualified opportunity zone business."

2. The most important and detailed of these terms are "qualified opportunity zone business" and "qualified opportunity zone business property." Let's review these two terms first because the other terms are easier to understand once these first two terms are mastered.

B. **Qualified Opportunity Zone Business Property**.

[19] Proposed Reg Section 1.1400Z-2(e)-1(a)(2).

1. Definition. "Qualified opportunity zone *business property*" (or "**OZ Biz Property**") means *tangible* property used in a *trade or business* of the OZ Fund if:

a. the property was acquired by purchase after December 31, 2017;

b. the property experienced its original use with the OZ Biz (the so-called "original use" test) or such property is substantially improved over a 30-month period by the OZ Biz; and

c. during substantially all of the OZ Fund's holding period, substantially all of the property was in an opportunity zone.[20]

2. Original Use of Land. Further, where land is just acquired (as opposed to being improved), the following phrase (in connection with the second requirement above) becomes important: "the property experienced its original use with the OZ Biz." This phrase means that rollover gain cannot be used to purchase unimproved realty or realty which will continue to be used in the same manner as it was used prior to being purchased by the OZ Fund (or subsidiary partnership or corporation).

3. 200% Rule. For purposes of the second requirement just listed, property is considered to be substantially improved only if the additions to basis during any 30-month period after acquisition exceed the amount of the adjusted basis at the beginning of the 30-month period.[21] This is often referred to as the 200% rule. The failure to meet the 200% rule by even one dollar appears to disqualify the improved property from being OZ Biz Property.

a. Proposed Regs. The Proposed Regs provide that, in the case of a building, (i) the substantial improvement test is measured by reference to the OZ Fund's additions to the basis of the building (excluding the basis in the land), and (ii) the OZ Fund is not required to "separately substantially improve the land upon which the building is located."[22]

b. Rev. Rul. 2018-29. Similarly, concurrent with the issuance of the Proposed Regs, the IRS released Rev. Rul. 2018-29, 2018-45 IRB (10/19/2018).

(1) Rev. Rul. 2018-29 ruled that (i) if an OZ Fund acquires a building located within a qualified opportunity zone, the original use requirement "is not applicable to the land on which the building is located," (ii) the substantial improvement test is measured by reference to the OZ Fund's additions to the basis of the building (excluding the basis in the land), and

[20] Code Section 1400Z-2(d)(2)(D)(i).
[21] Code Section 1400Z-2(d)(2)(D)(ii).
[22] Proposed Regs Section 1.1400Z-2(d)-1(c)(8)(ii)

(iii) the OZ Fund is not required to "separately substantially improve the land upon which the building is located."

(2) Further, Rev. Rul. 2018-29 ruled that, to satisfy the original use test, the building must also be used by the OZ Fund for a purpose different from the building's use prior to the OZ Fund's acquisition of the building. For example, if an OZ Fund acquires a residential apartment project, that apartment project cannot constitute OZ Biz Property if the OZ Fund continues to use the apartment project for residential purposes.

c. Example. Where the value of purchased land under a building is $250,000 and the purchased building on top of the land is valued at $500,000, the 200% rule says only $500,000 worth of building improvements are required rather than $750,000.

d. Purchase Price Allocations. Consequently, purchase price allocation provisions in real estate purchase contracts may receive more attention. However, such allocations may not be convincing to the IRS or the courts since the seller (in an effort to minimize depreciation recapture) and the purchaser (in an effort to satisfy the 200% rule under Section 1400Z-2) may not be opposing positions in respect to allocations to land (versus buildings).

C. **Qualified Opportunity Zone Business**. "Qualified opportunity zone *business*" (or "**OZ Business**") means:

1. **a trade or business in which substantially all of the tangible property owned or leased by the taxpayer is "*qualified opportunity zone business property*"[23] ("OZ Biz Property")**; and

a. 70% Rule. As noted below at IV.D., an OZ Fund can own qualified opportunity zone stock, a qualified opportunity zone partnership interest or an OZ Business. As noted immediately above, to be an OZ Business, *substantially all* of tangible property owned or leased in that business must be OZ Biz Property. Thus, where an OZ Fund owns qualified opportunity zone stock or a qualified opportunity zone partnership interest (i.e., the OZ Fund owns its OZ Business indirectly through a subsidiary corporation or partnership), the Proposed Regs provide that (solely for this purpose) "substantially all" means at least 70%.[24] Consequently, this means an OZ Fund which owns qualified opportunity zone stock or a qualified opportunity zone partnership interest may have as little as 63% of the capital invested in OZ Biz Property (i.e., 90% in the OZ Business per

[23] Code Section 1400Z-2(d)(3)(A)(i).
[24] Proposed Reg Section 1.1400Z-2(d)-1(d)(3).

the 90% asset test noted at IV.E.1. below multiplied by 70% of the OZ Biz Property). This obviously provides additional flexibility as to the time of capital investments into an OZ Fund and the use of that capital.

2. **at least 50% of the total gross income of the business must be derived from the active conduct of the business;**

3. **the average of the aggregate unadjusted basis of the OZ Biz Property attributable to "nonqualified financial property" must be *less than 5%*;[25] and**

a. Definition of "nonqualified financial property". "Nonqualified financial property" for these purposes is defined in Code Section 1397C to mean debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property specified in regulations; except that such term shall not include (a) *reasonable amounts of working capital* held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or (b) debt instruments described in Code Section 1221(a)(4) (certain receivables acquired in the ordinary course of trade or business).

b. Working Capital Safe Harbor for Substantial Improvements. The Proposed Regs provide a working capital safe harbor that acquires, constructs or rehabilitates tangible business property used in a business operated in an OZ; the Proposed Regs permit cash reserves to be treated as working capital (and therefore as OZ Biz Property) for a period of up to 31 months, provided that (i) there is a written plan which identifies the reserve as property held for the acquisition, construction or substantial improvement of tangible property in the OZ, (ii) there is a written schedule consistent with the ordinary business operation of the business that provides for the reserve to be spent within 31 months of receipt of the cash comprising the reserve, and (iii) the business substantially complies with the plan and spending schedule.[26]

4. **the business cannot be so-called "sin" business, i.e., private or commercial golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, race tracks and other facilities used for gambling, and "store the principal business of which is the sale of alcoholic beverages for consumption off premises."**[27]

a. Proposed Regs. The Proposed Regs do not make much of an effort to defined "sin" businesses. Consequently, there will likely be unresolved questions. For example, consider a brewery which serves its beer on site in a beer garden and

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[25] Code Section 1400Z-2(d)(3)(A)(ii).
[26] Proposed Reg Section 1.1400Z-2(d)-1(d)(5)(iv).
[27] Code Section 1400Z-2(d)(3)(A)(iii); Code Section 144(c)(6)(B); Proposed Reg Section 1.1400Z-2(d)-1(d)(6).

also sells unopened bottles for sale by liquor stores, grocery stores and other retailers. Does this brewery constitute liquor store selling for "off premises" consumption?

b. Interaction with New Market Credit. The NM Credit is similar to Code Section 1400Z-2 in that the "sin" business noted above are not eligible trade or businesses. However, certain other businesses are ineligible for the NM Credit, e.g., (i) the renting of residential property or (ii) farming businesses where the value of assets exceeds $500,000.[28]

Contrast the definitions of OZ Property (defined below) and OZ Biz Property (defined above). They differ simply due to the reference to "business property" versus "property".

D. **Qualified Opportunity Zone Property**. Qualified Opportunity Zone Property (or "OZ Property") includes any of (i) qualified opportunity zone stock, (ii) qualified opportunity zone partnership interest, or (iii) qualified opportunity zone property.

1. Qualified Opportunity Zone Stock. Qualified opportunity zone stock must be the stock of a domestic corporation (1) acquired by the OZ Fund after December 31, 2017 at original issue solely in exchange for cash, (2) provided that corporation owned a *qualified opportunity zone business* (or is being formed for purposes of being a qualified opportunity zone business) at the time the stock was issued, and (3) during substantially all of the OZ Fund's holding period for the stock, the corporation qualified as a *qualified opportunity zone business*.[29]

a. Redemptions. Pursuant to Code section 1400Z-2(d)(2)(B)(ii), anti-abuse rules similar to the rules of Code section 1202(c)(3) apply for purposes of determining whether stock issued by a corporate OZ Fund qualifies as qualified opportunity zone stock.

b. "Black-Outs" on Original Issuances Made 2-Years Before & After any Related Party Redemptions. Stock issued to a taxpayer will not qualify as qualified opportunity zone stock if, either 2 years before or 2 years after the issuance of that stock, the corporation issuing that stock redeems (directly or indirectly) other stock from the taxpayer or a person related to the taxpayer (within the meaning of Code section 267(b) or 707(b)).[30]

c. "Black-Outs" on Original Issuances Made 1-Year Before & After any Unrelated Party Redemptions. Similarly, stock issued to a taxpayer will not qualify as qualified opportunity zone stock if, either 1 year before or 1 year after

[28] Treas. Reg. Section 1.45D-1(d)(5).
[29] Code Section 1400Z-2(d)(2)(B)(i).
[30] Proposed Reg Section 1.1400Z-2(d)-1(c)(2)(ii)(A).

the issuance of that stock, the corporation issuing that stock makes one or more purchases of its stock having an aggregate value upon purchase exceeding 5% of the aggregate value of all the corporation's outstanding stock as of 1 year before the issuance.[31]

d. A Perspective on These Anti-Abuse Rules. Think of these anti-abuse rules as being comparable to the partnership disguised sale rules under Code Section 707(a)(2)(B). For example, consider the situation in which an OZ Fund's qualified opportunity zone stock is redeemed and then soon thereafter the redeeming corporation issues new stock to a subsequent OZ Fund. These anti-abuse rules prevent the stock issued to the subsequent OZ Fund from qualifying as qualified opportunity zone stock since the substance of these redemption/new issuance transactions are too similar to the subsequent OZ Fund having purchased the first OZ Fund's stock. These anti-abuse rules expand the "suspect period" from one to two years in the case of stock issued to persons related to the redeemed OZ Fund.

e. Impact of Anti-Abuse Rules on Redeemed Stock. A redemption of qualified opportunity zone stock only risks adversely affecting the shareholder receiving a new issuance of stock in the "black-out" period, so the shareholder selling the originally issued qualified opportunity zone stock before the redemption is still entitled to the benefits of Section 1400A-2.

f. Section 304. If a person related to the corporation would be treated as redeeming stock under Code Section 304, the corporation will be treated as redeeming the qualified opportunity zone stock for purposes of the anti-abuse rules.[32] Code Section 304 generally re-characterizes related party stock sales as redemptions in two instances:

(1) Parent Stock Sold to a Sub. Where a shareholder of a parent corporation sells stock of the parent to a subsidiary; and

(2) Brother Stock Sold to Another Brother. Where a shareholder who controls two brother corporations sells his or her stock in one brother to the other brother.

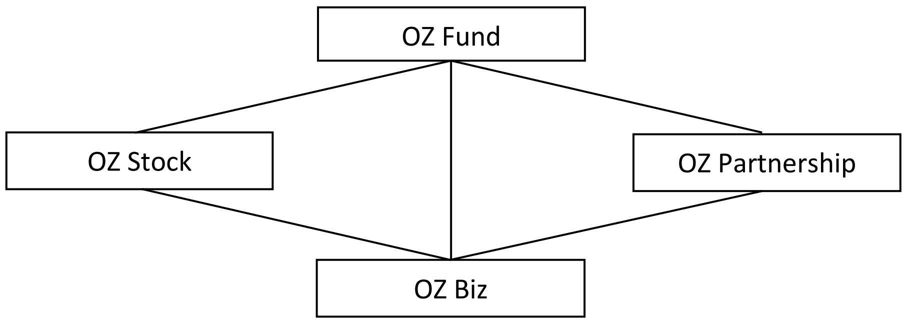
2. Qualified Opportunity Zone Partnership Interest. A qualified opportunity zone partnership interest is defined by the three requirements which are comparable to defining qualified opportunity zone stock, but the definition substitutes a domestic

[31] Proposed Reg Section 1.1400Z-2(d)-1(c)(2)(ii)(B).
[32] Proposed Reg Section 1.1400Z-2(d)-1(c)(2)(ii)(C).

partnership for a domestic corporation and the partnership interest may be a profits or a capital interest in the partnership.[33]

3. Qualified Opportunity Zone Business Property.[34] See the definition above.

The concepts of an OZ Fund and OZ Property are illustrated by the following:



E. **Opportunity Zone Fund**. To be eligible for Section 1400Z-2 benefits, a taxpayer must own an eligible interest in an Opportunity Zone Fund (or "**OZ Fund**"). An OZ Fund is a corporation or a partnership which is formed for the purposes of investing in qualified OZ Property (other than another OZ Fund). An "eligible interest" is an equity interest in the OZ Fund (i.e., common stock, preferred stock, or a partnership interest with or without special allocations), but does not include any debt instrument.[35]

1. 90% Test. The OZ Fund must hold at least 90% of its assets in OZ Property.[36] This 90% test is determined by the average percentage of OZ Property held in the OZ Fund measured on the last day of the first 6-month period of the OZ Fund's taxable year and the last day of the OZ Fund's taxable year.[37] Congress intends that the certification process for an OZ Fund will be done by the Treasury Department's Community Development Financial Institutions Fund in a manner similar to the process for allocating the new markets tax credit.[38]

2. Initial Self-Certification. The IRS website provides a Frequently Asked Questions page on OZ investments. The following question addresses the self-certification process:

[33] Code Section 1400Z-2(d)(2)(C).
[34] Code Section 1400Z-2(d)(2)(A).
[35] Proposed Reg Section 1400Z-2(a)-1(b)(3).
[36] Code Section 1400Z-2(d)(1).
[37] Code Section 1400Z-2(d)(1).
[38] Conf. Rept. No. 115-466 (PL 115-97) p. 538.

> "Q. How does a taxpayer become certified as a Qualified Opportunity Fund?
>
> A. To become a Qualified Opportunity Fund, an eligible taxpayer self certifies. (Thus, no approval or action by the IRS is required.) To self-certify, a taxpayer merely completes a form (which will be released in the summer of 2018) and attaches that form to the taxpayer's federal income tax return for the taxable year. (The return must be filed timely, taking extensions into account.)"[39]

The form referenced in the above answer is form 8996. The form 8996 must specify the first month in the initial tax year that the eligible entity want to be a OZ Fund. Investments made prior to the entity becoming an OZ Fund will not qualify for gain deferral.

The Proposed Regs address the self-certification process and related issues in much more detail.[40]

3. <u>Some Start-Up Flexibility on Testing</u>. The Proposed Regs give some flexibility on the testing dates an OZ Fund can use in its initial year to determine whether it satisfied the 90% test. The OZ Fund can choose both its first tax year as an OZ Fund and the month in which its first 6-month testing period begins.[41] This means an OZ Fund can conduct some activities before it needs to satisfy the 90% test on its first testing date. However, in no event can the first testing date be later than the last day of the OZ Fund's first tax year. The Proposed Regs do not permit any ramp-up period for an OZ Fund's initial period of operations in which it could raise investor money but not invest.

4. <u>Pre-Existing Entities</u>. The Proposed Regs provide that pre-existing entities can be OZ Funds as long as they satisfy the qualification requirements when they choose to be treated as an OZ Fund, including having 90% of its assets being comprised of OZ Property.[42]

a. <u>Practice Point</u>. The selection of the first OZ Fund month will determine the testing periods of for the OZ Fund.

5. <u>No Investment in Another OZ Fund</u>. An OZ Fund may not invest in another OZ Fund.[43]

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[39] https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions.
[40] Proposed Reg Section 1.1400Z-2(d)-1.
[41] Proposed Reg Section 1.1400Z-2(d)-1(a).
[42] Proposed Reg Section 1.1400Z-2(d)-1(a)(3).
[43] Code Section 1400Z-2(d)(1).

6. No Direct Investment by Individuals. Individuals cannot invest directly in the assets of a business located in an OZ and defer gain. Instead, they can only invest rollover gain into or through a corporation or partnership organized in one of the 50 States, the District of Columbia or a U.S. Possession, which in turn will invest (directly or indirectly) in the tangible assets.

a. Disregarded Entities. Because of this rule, disregarded limited liability companies ("LLCs") and disregarded partnerships will not qualify as investors in OZs. Instead, the investor will need to form a "regarded" partnership, a "regarded" LLC or a corporation to be the OZ Fund that will make the investment in tangible assets.

b. LLCs. Section 1400Z-2 does not specifically mention LLCs as being a kind of permitted OZ Fund. However, the Proposed Regs provide that, if an entity is classified as a partnership for Federal tax purposes (partnership), any capital or profits interest (partnership interest) in the entity is a qualified opportunity zone partnership interest if otherwise meets the requirements to be treated as such (see Section IV.D.2. above).[44]

c. S Corporations. Similarly, the Proposed Regs also provide that, if an entity is classified as a corporation for Federal tax purposes, then an equity interest in such entity will be treated as qualified opportunity zone stock if it otherwise meets the requirements to be treated as such (see Section IV.D.1. above).[45] Given this rule, an S corporation wholly-owned by one person be a permitted OZ Fund.

7. Penalty. If a QO Fund fails to meet the 90% requirement of Code section 1400Z-2(d)(1), the QO Fund will have to pay a penalty for each month it fails to meet this requirement.[46] The amount of the penalty owed each month the QO Fund fails to hold at least 90% of its assets in OZ Property is equal to the product of (1) the excess of (x) the amount equal to 90% of its aggregate assets over (y) the aggregate amount of OZ Property held by the QO Fund, and (2) the underpayment rate under Code section 6621(a)(2) for the month.[47] In other words, the penalty is proportional to the amount of the QO Fund's assets that are not invested in OZ Property. There is a reasonable cause exception that will cause the penalty to be abated.[48] Presently, given the pertinent statutory language, it is not clear whether the underpayment rate is per year or per month.

[44] Proposed Regs Section 1.1400Z-2(d)-1(c)(3).
[45] Proposed Regs Section 1.1400Z-2(d)-1(c)(2).
[46] Code Section 1400Z-2(f)(1). Although the statute refers to the 90% requirement of "paragraph (c)(1)", this appears to be a mistake, as such requirement is found in Code Section 1400Z-2(d)(1).
[47] Code Section 1400Z-2(f)(1).
[48] Code Section 1400Z-2(f)(3).

In other words, assuming a 5% underpayment rate, is the penalty 5% per month (or 60% per year) or annualized 5% payable for each month the OZ Fund does not qualify?

V. TIME CONSTRAINTS

A. **180-Day Rule**. To defer capital gains under Code section 1400Z-2, a taxpayer must reinvest an amount at least equal to the rollover gain into the OZ within 180 days of realizing the gain.

1. Pass-Thru Taxpayers. See modifications of this rule discussed at III.B.1. and III.B.2. above.

B. **30-Month Rule; 200% Test**. "Qualified opportunity zone *business* property" (or "**OZ Biz Property**") means *tangible* property used in a trade or business of the OZ Fund if (1) the property was acquired by purchase after December 31, 2017, (2) the property experienced its original use with the OZ Biz *or such property is substantially improved over a 30-month period* by the OZ Biz, and (3) during substantially all of the OZ Fund's holding period, substantially all of the property was in an OZ.[49] For these purposes, property is considered to be substantially improved only if the additions to basis during any 30-month period after acquisition exceed the amount of the adjusted basis at the beginning of the 30-month period (the "200% Test").[50] See the discussion at III.B.3. above.

C. **Interaction of 180-Day Rule with 30-Month Rule**. "Qualified opportunity zone *business* property" (or "OZ Biz Property") means *tangible* property used in a trade or business of the OZ Fund if (1) the property was acquired by purchase after December 31, 2017, (2) the property experienced its original use with the OZ Biz *or such property is substantially improved over a 30-month period* by the OZ Biz, and (3) during substantially all of the OZ Fund's holding period, substantially all of the property was in an OZ.[51] For these purposes, property is considered to be substantially improved only if the additions to basis during any 30-month period after acquisition exceed the amount of the adjusted basis at the beginning of the 30-month period.[52]

VI. COMPARISON WITH LIKE-KIND EXCHANGES

Here is an incomplete comparison of §§ 1400Z-2 and 1031:

A. The rollover gain doesn't need to be from realty;

B. the rollover gain doesn't need to be invested in realty;

[49] Code Section 1400Z-2(d)(2)(D)(i).
[50] Code Section 1400Z-2(d)(2)(D)(ii).
[51] Code Section 1400Z-2(d)(2)(D)(i).
[52] Code Section 1400Z-2(d)(2)(D)(ii).

C. under §1400Z-2, only the rollover gain needs to be reinvested, unlike a like-kind exchange which requires all of the sale proceeds to be reinvested (i.e., the return of basis as well as the rollover gain);

D. under §1031, there is no tax on the rollover gain in 2026; however, there can be a 15% reduction in the rollover gain under §1400Z-2;

E. under §1031, no gain deferral is possible for personal use property or "dealer" property; as discussed above, the Proposed Regs broadly define eligible gains as any capital gains which would otherwise be required to be recognized (but for §1400Z-2); therefore, no gain deferral under §1400Z-2 will be possible in respect to gain classified as ordinary income, e.g., "dealer" property;

F. the Proposed Regs provide that to the extent a partnership, S Corporation, trust, or decedent's estate does not elect to defer an eligible gain under §1400Z-2, the partners, shareholders or beneficiaries of such entity are entitled to elect to defer their distributive shares or income in respect to such eligible gain;[53] therefore, a partner of an exchanging partnership or the shareholder of an exchanging S corporation may be able to defer their gain even if the other partners or shareholders decide otherwise;

G. under §1031, it is difficult for funds used to make post-acquisition realty improvements to qualify for deferral, but under §1400Z-2, such funds can be expended over 30 months;

H. under §1400Z-2, funds cannot be expended for realty (due to the "original use" requirement) unless the OZ Fund makes additions to basis that exceed the purchase price for the land;

I. under §1031, a reverse" exchange is possible[54], unlike under §1400Z-2;

J. there's no 45-day period for identifying replacement property;

K. the replacement property needn't be like-kind;

L. §1400Z-2 permits a pre-death elimination of gain on "replacement" property;

M. under §1400Z-2, a sale to related party isn't possible, unlike under §1031(f), which simply adds an additional 2-year holding period;

N. under §1400Z-2, it may be possible to defer or avoid capital gain on non-real estate, but this is no long true under §1031; and

[53] Proposed Regs Section 1.1400-2(a)-1(c).
[54] Rev. Proc. 2000-37, 2000-2 CB 308.

O. under §1031, the pertinent investment doesn't need to be located in an OZ.

VII. RESOLVED AND UNRESOLVED QUESTIONS

Here are some of the questions which either have been or have not been answered by the Proposed Regs.

A. Recapture; Dealer Property. The Proposed Regs provide that only capital gains are eligible for §1400Z-2 gain deferral (see Section II.A.1.b. above); therefore, sale gain which results in ordinary income (e.g., recapture or proceeds from the sale of dealer property) will not be eligible for deferral. Given the late change in statutory language of Section 1400Z-2 to reference "any gain" rather than "capital gain", is Treasury justified in relying on Section 1400Z-2's legislative history to conclude that Section 1400Z-2 deferral only applies to capital gains?

B. Hot Assets. The Proposed Regs provide that only capital gains are eligible for §1400Z-2 gain deferral (see Section II.A.1.b. above); therefore, gain from recapture and inventory assets treated as ordinary income under Code section 751 will not be eligible for §1400Z-2 gain deferral.

C. Section 1231 Gain. Code section 1231 is not expressly discussed in the Proposed Regs. However, since "eligible gains" under 1400Z-2 potentially include all gains treated as capital gains for Federal income tax purposes (see Section II.A.1.b. above); all Code section 1231 capital gains otherwise meeting the §1400Z-2 deferral requirements should be eligible for deferral under §1400Z-2.

D. Successive Sales & Reinvestment. For purposes of computing the 5, 7 and 10 year holding periods under §1400Z-2, what happens when an OZ Fund sells OZ Biz Property but that OZ Fund reinvests the proceeds of that sale in other OZ Biz Property? Will the owners of the OZ Fund be taxable on the interim gains, thereby making §1400Z-2 less attractive, or will there be a rollover of the original rollover gain, or the gain in excess of the rollover gain?

E. Foreign Taxpayers. Will foreign taxpayers be entitled to rollover pre-2026 real property (FIRPTA) gain? This issue is not directly addressed in the Proposed Regs; however, Proposed Reg Section 1.1400Z-2(a)-1(b)(1) defines "eligible taxpayer" as "a person that may recognize gains for purposes of Federal income tax reporting."

F. Pre-Development Costs. Can the OZ Fund use rollover gain to pay for pre-development costs or financing of OZ Biz Property or an OZ Biz? It may be possible to pay pre-development costs, and possibly financing costs, with rollover gain, under the working capital safe harbor discussed in Section IV.C.3.b. above.

G. Leased Property. Can leased property be OZ Biz Property? Does the duration of the lease term or the lease provisions matter (e.g., financing leases versus capital leases)? Code section 1400Z-2(D)(i)(I) says OZ Biz Property "must be acquired ***by purchase*** (as defined in section 179(d)(2)) after December 31, 2017."

H. Tiered Partnerships. How will this work? Can more than one tier of pass-through entities reinvest?

I. Installment Sales. How will gain recognized over 3-4 years be treated for purposes of the 180-day reinvestment rule?

J. Anti-Abuse Rules. Will anti-abuse rules prevent refinancing distributions for the 2026 gain recognition year from reducing the 2026 fair market value (and thus reduce the 2026 taxable gain)? Will refinancing distributions be taxable when received?

K. Deemed Assumptions. If the investment in an partnership OZ Fund is only stepped up to its fair market value when sold after a 10-year hold, how will gain be avoided for a partner's share of liabilities deemed assumed by the purchaser?

L. Liquidation of Partnership Interests. Will the "inside" basis of partnership assets be stepped-up if a partner's interest in a partnership OZ Fund is liquidated?

M. Grace Periods for Reinvestment. Rollover gain can be re-invested in an OZ Fund within 180 days. Assuming an OZ Fund receives funds from a rollover gain on day 179, must the OZ Fund satisfy the 90% test on day 180, or will the OZ fund have until the end of its next 6-month testing period under the 90% test to reinvest those funds? On page 21 of the preamble to the Proposed Regs, it is noted that Code section 1400Z-2(e)(4)(B) authorizes regulations to ensure that an OZ Fund has a reasonable amount of time to reinvest, and states that soon-to-be released proposed regulations will provide guidance on this subject.

N. Applying the 90% Test. As noted above, an OZ Fund must hold at least 90% of its assets in OZ Property. In applying this test, what will count, i.e., original basis, adjusted basis or fair market value? The Proposed Regs require the OZ Fund to use (i) the asset values reported on the OZ Fund's financial statements for the taxable year (as defined in Treas. Reg. Section 1.475(a)-4(h)), or (ii) if it has no such financial statements, the cost of its assets.[55]

O. Meaning of Substantially All. OZ Biz Property must be used in the OZ for substantially all of the holding period for the property. What constitutes "substantially all" of the holding period? The preamble to the Proposed Regs solicits comments on this issue and on the use of "substantially all" in several other contexts. The Proposed Regs include a reserved section to address this issue in the future.[56] What if OZ Biz Property is traded-in on other OZ Biz Property? See Section VI.V. above.

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[55] Proposed Regulations Section 1.1400Z-2(d)-1(d)(3)(ii).

[56] Proposed Regulations Section 1.1400Z-2(d)-1(c)(5).

P. Penalty Calculation. With respect to the underpayment rate used for the non-compliance penalty, is that rate a per annum rate or does it apply every month? This issue is not addressed by the Proposed Regs. However, Code section 1400Z-2(f)(1) states the OZ Fund "shall pay a penalty for ***each month*** if fails to meet the requirement", in an amount equal to (A) the excess of (i) 90% of its aggregate assets, over (ii) the aggregate amount of qualified OZ Property it holds, multiplied by (B) the underpayment rate established under Code section 6621(a)(2) for such month. How will this penalty be calculated? See the discussion at IV.E.7. above. Further, will there be a general reasonable cause exception for this penalty? This issue is not addressed by the Proposed Regs. However, Code section 1400Z-2(f)(3) states "No penalty shall be imposed under this subsection with respect to any failure if it is shown that such failure is due to reasonable cause."

Q. 30-Month Deadline for Substantial Improvements. What happens if a taxpayer misses the 30-month deadline due to circumstances beyond the taxpayer's control, e.g., a Hurricane Harvey? Will there be a reasonable cause exception for the 30-month deadline? The Proposed Regs do not address this issue, but the preamble to the Proposed Regs (at page 24) requests additional comments regarding the working-capital safe harbor and ancillary safe harbors.

R. Related Party. OZ Biz Property cannot be acquired from a related party. Is this a 20% related party by reason of the related party definition in Code section 1400Z-2(e)(2), even though the definition of related person for a OZ Biz Property refers to a non-existent Code section 1400Z-2(d)(8)? The Proposed Regs use 20% (rather than 50%). See Section II.A.1.b. above.

S. Passive Activity Losses. How will suspended passive activity losses interact with a Section 1400Z-2 roll over? See the discussion above at III.C.1.

T. Section 1231 Gains. Will Section 1231 gains be eligible gains for purposes of Section 1400Z-2? See the discussion at footnote 5 above.

VIII. PLANNING EXAMPLE

Here is a planning example to help put things into perspective:

In December 2018, two groups of investors come together to form an LLC to purchase raw land from an unrelated party that is located in an OZ, the LLC will construct a hotel on that land. Sufficient services will be performed by the LLC to cause the hotel to constitute an active business. The cost of the constructed improvements will exceed the cost of the raw land, thereby satisfying the 200% rule. The total cost of the project will be $30,000,000. The LLC will obtain a nonrecourse loan for 70% of the total $30,000,000 cost (i.e., $21,000,000).

The first group of investors will fund 2/3rds of the needed equity, and they will fund their equity investment using capital gain recently realized from a variety of sources (e.g., the sale of a business, some unimproved realty and some publicly-traded stock). The membership interests issued by the LLC to the first group of investors will be "Class A" membership interests. The constructed improvements will be completed within 30 months of the gain realized by the first group of investors, thereby satisfying the requirements for the hotel to be OZ Biz Property (i.e., tangible property acquired after 2017 that was substantially improved within 30 months). Further, the cash funds received from the Class A investors and held during the 30-month construction period will constitute OZ Biz Property because the LLC will have (i) the requisite written plan which identifies that the Class A investor's funds will be used for the construction of the hotel, along with (ii) the requisite written schedule which details how and when the Class A Investor's funds will be spent on construction costs (thereby complying with the safe harbor under the Proposed Regs for substantial improvements). The Class A membership interests will be entitled to a 2/3rds sharing percentage or distributive share.

The second group of investors will fund 1/3rd of the needed equity, and they will fund their equity investment in the LLC using already-taxed cash. The membership interests issued by the LLC to the second group of investors will be "Class B" membership interests. The Class B membership interests will be entitled to a 1/3rd sharing percentage or distributive share.

Assume the LLC qualifies as an OZ Fund because it invests in a partnership (the "Hotel Operating Partnership") which owns an OZ Business (i.e., the hotel), and thus, the LLC's partnership interest will be a qualified opportunity zone partnership interest. Under the "mixed funds" rule, (i) all income and gains allocated to the Class A investors will be eligible for Section 1400Z-2 benefits as long as the LLC holds the hotel for the requisite 10-year period and (ii) all income and gains allocated to the Class B investors will receive the same tax treatment as exists irrespective of Section 1400Z-2. The Class A investors will also be eligible for 2/3rds of the depreciation deductions attributable hotel, to the extent of 2/3rds of the nonrecourse loan (i.e., $14,000,000).

At all times, at least 90% of the LLC's assets will be comprised of its partnership interest in the Hotel Operating Partnership. The partnership agreement for the Hotel Opportunity Partnership will provide that at least 70% of its assets will be comprised of OZ Biz Property.

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

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

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

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

conduct of trade or business even though used for routine personal purposes such as commuting to and from work. Reg. § 1.274-2(b)(1).

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

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

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

Example 3: The client of a self-employed attorney spends the day in the attorney's office to review strategy for an upcoming IRS Appeals conference. They take a break for lunch at a restaurant down the street. During lunch, they continue their discussion. The attorney pays for the meal. Is the meal nondeductible "entertainment"? Or is it (at least in part) a deductible business expense subject to the 50 percent limitation of § 274(n)(1)?

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

Example 1.

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

Example 2.

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

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

Example 3.

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

2. As in Example 2, the basketball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expense and is not deductible by C. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets, is not an entertainment expense and is not subject to the § 274(a)(1) disallowance. Therefore, C may deduct 50 percent of the expenses associated with the food and beverages provided at the game.

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

1. Those who move for work-related reasons now have a higher tax bill. Is this really good for the economy? Provided that certain requirements are met, Code § 217 allows a taxpayer to deduct moving expenses paid or incurred in connection with the taxpayer's commencement of work (either as an employee or as a self-employed individual) at a new principal place of work. Section 132(a)(6) of the Code excludes from an individual's gross income a "qualified moving expense reimbursement," defined in § 132(g) as an employer's reimbursement of moving expenses that, if paid by the employee, would be deductible under § 217. The 2017 Tax Cuts and Jobs Act amended both provisions. Section 11049 of the TCJA amended Code § 217 by adding § 217(k), which provides that the deduction for moving expenses shall not apply to any taxable year beginning after 2017 and before 2026. Section 11048 of the TCJA amended Code § 132(g) by adding § 132(g)(2), which provides that the exclusion from gross income for a qualified moving expense reimbursement shall not apply to any taxable year beginning after 2017 and before 2026. Both amendments contain an exception for members of the armed forces on active duty who move pursuant to a military order and incident to a permanent change of station, i.e., such individuals can still deduct moving expenses and exclude moving expense reimbursements.

a. Individuals can exclude from gross income reimbursements received from employers in 2018 for expenses incurred in connection with moves that occurred before 2018. Notice 2018-75, 2018-41 I.R.B. 556 (9/21/18). Prior to the 2017 Tax Cuts and Jobs Act, § 132(a)(6) permitted individuals to exclude from gross income a "qualified moving expense reimbursement," defined in § 132(g) as an employer's reimbursement of moving expenses that, if paid by the individual, would be deductible under § 217. In the Tax Cuts and Jobs Act, Congress suspended this exclusion (except with respect to members of the armed forces on active duty who move pursuant to military orders) for taxable years beginning after 2017 and before 2026. This notice provides that the suspension of the exclusion does not apply to individuals who receive reimbursements from employers in 2018 for expenses incurred in connection with moves that occurred before 2018. The notice provides as follows:

> Thus, if an individual moved in 2017 and the expenses for the move would have been deductible by the individual under section 217 as in effect prior to the amendments made by the Act if they had been paid directly by the individual in 2017, and the individual did not deduct the moving expenses, then the amount received (directly or indirectly) in 2018 by the individual from an employer as payment for or reimbursement of the expenses will be a qualified moving expense reimbursement under section 132(g)(1).

An individual therefore can exclude such payments by employers from gross income regardless of whether the employer paid the moving expense directly or instead reimbursed the individual. The notice provides that employers who have included such amounts in an individual's wages or compensation for purposes of federal employment taxes (and therefore have withheld and paid federal employment taxes on these amounts) can use the adjustment process under § 6413 or the refund claim process under § 6402 to correct the overpayment of federal employment taxes.

B. Qualified Deferred Compensation Plans

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

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

1. Church's blue-envelope system for collecting pastor's "shake-hand" money nevertheless results in green gross income, not excludable gifts. Felton v. Commissioner, T.C. Memo. 2018-168 (10/10/18). The taxpayer was the pastor of a sizeable church in Minnesota. The church had an envelope system for collecting offerings. White, gold, and blue envelopes where used. White envelopes were for tax-deductible contributions to the operating funds of the church. White envelopes included a line-item entry ("pastoral donations") for a congregant to indicate the portion of any contribution which the congregant desired to be paid by the church to the taxpayer-pastor. Under this system, the taxpayer-pastor was paid by the church and reported as gross income approximately $40,000 annually in compensation for the years 2008 and 2009. Gold envelopes were for tax-deductible contributions to special programs and retreats conducted by the church. Blue envelopes ostensibly were for nondeductible "gifts" made by congregants to the taxpayer-pastor. After the end of each church service, the blue envelopes were delivered directly to the taxpayer-pastor. The church did not collect or account for blue envelope monies. [In some churches, these "gifts" to pastors are known as "shake-hand" contributions because they are often given to the pastor upon shaking his or her hand while leaving church. The taxpayer objected to this (*underhanded?*) method of collecting "gifts" for pastors, so the taxpayer caused the church to institute the blue-envelope system.] The taxpayer-pastor as well as the church had announced during a business meeting that blue-envelope contributions were not tax deductible and were solely for the pastor's benefit; however, the distinction between blue-envelope and other contributions was not emphasized during church services. Upon audit, the IRS determined that the blue envelope monies provided to the taxpayer for the years 2008 ($258,001) and 2009 ($234,826) was gross income under § 61(a)(1) ("compensation for services"). The taxpayer-pastor argued that the blue envelope funds were excludable gifts under § 102(a). Essentially, the taxpayer's position was that the $40,000 paid by the church annually to the taxpayer in "pastoral donations" was his salary, while the blue-envelope monies were excludible gifts because congregants knew those amounts were not tax deductible. The IRS argued, of course, that the blue-envelope monies were not gifts but disguised compensation. To support this argument, the IRS emphasized that the taxpayer had reported zero taxable income for 2008 or 2009, yet had claimed for each year a parsonage allowance of $80,000, mortgage interest deductions of more than $50,000, and charitable contribution deductions of $50,000. The Tax Court (Judge Holmes) held that the blue-envelope monies were not excludible gifts but instead were gross income to the taxpayer for his services as pastor. Judge Holmes pointed to four factors supporting the court's conclusion: (1) the average congregant made blue-envelope donations in large part to keep the taxpayer-pastor preaching at the church; (2) the lack of emphasis in church services that blue-envelope monies were "gifts" to the pastor; (3) the routinized structure of the blue-envelope system for the taxpayer's benefit; and (4) the ratio of the taxpayer's salary to the purported blue-envelope "gifts." Judge Holmes also upheld the IRS's assertion of accuracy-related penalties under § 6662(a).

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

D. Deductions and Credits for Personal Expenses

1. Let's hope new withholding tables are issued soon. The deduction for personal exemptions has disappeared. The 2017 Tax Cuts and Jobs Act, § 11041, amended Code § 151(d) by adding § 151(d)(5), which reduces the exemption amount to zero for taxable years beginning after 2017 and before 2026. The effect of this amendment is to eliminate the deduction for personal exemptions. The reduction of the exemption amount to zero required conforming amendments to other Code provisions that make use of the exemption amount. For example, under § 6012, an individual taxpayer generally does not need to file a return if the taxpayer's gross income does not exceed the sum of the basic standard deduction plus the exemption amount under § 151(d). The legislation addresses this by amending § 6012 to provide that an individual need not file a return if the taxpayer's gross income does not exceed the standard deduction. Similarly, § 642(b)(2)(C) allows a qualified disability trust to deduct an amount equal to the exemption amount under § 151(d), and § 6334(d) exempts from levy an amount of weekly wages equal to 1/52 of the sum of the standard deduction and the aggregate amount of the taxpayer's deductions for personal exemptions under § 151. The legislation addresses this issue by amending those provisions to refer to $4,105 (to be adjusted for inflation), the exemption amount that had been scheduled to take effect in 2018 before the Tax Cuts and Jobs Act. The legislation also directs Treasury to develop rules to determine the amount of tax that employers are required to withhold from an employee's wages but gives Treasury the discretion to apply current wage withholding rules for 2018.

a. Now that the exemption amount in § 151(d) is zero, how do we determine who is a qualifying relative? Notice 2018-70, 2018-38 I.R.B. 441 (8/28/18). The 2017 Tax Cuts and Jobs Act, § 11041, amended Code § 151(d) by adding § 151(d)(5), which reduces the exemption amount to zero for taxable years beginning after 2017 and before 2026. The intended effect of this amendment is to eliminate the deduction for personal exemptions authorized by § 151(a). Nevertheless, it is still necessary to determine for various purposes whether an individual is a "dependent" within the meaning of § 152. These purposes include determining eligibility for the earned income tax credit and for head-of-household filing status. The two basic categories of dependents under § 152 are a (1) qualifying child, and (2) qualifyng relative. To be a qualifying relative, one of the requirements, set forth in § 152(d)(1)(B), is that the individual's gross income for the calendar year must be less than the exemption amount as defined in § 151(d). By virtue of the Tax Cuts and Jobs Act, the exemption amount in § 151(d) is now zero. This notice addresses this conundrum. According to the notice, "because it would be highly unusual for an individual to have gross income less than zero, virtually no individuals would be eligible as qualifying relatives." The notice provides that Treasury and the IRS intend to issue proposed regulations that will clarify that the zero exemption amount of § 151(d)(5)(A) for taxable years 2018-2025 does not apply to the gross income limitation in the definition of a qualifying relative in § 152(d)(1)(B). Instead, the proposed regulations will provide that,

> in defining a qualifying relative for purposes of various provisions of the Code that refer to the definition of dependent in § 152, including, without limitation, for purposes of the new credit under § 24(h)(4) and head of household filing status under § 2(b), the § 151(d) exemption amount referenced in § 152(d)(1)(B) will be treated as $4,150 (adjusted for inflation), for taxable years in which the § 151(d)(5)(A) exemption amount is zero.

Thus, in determining eligibility for head-of-household filing status and for the new $500 credit authorized by § 24(h)(4) for dependents other than a qualifying child, an individual can be treated as a qualifying relative in 2018 if the individual's gross income does not exceed $4,150. The notice provides that taxpayers can rely on the notice before the issuance of the proposed regulations.

2. **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.

c. The availability of a business expense deduction under § 162 for payments to charities is not affected by the recently issued proposed regulations, says the IRS. IRS News Release IR-2018-178 (9/5/18). This news release clarifies that the availability of a deduction for ordinary and necessary business expenses under § 162 for businesses that make payments to charities or government agencies and for which the business receives state tax credits is not affected by the proposed regulations issued in August 2018 that generally disallow a federal charitable contribution deduction under § 170 for charitable contributions made by an individual for which the individual receives a state tax credit. *See* REG-112176-18, Contributions in Exchange for State and Local Tax Credits, 83 F.R. 43563 (8/27/18). Thus, if a payment to a government agency or charity qualifies as an ordinary and necessary business expense under § 162(a), it is not subject to disallowance in the manner in which deductions under § 170 are subject to disallowance. This is true, according to the news release, regardless of whether the taxpayer is doing business as a sole proprietor, partnership or corporation. According to a "frequently asked question" posted on the IRS website, "a business taxpayer making a payment to a charitable or government entity described in § 170(c) is generally permitted to deduct the entire payment as an ordinary and necessary business expense under § 162 if the payment is made with a business purpose."

E. Divorce Tax Issues

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

VII. PARTNERSHIPS

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. You only need to read the first two sentences of this S corporation ESOP case to know that it's a loser for the taxpayer. Pacific Management Group et al. v. Commissioner, T.C. Memo 2018-131 (8/20/18). You know it's not going to go well for the taxpayers when the first two sentences of the Tax Court's opinion read as follows: "These consolidated cases involve a complex tax shelter scheme featuring four C corporations, five individual shareholder-employees of the C corporations, five employee stock ownership plans (ESOPs), five S corporations, and (inevitably) a partnership. This scheme was devised by [attorney], who serves as co-counsel for the petitioners in these cases." Essentially, the "scheme" (as Judge Lauber labeled it) enabled the taxpayers' C corporations to pay purportedly deductible "factoring fees" and "management fees" to the taxpayers' partnership over the years 2002 through 2005 in order to minimize or eliminate any corporate level tax. The partnership then allocated the income from those payments to S corporations, with one S corporation having been established for each of the five principals, with their allocable shares of partnership income being determined based upon their relative percentage ownership of stock in the C corporations. The principals received and paid taxes on their salaries from their respective S corporations, but the excess profits over their salaries accumulated tax free in the five separate S corporations that were owned by five separate ESOPs. Judge Lauber, after 80 pages of facts and analysis, held that the so-called "factoring fees" and "management fees" claimed by that the taxpayer C corporations were in fact either disguised dividends or improperly assigned income taxable to the five principals. Regarding the "factoring fees," Judge Lauber found that the arrangement lacked economic substance, and instead was merely a device to extract profits from the C corporations disguised as tax-deductible payments. Regarding the "management fees," which were compensation and bonuses paid to the principals for their services, Judge Lauber applied the *Elliotts* factors to determine whether the payments constituted reasonable compensation. *See Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1245-1247 (9th Cir. 1983), *rev'g and remanding* T.C. Memo. 1980-282. Applying those factors, Judge Lauber found that only a portion of the bonus payments constituted reasonable compensation. The balance of the bonuses constituted nondeductible dividends by the C corporations. Ultimately, the Tax Court agreed with the IRS's proposed adjustment of approximately $1.75 million of additional taxable income among the five principals. With respect to certain of the five principals, underpayment penalties also were imposed based upon their individual circumstances after taking into account other, unrelated income for the years in issue.

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

D. Tax Shelter Penalties

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Taxpayer's healthcare consulting nonprofit diagnosed as terminal under IRC § 501(c)(3). Abovo Found., Inc. v. Commissioner, T.C. Memo 2018-57 (4/30/18). Based upon the facts set forth in its application for exempt status (IRS Form 1023) and the administrative record, the Tax Court (Judge Foley) holds that the taxpayer, a Texas nonprofit corporation, failed the operational test and thus cannot qualify as tax-exempt under § 501(c)(3). Although the taxpayer met the requirements of the organizational test under § 501(c)(3) (i.e., the taxpayer had the proper § 501(c)(3) restrictive language in its articles and bylaws), a § 501(c)(3) also must meet an operational test to be exempt. Part of the operational test requires that an organization operate primarily for exempt purposes, and that no part of the organization's net earnings inure to the benefit of any private individual. The taxpayer disclosed in its Form 1023 that it planned to hire Dr. Okonkwo — a military veteran, medical doctor, and board certified expert in patient safety and risk management — as President and taxpayer's sole employee to deliver quality-management and patient-safety consulting services on behalf of the taxpayer. The taxpayer argued that its operations would "lessen the burdens of government" and thus should qualify as exempt. The taxpayer's Form 1023 and the administrative record, however, disclosed that Dr. Okonkwo would be paid a market rate for his services (i.e., a $217,000 salary plus an annual bonus of up to $100,000). Furthermore, no facts in the record demonstrated that the taxpayer would act on behalf of or otherwise lessen the burdens of government. Instead, Judge Foley determined that the taxpayer would (i) serve as as a "facade for Dr. Okonkwo's consulting activities;" (ii) help him develop his "business relationships;" (iii) further his consulting career as a board certified expert in patient safety and risk management; and (iv) potentially confer a private benefit on him of annual compensation in excess of $300,000. As a result, Judge Foley denied the taxpayer exempt status under § 501(c)(3).

B. Charitable Giving

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

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. You say "FBAR." We say "FUBAR." Treasury fails to update FBAR regulations resulting in FUBAR law, so the penalty for willful violations could be capped at $100,000 per account unless and until amended regulations are adopted. Some taxpayers successfully have argued in U.S. District Court that substantial foreign bank account reporting ("FBAR") penalties assessed by the IRS must be reduced. To understand the significance of these cases, some background is necessary. Under 31 U.S.C. § 5321(a)(5)(A), the Secretary of the Treasury "may impose" a penalty for FBAR violations, and pursuant to administrative orders, the authority to impose FBAR penalties has been delegated by the Secretary to the IRS. Further, under the *current* version of 31 U.S.C. § 5321(a)(5)(B)(i), the normal penalty for an FBAR violation is $10,000 per offending account; however, the penalty for a *willful* FBAR violation "shall be increased to the greater of" $100,000 or 50 percent of the balance in the offending account at the time of the violation. *See* 31 U.S.C. § 5321(a)(5)(C). These minimum and maximum penalties for willful FBAR violations were changed by the American Jobs Creation Act of 2004 ("AJCA"), Pub. L. No. 108-357, § 821, 118 Stat. 1418 (2004). The prior version of 31 U.S.C. § 5321(a)(5) provided that the penalty for *willful* FBAR violations was the greater of $25,000 or the balance of the unreported account up to $100,000. Treasury regulations issued under the pre-AJCA version of 31 U.S.C. § 5321(a)(5), reflecting the law at the time, capped the penalty for willful FBAR violations to $100,000 per account. *See* 31 C.F.R. § 1010.820(g). Unfortunately for the IRS in the cases summarized below, those pre-AJCA regulations have not been updated to reflect the change in the statute itself.

a. First taxpayer victory in the FBAR-FUBAR war. United States v. Colliot, 121 A.F.T.R.2d 2018-1834 (W.D. Tex. 5/16/18). The IRS had assessed multiple FBAR penalties totaling over $745,000 against the taxpayer for willful violations across the years 2007 through 2010. The bulk of the penalties were for violations in 2007 ($548,773) and in 2008 ($196,082). Contesting the IRS's assessment, the taxpayer argued that the "may impose" language of 31 U.S.C. § 5321(a)(5)(A) leaves the amount of assessable FBAR penalties to the discretion of the Secretary of the Treasury. Further, because the (albeit outdated) Treasury regulations had not been amended to reflect the AJCA's increase in the minimum and maximum FBAR penalties, the IRS's authority was limited to the amount prescribed by the existing regulations. As noted above, the existing regulations limit the FBAR penalty for willful violations to $100,000 per unreported account. The IRS argued that notwithstanding Treasury's failure to update the regulations, the amended statute "implicitly superseded or invalidated" the out-of-date regulations. The District Court for the Western District of

Texas, Judge Sparks, disagreed with the IRS and sided with the taxpayer. Judge Sparks reasoned that, although amended 31 U.S.C. § 5321(a)(5)(C) allows greater penalties for willful FBAR violations than the outdated regulations, the "may impose" language of the statute clearly leaves the Secretary of Treasury with the discretion to do so. Accordingly, because the Secretary of the Treasury has not exercised his discretion to update the regulations, the IRS's authority to assert penalties for willful FBAR violations, the court held, is capped at the greater of $25,000 or the balance of the unreported account up to $100,000 until the regulations are amended. Judge Sparks concluded his opinion by ordering the taxpayer and the IRS to brief the court on the appropriate remedy that should be granted, so the exact amount of the FBAR penalties (if any) to be imposed upon the taxpayer in *Colliot* was not determined by the court.

- In a subsequent order, the court declined to dismiss the case on the grounds that (1) most of the penalties asserted by the government did not exceed the limit set forth in the regulations, and (2) the appropriate remedy for the one penalty that did exceed the limit was to reduce the penalty to the permissible amount. United States v. Colliot, 122 A.F.T.R.2d 2018-5558 (W.D. Tex. 8/16/18).

b. Second taxpayer victory in the FBAR-FUBAR war. United States v. Wadhan, 325 F. Supp. 3d 1136 (D. Colo. 7/18/18). In a very similar case, the U.S. District Court for the District of Colorado (Judge Krieger) held that penalties totaling over $2 million assessed against a taxpayer for willful FBAR violations across the years 2008 through 2010 must be reduced and capped at $100,000 per unreported account. Judge Krieger reiterated that although the current version of 31 U.S.C. § 5321(a)(5) permits a higher amount, existing (albeit outdated) Treasury regulations (31 C.F.R. § 1010.820(g)) limit the IRS's authority to assess penalties to the greater of $25,000 or the balance of the unreported account up to $100,000. Judge Krieger cited the court's decision in *United States v. Colliot* 121 A.F.T.R.2d 2018-1834 (W.D. Tex. 5/16/18), as support for her decision. Judge Krieger further reasoned that, although Treasury has updated other regulations since 2004 to increase FBAR penalties for inflation (*see, e.g.*, 31 C.F.R. § 1010.821), Treasury has not updated the regulations to reflect the increased penalties allowed by amended 31 U.S.C. § § 5321(a)(5)(C). Like the court in *United States v. Colliot*, Judge Krieger did not determine the ultimate amount of penalties to be imposed upon the taxpayer other than to hold that the amount should not exceed $100,000 per unreported account.

c. But wait! A government victory in the FBAR-FUBAR war. Norman v. United States, 138 Fed. Cl. 189 (7/31/18). The government assessed a penalty of $803,500 for failure to file an FBAR in 2007 with respect to a Swiss Bank account. The taxpayer, relying on *United States v. Colliot*, 121 A.F.T.R.2d 2018-1834 (W.D. Tex. 5/16/18), argued that the relevant statute, 31 U.S.C. § 5321(a)(5), provides the Secretary of the Treasury with discretion to determine the amount of assessable FBAR penalties and that, because the outdated Treasury regulations had not been amended to reflect the AJCA's increase in the minimum and maximum FBAR penalties, the IRS's authority was limited to the amount prescribed by the existing regulations. The Court of Federal Claims (Judge Damich) rejected this argument. Judge Damich reasoned that the amended statute, which provides that the amount of penalties for willful FBAR violations *shall be* increased to the greater of $100,000 or 50 percent of the account value, is mandatory and removed Treasury's discretion to provide for a smaller penalty by regulation. Accordingly, the court held, the relevant regulation that provides for a smaller penalty, 31 C.F.R. § 1010.820(g), is invalid.

2. Like Attorney General Jeff Sessions, the Tenth Circuit, the Tax Court, the IRS, and Code § 280E continue to be buzz killers for the marijuana industry. Section 280E disallows any deduction or credit otherwise allowable if such amount is paid or incurred in connection with a trade or business consisting of trafficking in controlled substances. Marijuana remains a controlled substance under federal law (the "Controlled Substances Act") even though it has been legalized for medical or recreational use (or both) in a majority of states. Unlike some other federal agencies under the prior administration, the IRS has not turned a blind eye to taxpayers engaging in the domestic production and sale of marijuana, even where such activities are permitted under state law. Instead, relying upon § 280E, the IRS has audited such taxpayers, disallowed deductions, and asserted corresponding deficiencies and penalties. In general, the courts have upheld the IRS's position in these cases, as summarized below.

a. The taxpayer may have the "green solution," but the IRS gets the "green light" to continue its audit of this Colorado marijuana dispensary. The Green Solution Retail, Inc. v. United States, 855 F.3d 1111 (10th Cir. 5/2/17). The United States Court of Appeals for the Tenth Circuit, in an opinion by Judge McHugh, held that the Anti-Injunction Act ("AIA") and the Declaratory Judgment Act ("DJA") bar a marijuana dispensary's suit to enjoin the IRS from auditing its business records. The IRS's examination of the taxpayer, a Colorado-based marijuana dispensary, sought to determine if § 280E applies to disallow certain of the taxpayer's claimed deductions and credits. The taxpayer argued that the AIA and DJA do not apply and the IRS thus should be prohibited from examining the taxpayer's business records on three grounds. ***One,*** the taxpayer argued that the Tenth Circuit's prior decision in *Lowrie v. United States*, 824 F.2d 827, 830 (10th Cir. 1987), which held that the AIA bars actions seeking to enjoin "activities leading up to, and culminating in, ... assessment" (such as an IRS audit) was implicitly overruled by the Supreme Court of the United States in *Direct Marketing Ass'n v. Brohl*, ___ U.S. ___, 135 S.Ct. 1124 (2015). *Direct Marketing* involved a suit by taxpayers seeking to enjoin Colorado taxing authorities from obtaining information from online retailers about the retailers' customers. The Supreme Court held in *Direct Marketing* that the Tax Injunction Act ("TIA"), which generally prohibits federal injunctions against state tax assessment and collection actions, did not bar a federal suit seeking to enjoin Colorado from demanding information about customers from the online retailers. After a detailed examination of the language of the AIA as compared to the TIA, the Tenth Circuit determined that its decision in *Lowrie* was not implicitly overruled by *Direct Marketing*. Further, the Tenth Circuit determined that if the AIA bars the taxpayer's suit, then the DJA — which bars declaratory judgments in certain federal tax cases — similarly bars the taxpayer's suit because the acts are "coterminous." Therefore, at least in the Tenth Circuit, the AIA and DJA continue to bar taxpayer suits seeking to enjoin the IRS from "activities leading up to, and culminating in, ... assessment" (such as an IRS audit). ***Two,*** the taxpayer argued that, by seeking to determine in an audit whether the taxpayer was engaged in a federal crime under the Controlled Substances Act, the IRS was acting outside of its administrative authority. The Tenth Circuit was unconvinced. ***Three,*** the taxpayer argued that § 280E imposes a "penalty," not a "tax," and that the AIA and DJA prohibit only actions seeking to enjoin the assessment or collection of a federal "tax." The Tenth Circuit dispensed of this latter argument by the taxpayer as well and upheld the District Court's dismissal of the taxpayer's suit to enjoin the IRS's audit.

b. The Tenth Circuit snuffs out this marijuana business's refund claim. Alpenglow Botanicals, LLC v. United States, 894 F.3d 1187 (10th Cir. 7/3/18). In this case before the U.S. Court of Appeals for the Tenth Circuit, the taxpayers (who were the member-partners of Alpenglow Botanicals, LLC) sought a refund from the IRS arguing that, by disallowing Alpenglow's deductions under § 280E and assessing a deficiency against the taxpayers, the IRS exceeded its administrative authority. Specifically, the taxpayers argued that the IRS lacked authority to investigate and deny tax deductions under § 280E without a criminal conviction having been established first and that, even if it had such authority, the IRS had insufficient evidence of "trafficking" to apply § 280E to the taxpayers LLC. The taxpayers further argued that Congress has not expressly delegated to the IRS the authority to investigate violations of federal drug laws and therefore the IRS cannot make a predicate finding of "trafficking" necessary to deny deductions under § 280E. The taxpayers' arguments primarily stemmed (*no pun intended*) from the IRS's notice of deficiency which contained conclusory language that the taxpayer had "committed the crime of trafficking in controlled substances." Basically, the IRS argued in response that regardless of the conclusory language in the notice of deficiency, the taxpayer's argument was misplaced as it related to the IRS's authority to disallow deductions under § 280E. The Tenth Circuit agreed with the IRS, relying in part upon *Green Solution Retail* (discussed above). The court, with Judge McHugh writing for the three-judge panel, held that the IRS acted within its statutory authority by determining, as a matter of civil tax law, whether the taxpayers had trafficked in controlled substances for purposes of § 280E. Thus, the court denied the taxpayer's refund claim.

c. You must be high! Marijuana business conducted via an S corporation subjects taxpayer-shareholders to "double taxation" due to the application of § 280E. Loughman v. Commissioner, T.C. Memo. 2018-85 (6/18/18). The taxpayers were the sole owners of a Colorado-based S corporation licensed to grow and sell medical marijuana. For the years in question, the taxpayers' S corporation claimed deductions under § 162 for items such as compensation, repairs and maintenance, rents, state and local taxes, licenses, interest, depreciation, advertising, and employee benefits. The IRS disallowed most of these deductions under § 280E, but permitted the taxpayer to take into account certain expenses attributable to costs of goods sold for purposes of § 471 and inventory accounting. *See Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173, 180 (2007). The primary deduction disallowed by the IRS under § 280E consisted of wages paid to the taxpayer-shareholders. Of course, this disallowance resulted in the taxpayers being taxed not only on their allocable shares of the S corporation's income (without deduction for wages), but also for the amount of the wages actually paid to the taxpayer-shareholders. In effect, then, the taxpayer-shareholders were taxed twice on the same revenue even though the business was conducted via an S corporation. The taxpayers argued that this result was "discriminatory in violation of subchapter S." The Tax Court, Judge Kerrigan, dismissed this argument on the basis that the determination of taxable income is a function of statutory provisions in the Code and is not "discriminatory." In particular, § 1366 determines a shareholder's allocable share of income (after allowable deductions) from an S corporation, while § 61(a)(1) separately includes compensation in income. Judge Kerrigan acknowledged the taxpayers' "double taxation" hardship as a result of § 280E, but also pointed out that the harsh result was the product of the taxpayers' choice of entity, not a "discriminatory" violation of the principles of subchapter S.

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

XIII. TRUSTS, ESTATES & GIFTS

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

1. Violations of law just became a little more expensive. The 2017 Tax Cuts and Jobs Act, § 13306, amended Code § 162(f) to disallow deductions:

> for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law.

Prior to amendment, § 162(f) stated simply that "[n]o deduction shall be allowed … for any fine or similar penalty paid to a government for the violation of any law." The intent of this provision appears to be to broaden the category of nondeductible items beyond those that might technically constitute a fine or penalty. The amended statute contains exceptions for (1) certain amounts for restitution or remediation (including remediation of property) or to come into compliance with law that are identified as such in a court order or settlement agreement, (2) amounts paid or incurred pursuant to a court order in a suit in which no government or governmental entity is a party, and (3) any amount paid or incurred as taxes due. Payments of restitution for failure to pay taxes that are assessed as restitution in the same manner as a tax qualify for the first exception just listed only if the amounts "would have been allowed as a deduction under this chapter if it had been timely paid." This rule appears to mean that a payment of restitution in a tax case qualifies for the exception only if the taxes would have been deductible if timely paid. The legislation also adds to the Code § 6050X, which requires government agencies to report to the IRS and the taxpayer the amount of each settlement agreement or order entered into where the aggregate amount required to be paid or incurred to or at the direction of the government is at least $600 (or such other amount as may be specified by Treasury). These reports will separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance. The disallowance of deductions and the new reporting requirement apply to amounts paid or incurred on or after December 22, 2017, the date of enactment, but do not apply to amounts paid or incurred under any binding order or agreement entered into before that date.

a. Guidance on amended § 162(f). Notice 2018-23, 2018-15 I.R.B. 474 (3/27/18). Section 162(f), as amended by the Tax Cuts and Jobs Act, is effective for amounts paid or incurred on or after December 22, 2017, the date of enactment. Nevertheless, Notice 2018-23 delays the information reporting requirement otherwise imposed upon officials of government and governmental entities under § 6050X until a date specified in to-be-proposed regulations (but not earlier than January 1, 2019). Notice 2018-23 also requests comments addressing the development of regulations under amended § 162(f) and new § 6050X. In addition, Notice 2018-23 provides transitional guidance regarding one of the exceptions to the disallowance rule of § 162(f)(1). One exception, set forth in § 162(f)(2),provides that an amount otherwise deductible under the Code is not disallowed if the taxpayer satisfies the requirements of § 162(f)(2)(A)(i), (ii), and (iii). Section 162(f)(2)(A)(i) requires a taxpayer to establish that the amount paid or incurred (1) constitutes restitution (including remediation of property) for damage or harm that was or may be caused by violation of any law or the potential violation of any law; or (2) is paid to come into compliance with any law that was violated or otherwise involved in the investigation or inquiry into the potential violation of any law (the "establishment requirement"). Section 162(f)(2)(A)(ii) further requires that the amount paid or incurred be identified as restitution or as an amount paid to come into compliance with such law in the court order or settlement agreement (the "identification requirement"). Finally, § 162(f)(2)(A)(iii) provides that in the case of any amount of restitution for failure to pay any tax imposed under the Code, the amount is treated as if it were a payment of tax if it would have been allowed as a deduction had it been timely paid. Section 162(f)(2)(A) further provides that meeting the identification requirement of § 162(f)(2)(A)(ii) alone is not sufficient to meet the establishment requirement under § 162(f)(2)(A)(i). Until proposed regulations are issued, the identification requirement in § 162(f)(2)(A)(ii) is treated as satisfied for an amount if the settlement agreement or court order specifically states on its face that the amount is restitution, remediation, or for coming into compliance with the law. Notice 2018-23 reiterates that even if the identification requirement is treated as satisfied under the Notice, taxpayers must meet the establishment requirement as well in order to qualify for the § 162(f)(2) exception.

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F. Credits

G. Natural Resources Deductions & Credits

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

D. Deductions and Credits for Personal Expenses

1. **Standard deduction for 2019.** Rev. Proc. 2018-57, 2018-49 I.R.B. ___ (11/15/18). The standard deduction for 2019 will be $24,400 for joint returns and surviving spouses (increased from $24,000), $12,200 for unmarried individuals and married individuals filing separately (increased from $12,000), and $18,350 for heads of households (increased from $18,000).

E. Divorce Tax Issues

F. Education

G. Alternative Minimum Tax

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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. **Liability for withholding taxes under §§ 1446 and 1461 is a partnership item and therefore property before the Tax Court in a partnership-level proceeding.** YA Global Investments v. Commissioner, 151 T.C. No. 2 (8/8/18). The IRS issued both a notice of final partnership administrative adjustment and a notice of deficiency with respect to YA Global Investments, LP, a TEFRA partnership. The IRS asserted that the partnership, which was based in the Cayman Islands, was engaged in the conduct of a trade or business in the U.S. and had failed to withhold on effectively connected taxable income allocable to its foreign partners as required by § 1446. Therefore, according to the IRS, the partnership was liable for the taxes it had failed to withhold pursuant to § 1461, which provides that "[e]very person required to deduct and withhold any tax under … chapter [3] is hereby made liable for such tax." The partnership's tax matters partner filed a petition for readjustment of the partnership items and the partnership filed a petition in response to the notice of deficiency. Both parties filed motions to dismiss for lack of jurisdiction in which they argued that liability for withholding taxes under §§ 1446 and 1461 is not a partnership item and therefore not properly before the court in a partnership-level proceeding. The Tax Court (Judge Buch) held that

> A liability stemming from duty to withhold under section 1446 is a partnership liability and therefore properly before the Court in a partnership-level proceeding, as are penalties relating to the partnership-item adjustment.

The court reasoned that liability for the taxes required to be withheld under § 1446 is a partnership item because it is a liability imposed on the partnership. Under Reg. § 301.6231(a)(3)-1(a)(v), partnership liabilities are partnership items.

G. Miscellaneous

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. The Ninth Circuit channels the economic substance doctrine to tell the Tax Court that it was too quick to dismiss transferee liability in a midco case. Slone v. Commissioner, 788 F.3d 1049 (9th Cir. 6/8/15), *amended*, 2015 WL 5061315 (8/28/15), *vacating and remanding*, T.C. Memo. 2012-57 (3/1/12). The taxpayer's family-owned corporation sold all of its assets for cash, resulting in a gain of over $38 million and an estimated combined federal and state income tax liability of over $15 million. None of the proceeds had been distributed at the time Fortrend and MidCoast made an unsolicited offer to purchase the stock of the corporation, which ultimately was accepted, at a purchase price of $35,753,000, plus assumption of the corporation's liabilities for federal and state income taxes owed as of the closing date. Not unsurprisingly, the taxes were never paid and the IRS asserted transferee liability against the shareholders. Because the asset sale and stock sale were independent of each other and the shareholders "had no reason to believe that Fortrend's methods were illegal or inappropriate, . . . [n]either the substance over form doctrine nor any related doctrines appl[ied] to recast the stock sale as a liquidating distribution." Thus, because the IRS's transferee liability theory was grounded on recasting the stock sale as a liquidation, the IRS lost in the Tax Court because under this view the taxpayer was not a "transferee."

On appeal, the Tax Court's decision was vacated and remanded in a decision written by Judge Ikuta. According to the Ninth Circuit, the Tax Court erred in respecting the form of the shareholders' stock sale because it applied an erroneous standard. The Court of Appeals' majority opinion first noted that that the "Supreme Court has long recognized 'the importance of regarding matters of substance and disregarding forms,' *United States v. Phellis*, 257 U.S. 156, 168 because '[t]he incidence of taxation depends upon the substance of a transaction,' *Comm'r v. Court Holding Co.*, 324 U.S. 331, 334 (1945)." The court then looked to its economic substance doctrine precedents to conclude that the same "approach is applicable for determining whether a taxpayer is a transferee for purposes of § 6901. Accordingly, when the Commissioner claims a taxpayer was 'the shareholder of a dissolved corporation' for purposes of 26 C.F.R. § 301.6901-1(b), but the taxpayer did not receive a liquidating distribution if the form of the transaction is respected, a court must consider the relevant subjective and objective factors to determine whether the formal transaction 'had any practical economic effects other than the creation of income tax losses.'" However, the majority concluded that it could not determine on appeal whether the shareholder was a transferee because the Tax Court "did not address either the subjective or objective factors we apply in characterizing a transaction for tax purposes, as it failed to make any finding on whether the shareholders had a business purpose for entering into the stock purchase transaction other than tax avoidance, or whether the stock purchase transaction had economic substance other than shielding the ... shareholders from tax liability." The Tax Court was directed on remand to make the findings necessary to correctly apply the transferee test as articulated by the Court of Appeals. "[T]he tax court should apply the relevant subjective and objective factors to determine whether the Commissioner erred in disregarding the form of the transaction in order to impose tax liability on the shareholders as 'transferees' under § 6901."

- Judge Noonan concurred with the majority's holding that the Tax Court erred by applying the wrong standard and that economic substance doctrine principles properly applied to determine whether to disregard the form of the transaction in order to determine whether the shareholders were transferees under § 6901. But he thought the record was sufficient to hold that the stock sale transaction had no economic substance and that the shareholders were transferees under § 6901. He would have remanded to the Tax Court only on the question of state law substantive liability.

a. The Ninth Circuit has reversed the Tax Court yet again in this midco case. Slone v. Commissioner, 896 F.3d 1083 (9th Cir. 7/24/18), *vacating and remanding* T.C. Memo. 2016-115 (6/13/16). This case has considerable history, as recounted above, but in both instances the Tax Court held for the taxpayers only to have the Ninth Circuit reverse in favor of the IRS. In this second round in the Ninth Circuit, the IRS appealed the Tax Court's decision (Judge Haines) that the form of the transaction (a stock sale) could not be ignored to impose transferee liability on the taxpayers unless the taxpayers knew that the "entire transactional scheme" was intended to avoid taxes. Judge Haines determined that the IRS had not met its burden of proof on this issue. In an opinion by Judge Schroeder, however, the Ninth Circuit concluded that the "record contains ample evidence" the taxpayers were at the very least on "constructive notice that the entire scheme has no purpose other than tax avoidance." The court stated as follows:

> This record establishes that the Petitioners were, at the very least, on constructive notice of such a purpose. In reaching a contraryconclusion, the TaxCourt confused actual and constructive notice, in effect allowing Petitioners to shield themselves through "the willful blindness the constructive knowledge test was designed to root out." *Diebold*, 736 F.3d at 189–90; *see Salus Mundi*, 776 F.3d at 1020.

In the Ninth Circuit's view, the transaction constituted a constructive liquidation (not a stock sale) resulting in transferee liability being imposed upon the taxpayers. The court reversed and remanded for entry of judgment in favor of the IRS.

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

D. Tax Shelter Penalties

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Oh goody! Changes to the UBIT rules too! The 2017 Tax Cuts and Jobs Act, §§ 13702 and 13703, also made certain changes to the determination of unrelated business income with respect to tax-exempt organizations. Most tax-exempt organizations are subject to federal income tax at regular rates (corporate rates for exempt corporations and trust rates for exempt trusts) on net income (i.e., after permissible deductions) from a trade or business, regularly carried on, that is unrelated to the organization's exempt purpose (other than its need for revenue). Exceptions exist for most types of passive, investment income as well as for narrow categories of other types of income (e.g., thrift store sales). *See* §§ 511-514.

Stop using good UBI money to chase bad UBI money! Under pre-TCJA law, if an exempt organization had unrelated business income from one activity, but unrelated losses from another activity, then the income and losses could offset, meaning that the organization would report zero or even negative UBI. Congress apparently doesn't like this result, so under new § 512(a)(6) income and losses from separate unrelated businesses no longer may be aggregated. This new UBI provision is effective for taxable years beginning after 2017, thus giving fiscal year nonprofits some time to plan. Moreover, under a special transition rule, unrelated business income net operating losses arising in a taxable year beginning before January 1, 2018, that are carried forward to a taxable year beginning on or after such date, are not subject to § 512(a)(6).

Congress doesn't like using UBI to help fund fringe benefits, so when your organization's employees are pumping iron at the charity's free gym, you can pump up your UBI too. Under new § 512(a)(7), an organization's unrelated business taxable income is increased by the amount of any expenses paid or incurred by the organization that are not deductible because of the limitations of § 274 for (i) qualified transportation fringe benefits (as defined in § 132(f)); (ii) a parking facility used in connection with qualified parking (as defined in § 132(f)(5)(C)); or (iii) any on-premises athletic facility (as defined in § 132(j)(4)(B)). New § 512(a)(7) is effective for amounts paid or incurred after 2017, so affected tax-exempt organizations need to deal with this change immediately.

Perhaps worth noting here: Because the TCJA reduced the top federal income tax rate on C corporations to 21 percent, it likewise reduced to 21 percent the top rate on UBI of tax-exempt organizations formed as nonprofit corporations, which are the vast majority. So, the news for tax exempts is not all bad.

a. A tax law oxymoron: nonprofit trades or businesses. *Huh?* Notice 2018-67, 2018-36 I.R.B. 409 (8/21/18). Organizations described in §§ 401(a) (pension and retirement plans) and 501(c) (charitable and certain other entities) generally are exempt from federal income taxation. Nevertheless, §§ 511 through 514 impose federal income tax upon the "unrelated business taxable

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1. Violations of law just became a little more expensive. The 2017 Tax Cuts and Jobs Act, § 13306, amended Code § 162(f) to disallow deductions:

> for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law.

Prior to amendment, § 162(f) stated simply that "[n]o deduction shall be allowed … for any fine or similar penalty paid to a government for the violation of any law." The intent of this provision appears to be to broaden the category of nondeductible items beyond those that might technically constitute a fine or penalty. The amended statute contains exceptions for (1) certain amounts for restitution or remediation (including remediation of property) or to come into compliance with law that are identified as such in a court order or settlement agreement, (2) amounts paid or incurred pursuant to a court order in a suit in which no government or governmental entity is a party, and (3) any amount paid or incurred as taxes due. Payments of restitution for failure to pay taxes that are assessed as restitution in the same manner as a tax qualify for the first exception just listed only if the amounts "would have been allowed as a deduction under this chapter if it had been timely paid." This rule appears to mean that a payment of restitution in a tax case qualifies for the exception only if the taxes would have been deductible if timely paid. The legislation also adds to the Code § 6050X, which requires government agencies to report to the IRS and the taxpayer the amount of each settlement agreement or order entered into where the aggregate amount required to be paid or incurred to or at the direction of the government is at least $600 (or such other amount as may be specified by Treasury). These reports will separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance. The disallowance of deductions and the new reporting requirement apply to amounts paid or incurred on or after December 22, 2017, the date of enactment, but do not apply to amounts paid or incurred under any binding order or agreement entered into before that date.

a. Guidance on amended § 162(f). Notice 2018-23, 2018-15 I.R.B. 474 (3/27/18). Section 162(f), as amended by the Tax Cuts and Jobs Act, is effective for amounts paid or incurred on or after December 22, 2017, the date of enactment. Nevertheless, Notice 2018-23 delays the information reporting requirement otherwise imposed upon officials of government and governmental entities under § 6050X until a date specified in to-be-proposed regulations (but not earlier than January 1, 2019). Notice 2018-23 also requests comments addressing the development of regulations under amended § 162(f) and new § 6050X. In addition, Notice 2018-23 provides transitional guidance regarding one of the exceptions to the disallowance rule of § 162(f)(1). One exception, set forth in § 162(f)(2),provides that an amount otherwise deductible under the Code is not disallowed if the taxpayer satisfies the requirements of § 162(f)(2)(A)(i), (ii), and (iii). Section 162(f)(2)(A)(i) requires a taxpayer to establish that the amount paid or incurred (1) constitutes restitution (including remediation of property) for damage or harm that was or may be caused by violation of any law or the potential violation of any law; or (2) is paid to come into compliance with any law that was violated or otherwise involved in the investigation or inquiry into the potential violation of any law (the "establishment requirement"). Section 162(f)(2)(A)(ii) further requires that the amount paid or incurred be identified as restitution or as an amount paid to come into compliance with such law in the court order or settlement agreement (the "identification requirement"). Finally, § 162(f)(2)(A)(iii) provides that in the case of any amount of restitution for failure to pay any tax imposed under the Code, the amount is treated as if it were a payment of tax if it would have been allowed as a deduction had it been timely paid. Section 162(f)(2)(A) further provides that meeting the identification requirement of § 162(f)(2)(A)(ii) alone is not sufficient to meet the establishment requirement under § 162(f)(2)(A)(i). Until proposed regulations are issued, the identification requirement in § 162(f)(2)(A)(ii) is treated as satisfied for an amount if the settlement agreement or court order specifically states on its face that the amount is restitution, remediation, or for coming into compliance with the law. Notice 2018-23 reiterates that even if the identification requirement is treated as satisfied under the Notice, taxpayers must meet the establishment requirement as well in order to qualify for the § 162(f)(2) exception.

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

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

1. Standard deduction for 2019. Rev. Proc. 2018-57, 2018-49 I.R.B. ___ (11/15/18). The standard deduction for 2019 will be $24,400 for joint returns and surviving spouses (increased from $24,000), $12,200 for unmarried individuals and married individuals filing separately (increased from $12,000), and $18,350 for heads of households (increased from $18,000).

E. Divorce Tax Issues

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

VII. PARTNERSHIPS

A. Formation and Taxable Years

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

C. Distributions and Transactions Between the Partnership and Partners

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

1. Liability for withholding taxes under §§ 1446 and 1461 is a partnership item and therefore property before the Tax Court in a partnership-level proceeding. YA Global Investments v. Commissioner, 151 T.C. No. 2 (8/8/18). The IRS issued both a notice of final partnership administrative adjustment and a notice of deficiency with respect to YA Global Investments, LP, a TEFRA partnership. The IRS asserted that the partnership, which was based in the Cayman Islands, was engaged in the conduct of a trade or business in the U.S. and had failed to withhold on effectively connected taxable income allocable to its foreign partners as required by § 1446. Therefore, according to the IRS, the partnership was liable for the taxes it had failed to withhold pursuant to § 1461, which provides that "[e]very person required to deduct and withhold any tax under … chapter [3] is hereby made liable for such tax." The partnership's tax matters partner filed a petition for readjustment of the partnership items and the partnership filed a petition in response to the notice of deficiency. Both parties filed motions to dismiss for lack of jurisdiction in which they argued that liability for withholding taxes under §§ 1446 and 1461 is not a partnership item and therefore not properly before the court in a partnership-level proceeding. The Tax Court (Judge Buch) held that

> A liability stemming from duty to withhold under section 1446 is a partnership liability and therefore properly before the Court in a partnership-level proceeding, as are penalties relating to the partnership-item adjustment.

The court reasoned that liability for the taxes required to be withheld under § 1446 is a partnership item because it is a liability imposed on the partnership. Under Reg. § 301.6231(a)(3)-1(a)(v), partnership liabilities are partnership items.

G. Miscellaneous

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. The Ninth Circuit channels the economic substance doctrine to tell the Tax Court that it was too quick to dismiss transferee liability in a midco case. Slone v. Commissioner, 788 F.3d 1049 (9th Cir. 6/8/15), *amended*, 2015 WL 5061315 (8/28/15), *vacating and remanding*, T.C. Memo. 2012-57 (3/1/12). The taxpayer's family-owned corporation sold all of its assets for cash, resulting in a gain of over $38 million and an estimated combined federal and state income tax liability of over $15 million. None of the proceeds had been distributed at the time Fortrend and MidCoast made an unsolicited offer to purchase the stock of the corporation, which ultimately was accepted, at a purchase price of $35,753,000, plus assumption of the corporation's liabilities for federal and state income taxes owed as of the closing date. Not unsurprisingly, the taxes were never paid and the IRS asserted transferee liability against the shareholders. Because the asset sale and stock sale were independent of each other and the shareholders "had no reason to believe that Fortrend's methods were illegal or inappropriate, . . . [n]either the substance over form doctrine nor any related doctrines appl[ied] to recast the stock sale as a liquidating distribution." Thus, because the IRS's transferee liability theory was grounded on recasting the stock sale as a liquidation, the IRS lost in the Tax Court because under this view the taxpayer was not a "transferee."

On appeal, the Tax Court's decision was vacated and remanded in a decision written by Judge Ikuta. According to the Ninth Circuit, the Tax Court erred in respecting the form of the shareholders' stock sale because it applied an erroneous standard. The Court of Appeals' majority opinion first noted that that the "Supreme Court has long recognized 'the importance of regarding matters of substance and disregarding forms,' *United States v. Phellis*, 257 U.S. 156, 168 because '[t]he incidence of taxation depends upon the substance of a transaction,' *Comm'r v. Court Holding Co.*, 324 U.S. 331, 334 (1945)." The court then looked to its economic substance doctrine precedents to conclude that the same "approach is applicable for determining whether a taxpayer is a transferee for purposes of § 6901. Accordingly, when the Commissioner claims a taxpayer was 'the shareholder of a dissolved corporation' for purposes of 26 C.F.R. § 301.6901-1(b), but the taxpayer did not receive a liquidating distribution if the form of the transaction is respected, a court must consider the relevant subjective and objective factors to determine whether the formal transaction 'had any practical economic effects other than the creation of income tax losses.'" However, the majority concluded that it could not determine on appeal whether the shareholder was a transferee because the Tax Court "did not address either the subjective or objective factors we apply in characterizing a transaction for tax purposes, as it failed to make any finding on whether the shareholders had a business purpose for entering into the stock purchase transaction other than tax avoidance, or whether the stock purchase transaction had economic substance other than shielding the ... shareholders from tax liability." The Tax Court was directed on remand to make the findings necessary to correctly apply the transferee test as articulated by the Court of Appeals. "[T]he tax court should apply the relevant subjective and objective factors to determine whether the Commissioner erred in disregarding the form of the transaction in order to impose tax liability on the shareholders as 'transferees' under § 6901."

- Judge Noonan concurred with the majority's holding that the Tax Court erred by applying the wrong standard and that economic substance doctrine principles properly applied to determine whether to disregard the form of the transaction in order to determine whether the shareholders were transferees under § 6901. But he thought the record was sufficient to hold that the stock sale transaction had no economic substance and that the shareholders were transferees under § 6901. He would have remanded to the Tax Court only on the question of state law substantive liability.

a. The Ninth Circuit has reversed the Tax Court yet again in this midco case. Slone v. Commissioner, 896 F.3d 1083 (9th Cir. 7/24/18), *vacating and remanding* T.C. Memo. 2016-115 (6/13/16). This case has considerable history, as recounted above, but in both instances the Tax Court held for the taxpayers only to have the Ninth Circuit reverse in favor of the IRS. In this second round in the Ninth Circuit, the IRS appealed the Tax Court's decision (Judge Haines) that the form of the transaction (a stock sale) could not be ignored to impose transferee liability on the taxpayers unless the taxpayers knew that the "entire transactional scheme" was intended to avoid taxes. Judge Haines determined that the IRS had not met its burden of proof on this issue. In an opinion by Judge Schroeder, however, the Ninth Circuit concluded that the "record contains ample evidence" the taxpayers were at the very least on "constructive notice that the entire scheme has no purpose other than tax avoidance." The court stated as follows:

> This record establishes that the Petitioners were, at the very least, on constructive notice of such a purpose. In reaching a contraryconclusion, the TaxCourt confused actual and constructive notice, in effect allowing Petitioners to shield themselves through "the willful blindness the constructive knowledge test was designed to root out." *Diebold*, 736 F.3d at 189–90; *see Salus Mundi*, 776 F.3d at 1020.

In the Ninth Circuit's view, the transaction constituted a constructive liquidation (not a stock sale) resulting in transferee liability being imposed upon the taxpayers. The court reversed and remanded for entry of judgment in favor of the IRS.

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

D. Tax Shelter Penalties

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Oh goody! Changes to the UBIT rules too! The 2017 Tax Cuts and Jobs Act, §§ 13702 and 13703, also made certain changes to the determination of unrelated business income with respect to tax-exempt organizations. Most tax-exempt organizations are subject to federal income tax at regular rates (corporate rates for exempt corporations and trust rates for exempt trusts) on net income (i.e., after permissible deductions) from a trade or business, regularly carried on, that is unrelated to the organization's exempt purpose (other than its need for revenue). Exceptions exist for most types of passive, investment income as well as for narrow categories of other types of income (e.g., thrift store sales). *See* §§ 511-514.

Stop using good UBI money to chase bad UBI money! Under pre-TCJA law, if an exempt organization had unrelated business income from one activity, but unrelated losses from another activity, then the income and losses could offset, meaning that the organization would report zero or even negative UBI. Congress apparently doesn't like this result, so under new § 512(a)(6) income and losses from separate unrelated businesses no longer may be aggregated. This new UBI provision is effective for taxable years beginning after 2017, thus giving fiscal year nonprofits some time to plan. Moreover, under a special transition rule, unrelated business income net operating losses arising in a taxable year beginning before January 1, 2018, that are carried forward to a taxable year beginning on or after such date, are not subject to § 512(a)(6).

Congress doesn't like using UBI to help fund fringe benefits, so when your organization's employees are pumping iron at the charity's free gym, you can pump up your UBI too. Under new § 512(a)(7), an organization's unrelated business taxable income is increased by the amount of any expenses paid or incurred by the organization that are not deductible because of the limitations of § 274 for (i) qualified transportation fringe benefits (as defined in § 132(f)); (ii) a parking facility used in connection with qualified parking (as defined in § 132(f)(5)(C)); or (iii) any on-premises athletic facility (as defined in § 132(j)(4)(B)). New § 512(a)(7) is effective for amounts paid or incurred after 2017, so affected tax-exempt organizations need to deal with this change immediately.

Perhaps worth noting here: Because the TCJA reduced the top federal income tax rate on C corporations to 21 percent, it likewise reduced to 21 percent the top rate on UBI of tax-exempt organizations formed as nonprofit corporations, which are the vast majority. So, the news for tax exempts is not all bad.

a. A tax law oxymoron: nonprofit trades or businesses. *Huh?* Notice 2018-67, 2018-36 I.R.B. 409 (8/21/18). Organizations described in §§ 401(a) (pension and retirement plans) and 501(c) (charitable and certain other entities) generally are exempt from federal income taxation. Nevertheless, §§ 511 through 514 impose federal income tax upon the "unrelated business taxable income" ("UBTI") of such organizations including for this purpose state colleges and universities. The principal sources of UBTI are §§ 512 and 513 "unrelated trade or business" gross income (minus deductions properly attributable thereto) and § 514 "unrelated debt-financed income" (minus deductions), including a partner's allocable share of income from a partnership generating UBTI. Prior to TCJA, exempt organizations could aggregate income and losses from unrelated trades or businesses before determining annual UBTI potentially subject to tax. Excess losses (if any) after aggregating all UBTI-related items of an exempt organization created a net operating loss subject to the rules of § 172. [See Reg. § 1.512(a)-1(a) prior to enactment of TCJA. After TCJA, § 172 permits only carryforwards.] Effective for taxable years beginning after 2017, however, TCJA added new § 512(a)(6) to disaggregate unrelated trades or businesses of exempt organizations for purposes of determining UBTI. Specifically, new § 512(a)(6) provides that for any exempt organization with more than one unrelated trade or business: (1) UBTI must be computed separately (including for purposes of determining any net operating loss deduction) for each such unrelated "trade or business;" and (2) total annual UBTI is equal to (i) the sum of positive UBTI from each such separate "trade or business" minus (ii) the specific $1,000 deduction allowed by § 512(b)(12). Under a special transition rule, unrelated business income net operating losses arising in a taxable year beginning before January 1, 2018 and carried forward to a taxable year beginning on or after such date, are not subject to new § 512(a)(6).

Now we get to the crux of the matter. The logical result of new § 512(a)(6) is that every exempt organization must segregate its unrelated trade or business income and losses for purposes of determining its annual UBTI. Yet, Treasury and IRS have never defined separate "trades or businesses" for this purpose or, frankly, for any other federal income tax purpose. Further complicating matters, TCJA also enacted a related subsection, new § 512(a)(7), that increases an exempt organization's UBTI by expenses for which a deduction is disallowed under certain provisions of §§ 274 and 132 (specified transportation, parking, and athletic facility fringe benefits) *unless* the expense is "directly connected with an unrelated trade or business which is regularly carried on by the organization." Thus, new § 512(a)(7) also requires identification of each unrelated "trade or business" of an exempt organization, but § 512(a)(7) has the further deleterious effect of potentially creating UBTI for an exempt organization that otherwise has no unrelated trade or business. In Notice 2018-67, Treasury and IRS take the first step toward providing guidance with respect to both § 512(a)(6) and (7) and delineating separate trades or businesses for UBIT purposes.

What's in the Notice? Aside from requesting comments, Notice 2018-67 is lengthy (36 pages) and contains thirteen different "SECTIONS," ten of which address substantive, technical aspects of new § 512(a)(6) and (7). The high points are summarized below, but Notice 2018-67 is a must read for tax advisors to § 501(c) organizations, state colleges and universities, and § 401(a) pension and retirement plans, especially where those entities have UBTI from partnership interests they hold as investments. To summarize:

1. *General Rule.* Until proposed regulations are published, all exempt organizations affected by the changes to § 512(a)(6) and (7) may rely upon a "reasonable, good-faith interpretation" of §§ 511 through 514, considering all relevant facts and circumstances, for purposes of determining whether the organization has more than one unrelated trade or business. Because of the way § 512(a)(6) operates, exempt organizations will be inclined to conclude that they have only one unrelated trade or business, but that is not easy to do given the so-called "fragmentation" principle of § 513(c) and Reg. § 1.513-1(b). For example, advertising income earned by an exempt organization (e.g., National Geographic) from ads placed in the organization's periodical is UBTI even if subscription income is not UBTI. For an exempt organization this general rule includes using a reasonable, good-faith interpretation when determining: (a) whether to separate debt-financed income described in §§ 512(b)(4) and 514; (b) whether to separate income from a controlled entity described in § 512(b)(13); and (c) whether to separate insurance income earned through a controlled foreign corporation as described in § 512(b)(17). The use of the 6-digit code North American Industry Classification System ("NAICS") for segregating trades or businesses will be considered a reasonable, good-faith interpretation until regulations are proposed.
2. *Partnership Interests*. In general, partnership activities are attributable to partners such that holding a partnership interest can result in multiple lines of UBTI being considered allocable

to an exempt organization partner. Until proposed regulations are issued, however, exempt organizations (other than § 501(c)(7) social clubs) may rely upon either of two rules for aggregating multiple lines of UBTI from a partnership, including UBTI attributable to lower-tier partnerships and unrelated debt-financed income:

- The "interim rule" that permits the aggregation of multiple lines of UBTI from an exempt organization's interest in a single partnership if the partnership meets either a "de minimis test" or a "control test." The de minimis test generally is met if the exempt organization partner holds a 2 percent or less capital and profits interest in a partnership. The control test generally is met if the exempt organization partner holds a 20 percent or less capital interest in a partnership and does not have "control or influence" over the partnership. Control or influence over a partnership is determined based upon all relevant facts and circumstances. For purposes of determining an exempt organization's percentage interest in a partnership under the interim rule, partnership interests held by disqualified persons (as defined in § 4958), supporting organizations (as defined in § 509(a)(3)), and controlled entities (as defined in § 512(b)(13)(D)) must be considered.
- The "transition rule" that permits the aggregation of multiple lines of UBTI from an exempt organization's interest in a single partnership if the interest was acquired prior to August 21, 2018. For example, if an organization has a 35 percent interest in a partnership [acquired] prior to August 21, 2018, it can treat the partnership as being in a single unrelated trade or business even if the partnership's investments generated UBTI from various lower-tier partnerships that were engaged in multiple types of trades or businesses (or, presumably, from debt-financed income).

3. *IRC § 512(a)(7)*. Income under § 512(a)(7) [i.e., the UBIT increase for expenses not directly connected with an unrelated trade or business regularly carried on by the organization and for which a deduction is disallowed under certain provisions of §§ 274 and 132 (specified transportation, parking, and athletic facility fringe benefits)] is not income from a trade or business for purposes of § 512(a)(6). Thus, such UBIT appears to be entirely separate from § 512(a)(6) income and therefore not offset by any deductions or losses.

4. *GILTI*. An exempt organization's inclusion of global intangible low-taxed income ("GILTI") under § 951A is treated as a dividend which is not UBTI (pursuant to § 512(b)(1)) unless it is debt-financed (and thus included in UBIT under § 512(b)(4)).

B. Charitable Giving

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. Congress has directed Treasury to issue preparer due diligence requirements with respect to head-of-household filing status. The 2017 Tax Cuts and Jobs Act, § 11001(b), amended Code § 6695(g) to extend the preparer due diligence requirements to returns or claims for refund that claim eligibility for head-of-household filing status. This change is effective for taxable years beginning after 2017.

a. Return preparers need to be extra careful with not only the earned income tax credit, but also with the child tax credit, additional child tax credit, the American Opportunity Tax Credit, and head-of-household filing status. T.D. 9842, Tax Return Preparer Due Diligence Penalty Under Section 6695(g), 83 F.R. 55632 (11/7/18). The Treasury Department and the IRS have finalized amendments to Reg. § 1.6695-2 to implement changes made by the Protecting Americans from Tax Hikes Act of 2015 (2015 PATH Act) and the 2017 Tax Cuts and Jobs Act. The 2015 PATH Act extended the § 6695(g) preparer due diligence requirements for taxable years beginning after 2015 to returns or claims for refund including claims of the child tax credit (CTC), additional child tax credit (ACTC), and American Opportunity Tax Credit (AOTC), in addition to the earned income credit (EIC). The 2017 Tax Cuts and Jobs Act amended Code § 6695(g) to extend the preparer due diligence requirements to returns or claims for refund that claim eligibility for head-of-household filing status effective for taxable years beginning after 2017. Previously, Treasury and the

IRS issued proposed and temporary regulations in 2016 addressing the changes made by the 2015 PATH Act (see T.D. 9799, Tax Return Preparer Due Diligence Penalty Under Section 6695(g), 81 F.R. 87444 (12/5/16)) and issued proposed regulations in 2018 addressing the changes made by the 2017 Tax Cuts and Jobs Act and revising the 2016 proposed regulations (see REG-103474-18, Tax Return Preparer Due Diligence Penalty Under Section 6695(g), 83 F.R. 33875 (7/18/18)). These final regulations adopt the 2016 and 2018 proposed regulations without substantive change. As a result of the legislative changes, one return or claim for refund may contain claims for more than one credit or claim head-of-household filing status, all of which are subject to the due diligence requirements. Each failure to comply with the due diligence requirements set forth in the regulations results in a penalty, and therefore more than one penalty could apply to a single return or claim for refund. Examples in the regulations illustrate how multiple penalties could apply when one return or claim for refund is filed and illustrate the types of situations in which return preparers must make inquiries and document the inquiries and responses. The final regulations are effective November 7, 2018, but they generally apply to tax returns and claims for refund prepared on or after December 5, 2016, for tax years beginning after December 31, 2015, except for the rules relating to the determination of a taxpayer's eligibility for head-of-household filing status, which apply to tax returns and claims for refund prepared on or after November 7, 2018, for tax years beginning after December 31, 2017.

2. The IRS does not bear the burden of proof with respect to penalties in a partnership-level proceeding, says the Tax Court. Dynamo Holdings, Limited Partnership v. Commissioner, 150 T.C. No. 10 (5/7/18). The IRS issued a notice of final partnership administrative adjustment with respect to three taxable years of Dynamo Holdings, Limited Partnership. In addition to adjustments to partnership items, the IRS determined that accuracy-related penalties applied under § 6662(a) and (b)(1)-(2) for negligence and substantial understatements of income tax. In *Graev v. Commissioner*, 149 T.C. No. 23 (12/20/17), the court had held that the IRS's burden of production includes evidence of written supervisory approval of penalties as required by § 6751(b)(1). In this case, the IRS had introduced some evidence of written supervisory approval, but the evidence, according to the court, was inconclusive and it was not clear whether the IRS had met the burden of production. Accordingly, among other issues, the court considered whether the IRS bears the burden of production with respect to penalties determined in a TEFRA partnership-level proceeding. Section 7491(c) provides:

> Notwithstanding any other provision of this title, the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.

In a unanimous, reviewed opinion by Judge Buch (with Judge Vasquez not participating), the Tax Court held that the IRS does not bear the burden of production with respect to penalties in a partnership-level proceeding. To the extent that the court's prior decisions have suggested to the contrary (such as *RERI Holdings I, LLC v. Commissioner*, 149 T.C. 1 (7/3/17), and *Curtis Inv. Co. v. Commissioner*, T.C. Memo. 2017-150), the court will not follow them. In reaching this conclusion, the court relied in part on the plain language of the statute, which requires a "proceeding with respect to the liability of any individual." Partnership-level proceedings, the court reasoned, do not determine liability and are not with respect to individuals. The court also expressed concern about the practical effect of applying § 7491(c) in a partnership-level proceeding. Doing so would require the court (contrary to the purpose of the TEFRA audit procedures) to devote time and resources to identifying the ultimate taxpaying partners. As an example, if one partner were a corporation and another were an individual, the IRS would bear the burden of production as to penalties with respect to one partner but not the other, which might require the court to render separate holdings. The partnership had not raised the lack of supervisory approval of the penalties in its petition, at trial, or in its post-trial briefing and therefore had waived asserting the lack of supervisory approval as a defense to penalties. Because the IRS, according to the court's holding, does not bear the burden of production with respect to penalties in a partnership-level proceeding, the court denied the partnership's motion to dismiss as to penalties.

3. Is the Pope Catholic? The Tax Court does not need the written approval of a supervisor before imposing penalties for delay or frivolous arguments under § 6673(a)(1). Williams v. Commissioner, 151 T.C. No. 1 (7/3/18). Section 6673(a)(1) authorizes the Tax Court to impose a penalty of up to $25,000 when a taxpayer has initiated or maintained proceedings primarily for delay, advanced a position that is frivolous or groundless, or has unreasonably failed to pursue available administrative remedies. In this case, the Tax Court (Judge Ruwe) held, not surprisingly, that § 6751(b), which provides that no penalty under Title 26 can be assessed "unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination," does not apply to the Tax Court when it imposes penalties under § 6673(a)(1).

B. Discovery: Summonses and FOIA

1. Non-government attorneys KEEP OUT! REG-132434-17, Proposed Regulations on Certain Non-Government Attorneys Not Authorized to Participate in Examinations of Books and Witnesses as a Section 6103(n) Contractor, 83 F.R. 13206 (3/28/18). Treasury and the IRS have issued a notice of proposed rulemaking that would significantly narrow final regulations issued in 2016 that permit service providers with whom the IRS contracts to receive books and records provided in response to a summons and participate in a summons interview. Section 6103(n) and Reg. § 301.6103(n)-1(a) permit the disclosure of returns and return information to any person for purposes of tax administration to the extent necessary in connection with the acquisition of property or certain services (such as processing, storage and reproduction) related to returns or return information. The final regulations issued in 2016 clarified that such persons with whom the IRS or Chief Counsel contracts for services could not only receive and review books, papers, and records produced in compliance with a summons issued by the IRS, but also in the presence and under the guidance of an IRS officer or employee, participate fully in the interview of a witness summoned by the IRS to provide testimony under oath. *See* T.D. 9778, Participation of a Person Described in Section 6103(n) in a Summons Interview Under Section 7602(a)(2) of the Internal Revenue Code, 81 F.R. 45409 (7/14/16). Commentators, including the State Bar of Texas Tax Section, had recommended removing the provisions permitting contractors to participate in a summons interview because, among other reasons, doing so would "avoid the unsettled question of whether a private contractor has the legal authority to examine a witness." 2014 TNT 180-24 (9/16/14). After publishing Notice 2017-38, 2017-30 I.R.B. 147 (7/7/17) [which related to the subsequently issued Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, Dep't of Treasury, Press Release (10/2/17), and Department of the Treasury, 2017-2018 Priority Guidance Plan (10/20/17)], the IRS identified eight sets of regulations that "impose an undue financial burden," "add undue complexity," or "exceed [the IRS's] statutory authority." The above-mentioned final regulations under § 7602 were one of the eight targeted for revision. Accordingly, Prop. Reg. § 301.7602-1(b)(3) provides new rules that significantly narrow the scope of the current regulations under § 7602 by excluding non-government attorneys from receiving summoned books, papers, records, or other data or from participating in the interview of a witness summoned by the IRS to provide testimony under oath. The proposed regulations contain a limited exception for an attorney hired by the IRS as a specialist in foreign, state, or local law, including tax law, or in non-tax substantive law that is relevant to an issue in the examination, such as patent law, property law, or environmental law, or is hired for knowledge, skills, or abilities other than providing legal services as an attorney. The preamble to the proposed regulations explains the change as follows:

> The Summons Interview Regulations require the IRS to retain authority over important decisions when section 6103(n) contractors question witnesses, but there is a perceived risk that the IRS may not be able to maintain full control over the actions of a non-government attorney hired by the IRS when such an attorney, with the limited exception described below, questions witnesses. The actions of the non-governmental attorney while questioning witnesses could foreclose IRS officials from independently exercising their judgment. Managing an examination or summons interview is therefore best exercised solely by government employees, including government attorneys, whose only duty is to serve the public interest. These concerns outweigh the countervailing need for the IRS to use non-government attorneys, except in the limited circumstances set forth in proposed paragraph (b)(3)(ii). Treasury and the IRS remain confident that the core functions of questioning witnesses and conducting examinations are well within the expertise and ability of government attorneys and examination agents.

The proposed regulations apply to examinations begun or administrative summonses served by the IRS on or after March 27, 2018.

- The IRS's position in the proposed regulations represents a change in policy. The IRS made a controversial decision to engage the law firm Quinn Emanuel Urquhart & Sullivan, LLP, as a private contractor to assist in the IRS's examination of Microsoft's 2004 to 2006 tax years. A federal district court expressed concern about this practice, but upheld enforcement of the summonses issued by the IRS to Microsoft. *See United States v. Microsoft Corp.*, 154 F. Supp. 3d (W.D. Wash. 2015).

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

1. Gains from the sale of PFIC stock allocated to years other than the year of disposition are not counted as gross income for purposes of the six-year limitations provision of § 6501(e)(1)(A)(i). Toso v. Commissioner, 151 T.C. No. 4 (9/4/18). Under § 6501(a), the IRS generally can assess tax within three years from the time the return for the year is filed. This period is extended to six years by § 6501(e)(1)(A)(i) if a taxpayer omits from gross income an amount properly includible in gross income that exceeds 25 percent of the amount of gross income stated in the return. The taxpayer in this case failed to report for 2006 through 2008 gains from the sale of stock in passive foreign investment companies (PFICs). The IRS isued a notice of deficiency on January 6, 2015. The taxpayer asserted that the IRS was precluded from assessing tax for the years in question by the three-year limitations period of § 6501(a). The parties stipulated that, if the six-year limitations period of § 6501(e)(1)(A)(i) applied, then the IRS was not precluded from assessing tax. The issue before the court was whether gains from the sale of PFIC stock are counted as gross income for purposes of § 6501(e)(1)(A)(i). The Tax Court (Judge Thornton) held that only gains from the sale of PFIC stock allocated to the year of disposition (current-year PFIC gain) is included in gross income for purposes of § 6501(e)(1)(A)(i), and that gain allocated to years other than the year of disposition (non-current-year PFIC gain) is not so included. There are three regimes that potentially apply to PFIC stock: (1) the default regime in § 1291(a)(l)-(2); (2) the elective treatment as a qualified electing fund authorized by § 1295 and set forth in § 1293; and (3) the elective mark-to-market treatment authorized by § 1296. The taxpayer had not made either of the latter two elections and therefore the default regime applied. Under the default regime, a United States person who owns stock in a PFIC is permited to defer U.S. tax on the PFIC's earning, but upon a disposition of the PFIC stock (or receipt of an excess distribution) the United States person must pay both U.S. tax and interest on the deferred U.S. tax liability. This is accomplished by (1) allocating the gain from the disposition of the PFIC stock over the post-1986 years the shareholder held the stock; (2) applying the highest rate of tax on ordinary income in each year (other than the current year) to the amount of gain allocated to that year; (3) computing interest on the tax liability for each year as if the shareholder had failed to pay the tax liability when it was due; and (4) taking the sum of the amounts in steps 2 and 3. This sum is the "deferred tax amount." The court reasoned that, under this default regime, § 1291(a)(l)(B) provides that gross income includes only current-year PFIC gain. In contrast, non-current-year PFIC gain is not included in gross income. Instead, the taxpayer's tax liability for the current year is increased by the "deferrred tax amount." Under this approach, the amounts the taxpayer had excluded from gross income for 2006 (not including non-current-year PFIC gains) exceeded 25 percent of the amount of gross income stated in the return, and therefore the IRS was not precluded from assessing tax, but the limitations periods for assessing tax for 2007 and 2008 had expired. The court rejected the taxpayer's argument with respect to 2006 that the taxpayer could net losses from the sale of PFIC stock against gains from such sales and that only net gain is allocated to the taxpayer's holding period for the stock.

F. Liens and Collections

G. Innocent Spouse

H. Miscellaneous

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. The IRS wins three battles but loses the war in this withholding trust fund tax case; a CPA firm may have been the taxpayers' salvation. Byrne v. United States, 857 F.3d 319 (6th Cir. 5/15/17). The two taxpayers were CEO and President of a manufacturing company that they, the company's controller, and other investors purchased in October 1998. Early in 1999, the taxpayers became aware that the company's controller had mishandled payroll tax payments (i.e., making biweekly instead of semiweekly payments) for several months resulting in a large penalty assessment by the IRS. As a result of the controller's continued mishandling of the company's finances, in April and July of 2000 the taxpayers hired two new employees to assist the controller. In October 2000, the IRS sent the company a notice of a penalty for $98,622.32 for unpaid trust-fund taxes for the first quarter of 2000. These unpaid taxes plus interest were paid in November 2000. In December 2000, the company's independent CPA firm issued a "clean" audit letter regarding the company's financial statements through September 30, 2000; however, the letter noted that the company had "flaws" in its accounting practices. Subsequently, in January of 2001, the company's lender discovered that not only had the company missed payroll tax payments for the last three quarters of 2000, but the controller had falsely overstated accounts receivable records to hide the company's financial difficulties. In April 2001, the company filed for bankruptcy protection and ultimately was liquidated. Then, in July 2005, the IRS assessed $855,668.35 responsible person penalty taxes against the taxpayers under § 6672. The taxpayers subsequently paid a portion of the penalty taxes and filed refund claims instituting this action. The U.S. Court of Appeals for the Sixth Circuit previously had affirmed the District Court's ruling that the taxpayers were responsible persons for purposes of § 6672(a), but remanded the case to the District Court to determine if the taxpayers had acted willfully as required by the statute. *Byrne v. United States*, 498 Fed. Appx. 555 (6th Cir. 2012). After a bench trial, the District Court held that the taxpayers had acted willfully because they recklessly disregarded the risk that the trust fund taxes were not being paid. In an opinion by Judge Batchelder, a three-judge panel of the Sixth Circuit reversed the District Court and held as a matter of first impression that (i) a determination of "willfulness" under § 6672 is a question of "ultimate fact" subject to de novo review on appeal, and (ii) even if the taxpayers were negligent, and possibly even reckless, in their failure to determine whether trust fund taxes were being paid, their belief that the trust fund taxes had been paid was reasonable under the circumstances and therefore they had not acted willfully within the meaning of § 6672. In particular, the Sixth Circuit pointed to the hiring of two employees to assist the controller in 2000 and the taxpayers' reliance upon the "clean" audit letter issued by the company's CPA firm in December 2000.

In reaching its decision, the Sixth Circuit apparently aligns itself with a similar "reasonable belief" exception adopted by the Second Circuit, noting:

> In many circuits, "[r]eckless disregard includes failure to investigate or correct mismanagement after being notified that withholding taxes have not been paid." *Morgan v. United States*, 937 F.2d 281, 286 (5th Cir. 1991) (per curiam); *see also Greenberg v. United States*, 46 F.3d 239, 244 (3rd Cir. 1994); *Denbo v. United States*, 988 F.2d 1029, 1033 (10th Cir. 1993); *Godfrey v. United States*, 748 F.2d 1568, 1577 (Fed. Cir. 1984) . . . But the Second Circuit recognizes an exception to § 6672(a) liability when a responsible person "believed that the taxes were in fact being paid, so long as that belief was, in the circumstances, a reasonable one." *Id.* (citation and internal quotation marks omitted). The Fifth Circuit has also held that taxpayers who act with reasonable cause may be able to defeat a finding of willfulness. *See Conway v. United States*, 647 F.3d 228, 234, 235 (5th Cir. 2011) (finding that reasonable reliance on the advice of counsel may constitute reasonable cause under some circumstances).

a. Unlike the taxpayer in *Byrne* who had a reasonable basis to believe the company was meeting its payroll tax obligations, this taxpayer found out that the ostrich defense will not "fly" (*pun intended*). United States v. Hartman, 896 F.3d 759 (6th Cir. 7/25/18). In a case somewhat similar to *Byrne v. United States*, 857 F.3d 319 (6th Cir. 5/15/17), the Sixth Circuit (in an opinion by Judge Sutton) upheld a federal district court decision imposing liability on the taxpayer under § 6672 for an amount equal to the business's unpaid withholding taxes. The taxpayer and another individual had founded the company, and the taxpayer had placed the other individual in charge of payroll. Unfortunately, though, the other individual did not do well in this role, and eventually the taxpayer discovered that the company had not paid payroll taxes to the IRS. After both founders met with the IRS, the taxpayer directed the other individual founder to pay all delinquencies as well as future payroll taxes on a timely basis; however, the taxpayer did not follow up and subsequently became aware (finding a number of unmailed checks to the IRS as well as learning other clues) that payroll taxes were not being paid. The District Court held on a motion for summary judgment that the taxpayer "recklessly" disregarded the company's payroll obligations, which was tantamount to willfulness, even if the taxpayer did not have actual knowledge that payroll taxes were not being paid to the IRS. The Sixth Circuit upheld the District Court's ruling, holding that although neither negligence nor gross negligence constitutes willfulness, reckless disregard is tantamount to willfulness. The Sixth Circuit concluded that the taxpayer was reckless because he had actual knowledge of the other individual founder's "extensive track record of misconduct." Coupled with other facts of which the taxpayer was aware and which indicated payroll taxes had not been paid, the Sixth Circuit determined that the taxpayer "had no plausible basis" for believing that the company's payroll tax obligations were being met. Yet, despite this knowledge, the taxpayer did nothing to correct the situation. These facts, the Sixth Circuit wrote, distinguished this case from *Byrne* where the taxpayers took meaningful steps (by hiring an accounting firm and in-house accountant) to address unpaid payroll taxes.

B. Self-employment Taxes

C. Excise Taxes

XII. TAX LEGISLATION

XIII. TRUSTS, ESTATES & GIFTS

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

1. The long reach of the uniform capitalization rules. Wasco Real Properties I, LLC v. Commissioner, T.C. Memo. 2016-224 (12/13/16). The Tax Court (Judge Buch) held that real estate taxes on land on which commercial almond trees were planted were subject to capitalization as indirect costs under § 263A:

> Although WRP I deducted its property taxes, those taxes directly benefit the growing of the almond trees and are allocable to the produced property (the almond trees) that will produce income in the future. Allowing a current deduction of the property taxes would distort WRP I's actual income for the subject years and would otherwise allow

WRP I to offset its unrelated income. This is precisely the mismatch of expenses and revenues that section 263A was enacted to prevent.

In addition, interest on a loan to acquire the land on which the commercial almond trees were planted was subject to capitalization under § 263A(f). "The land does not have to be the property that is being produced to bring interest on a financing of the land within the reach of section 263A. Rather, pursuant to the command of section 263A(f)(2)(A)(i), the interest that the entities paid on their financing of their land must be capitalized as a cost of their almond trees if the cost of the land is a production expenditure with respect to the almond trees." Capitalized interest is added to the basis of the almond trees, not the land.

a. Expect the price of almonds to rise. The Ninth Circuit has affirmed the Tax Court's decision that interest and property taxes with respect to land used to grow almonds are subject to the uniform capitalization rules. Today, these partnerships might be able to elect not to be subject to § 263A. Wasco Real Properties I, LLC v. Commissioner, 744 Fed. Appx. 534 (9th Cir. 12/5/18). In a brief, memorandum opinion, the U.S. Court of Appeals for the Ninth Circuit has affirmed the Tax Court's decision and held that real property taxes on land used by the taxpayers to grow almond trees and interest on a loan used to acquire the land had to be capitalized under the uniform capitalization rules of § 263A. The court held that the real property taxes corresponding to the portion of the property used to grow almond trees were indirect costs allocable to the production of the almond trees and were required to be capitalized under I.R.C. § 263A(2)(B). With respect to the interest on the financing used to acquire the land, the court held that the interest was allocable to the almond trees within the meaning of § 263A(f)(1)(B) because the cost of the land was a production expenditure of the trees and therefore the interest was directly attributable to the production expenditures of the almond trees. "The cost of the land is an indirect cost because it 'directly benefit[s]' or is 'incurred by reason of the performance of production' of the almond trees. 26 C.F.R. § 1.263A-1(e)(3)(i)(A)."

- The 2017 Tax Cuts and Jobs Act, § 13102, redesignated Code § 263A(i) as § 263A(j) and added new § 263A(i). New § 263A(i) excludes from the uniform capitalization rules of § 263A any taxpayers meeting the gross receipts test of § 448(c) (average annual gross receipts, measured over the three prior years, do not exceed $25 million). Unlike the prior, more limited exclusion from the uniform capitalization rules, this exclusion applies both to those who acquire property for resale and those who produce property. Thus, beginning in 2018, the taxpayers in this case could elect not to apply the uniform capitalization rules of § 263A and instead deduct the property taxes and interest.

C. Reasonable Compensation

D. Miscellaneous Deductions

1. Standard mileage rates for 2019. Notice 2019-2, 2019-2 I.R.B. 281 (12/14/18). The standard mileage rate for business miles in 2019 goes up to 58 cents per mile (from 54.5 cents in 2018) and the medical/moving rate goes up to 20 cents per mile (from 18 cents in 2018). The charitable mileage rate remains fixed by § 170(i) at 14 cents. The portion of the business standard mileage rate treated as depreciation goes up to 26 cents per mile for 2019 (from 25 cents in 2018). The maximum standard automobile cost may not exceed $50,400 (up from $50,000 in 2018) for passenger automobiles (including trucks and vans) for trucks and vans for purposes of computing the allowance under a fixed and variable rate (FAVR) plan.

- The notice reminds taxpayers that (1) the business standard mileage rate cannot be used to claim an itemized deduction for unreimbursed employee travel expenses because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed miscellaneous itemized deductions for 2019, and (2) the standard mileage rate for moving has limited applicability for the use of an automobile as part of a move during 2019 because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed the deduction of moving expenses for 2019 (except for members of the military on active duty who move pursuant to military orders incident to a permanent change of station, who can still use the standard mileage rate for moving).

2. And no more deductions for employers for most qualified transportation fringe benefits such as employer-paid parking. The 2017 Tax Cuts and Jobs Act, § 13304(c), amended Code § 274(a) by adding § 274(a)(4), which provides that, for amounts paid or incurred after 2017, no deduction is allowed for any "qualified transportation fringe" (as defined in § 132(f)) provided to an employee of the taxpayer. A qualified transportation fringe is any of the following provided by an employer to an employee: (1) transportation in a commuter highway vehicle in connection with travel between the employee's residence and place of employment, (2) any transit pass, (3) qualified parking, and (4) any qualified bicycle commuting reimbursement. Further, the legislation added new § 274(*l*), which provides:

1. **General Rule.** No deduction shall be allowed under this chapter for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee.
2. **Exception.** In the case of any qualified bicycle commuting reimbursement (as described in section 132(f)(5)(F)), this subsection shall not apply for any amounts paid or incurred after December 31, 2017, and before January 1, 2026.

Effect on Employers. Under § 274 as amended, an employer *cannot* deduct the cost of transportation in a commuter highway vehicle, a transit pass, or qualified parking paid or incurred after 2017. However, the employer *can* deduct the cost of a qualified bicycle commuting reimbursement paid or incurred after 2017 and before 2026.

Effect on Employees. With one exception, the legislation did not change the tax treatment of employees with respect to qualified transportation fringes. Employees can still (as under prior law) exclude from gross income (subject to applicable limitations) any of the following provided by an employer: (1) transportation in a commuter highway vehicle in connection with travel between the employee's residence and place of employment, (2) any transit pass, or (3) qualified parking. The exception is a qualified bicycle commuting reimbursement, which, under new § 132(f)(8), must be included in an employee's gross income for taxable years beginning after 2017 and before 2026.

a. Guidance on determining the nondeductible portion of the cost of employer-provided parking. Notice 2018-99, 2018-52 I.R.B. 1067 (12/10/18). In this notice, the IRS announced that Treasury and the IRS will issue proposed regulations under § 274 that will include guidance on determining nondeductible parking expenses and other expenses for qualified transportation fringes (and also the calculation of increased unrelated business taxable income (UBTI) of tax-exempt organizations that provide qualified transportation fringes). Until further guidance is issued, employers that own or lease parking facilities where their employees park can rely on interim guidance provided in the notice to determine the nondeductible portion of parking expenses under § 274(a)(4) and the corresponding increase in the amount of UBTI under § 512(a)(7) attributable to nondeductible parking expenses.

Employer Pays a Third Party for Employee Parking Spots. According to the notice, in situations in which an employer pays a third party an amount so that employees may park at the third party's parking lot or garage, the amount disallowed by § 274(a)(4) generally is the taxpayer's total annual cost of employee parking paid to the third party. Nevertheless, if the amount paid by the employer exceeds the § 132(f)(2) monthly limitation on exclusion ($260 for 2018 and $265 for 2019), the employer must treat the excess amount as compensation and wages to the employee. Accordingly, the excess amount is not disallowed as a deduction pursuant to § 274(e)(2), which provides that § 274(a) does not disallow as a deduction expenses for goods, services, and facilities to the extent the taxpayer treats the expenses as wages to its employees. The result is that the employer can deduct the monthly cost of parking provided to an employee to the extent the cost exceeds the § 132(f)(2) monthly limitation. These rules are illustrated by examples 1 and 2 in the notice.

Taxpayer Owns or Leases All or a Portion of a Parking Facility. The notice provides that, until further guidance is issued, if a taxpayer owns or leases all or a portion of one or more parking facilities where employees park, the nondeductible portion of the cost of providing parking can be calculated using any reasonable method. The notice provides a four-step methodology that is deemed to be a reasonable method. The notice cautions that, because § 274(a)(4) disallows a deduction for the *expense* of providing a qualified transportation fringe, using the *value* of employee parking to determine expenses allocable to employee parking is not a reasonable method. For purposes of the notice, the term "total parking expenses," a portion of which is disallowed, does *not* include a deduction for depreciation on a parking structure used for parking by the taxpayer's employees, but *does* include, without limitation, "repairs, maintenance, utility costs, insurance, property taxes, interest, snow and ice removal, leaf removal, trash removal, cleaning, landscape costs, parking lot attendant expenses, security, and rent or lease payments or a portion of a rent or lease payment." Under the four-step methodology provided in the notice, employers can determine the nondeductible portion of parking costs by: **(1)** determining the percentage of parking spots that are reserved employee spots and treating that percentage of total parking expenses as disallowed; **(2)** determining whether the primary use of the remaining spots (greater than 50 percent actual or estimated usage) is providing parking to the general public, in which case the remaining portion of total parking expenses is not disallowed by § 274(a)(4); **(3)** if the primary use of the remaining parking spots (from step 2) is *not* to provide parking to the general public, identifying the number of remaining spots exclusively reserved for nonemployees, including visitors, customers, partners, sole proprietors, and 2-percent shareholders of S Corporations and treating this percentage of total parking expenses as not disallowed by § 274(a)(4); and **(4)** if there are any remaining parking expenses not specifically categorized as deductible or nondeductible after completing steps 1-3, reasonably determining "the employee use of the remaining parking spots during normal business hours on a typical business day … and the related expenses allocable to employee parking spots." This four-step methodology is illustrated by examples 3 through 8 in the notice.

E. Depreciation & Amortization

F. Credits

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

I. At-Risk and Passive Activity Losses

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. The IRS searched unsuccessfully for sale or exchange treatment on Monster.com. Estate of McKelvey v. Commissioner, 148 T.C. 312 (4/19/17). The decedent in this case was the founder and CEO of Monster Worldwide, Inc. (Monster), known for its job-search website, monster.com. In 2008, the decedent entered into variable prepaid forward contracts (VPFC) with two investment banks. Pursuant to the terms of each VPFC, the decedent received a cash payment from each investment bank in exchange for his agreement to deliver Monster shares or their cash equivalents over the course of several future settlement dates. The number of shares of Monster that the decedent was obligated to deliver varied and was determined by a formula that took into account the closing price of Monster shares on the settlement dates. In connection with each VPFC, the decedent pledged a specified number of shares of Monster stock to secure his obligations but could substitute other collateral with the bank's consent. In the same year, prior to the first settlement date, the decedent entered into an agreement with each investment bank pursuant to which the decedent made a cash payment to each bank in exchange for the bank's agreement to extend the settlement dates. Following the decedent's death, his estate delivered the requisite number of Monster shares to the banks. The IRS acknowledged that the initial VPFCs qualified for open transaction reporting under Rev. Rul. 2003-7, 2003-1 C.B. 363. However, the IRS took the position that the agreements pursuant to which the settlement dates were extended: (1) were taxable exchanges of the original VPFCs for the extended VPFCs that resulted in short-term capital gain of $88 million, and (2) resulted in constructive sales of the underlying Monster shares under § 1259 that gave rise to long-term capital gain of $112.8 million. The Tax Court (Judge Ruwe) held that the extension agreements did not result in taxable exchanges and that the extensions did not constitute constructive sales under § 1259. The court reasoned that, in order for the extensions to constitute taxable exchanges of the VPFCs, "two conditions must be satisfied: (1) the original VPFCs must constitute property to decedent at the time of the extensions and (2) the property must be exchanged for other property differing materially either in kind or in extent." The first condition, the court concluded, was not satisfied. The VPFCs were not property of the decedent, but rather obligations of the decedent. Once the decedent had received the cash payments under the VPFCs, the decedent had only the obligation to deliver a specified number of Monster shares or their cash equivalent. The court also rejected the government's argument that the extensions resulted in constructive sales of the underlying Monster shares under § 1259. Section 1259(a)(1) provides that, if there is a constructive sale of an appreciated financial position, the taxpayer must recognize gain as if that position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. Under § 1259(c)(1)(C), a constructive sale of an appreciated financial position occurs if a taxpayer "enters into a future or forward contract to deliver the same or substantially identical property," but according to the provision's legislative history, a forward contract does not result in a constructive sale of stock if it calls for the delivery of "an amount of property, such as shares of stock, that is subject to significant variation under the contract terms." The court reasoned that the IRS's acceptance of open transaction reporting for the initial VPFCs meant that the IRS acknowledged that the initial VPFCs did not trigger a constructive sale under § 1259. Accordingly, the IRS's argument that the extensions resulted in constructive sales under § 1259 "is predicated upon a finding that there was an exchange of the extended VPFCs for the original VPFCs," a finding that the court had already declined to make.

a. But the Second Circuit has determined that the IRS's search for taxes is not yet finished. Estate of McKelvey v. Commissioner, 906 F.3d 26 (2d Cir. 9/26/18), *rev'g and remanding* 148 T.C. No. 13. The Second Circuit, in an opinion by Judge Newman, reversed the Tax Court's decision against the IRS and in favor of the decedent-taxpayer and remanded the case for a determination of both the potential short-term capital gain and long-term capital gain to be recognized in 2008 prior to the decedent-taxpayer's death. Although the Second Circuit agreed with the Tax Court that the extension of the VPFCs in 2008 did not equate to a taxable exchange of the VPFCs because the contracts were obligations, not property, the Second Circuit sided with the IRS that the extensions could be "terminations" of the VPFCs resulting in gain under § 1234A. Section 1234A provides that "[g]ain . . . attributable to the cancellation . . . or other termination of . . . a right or obligation . . . with respect to property which is . . . a capital asset in the hands of the taxpayer . . . shall be treated as gain . . . from the sale of a capital asset." The IRS had not argued the application of § 1234A in the Tax Court; however, for reasons that are not clear from the opinion both the decedent-taxpayer and the IRS agreed that the issue could be raised on appeal. The Second Circuit reasoned that although the 2008 extension of the original VPFCs was not a sale or exchange giving rise to gain, the 2008 extension did rise to the level of a *new contract*, not merely a "continuation" of the original VPFCs as the Tax Court had held. Therefore, the Second Circuit decided that with respect to the issue of recognition of short-term capital gain in 2008 and the amount thereof (if any), the case should be remanded to Tax Court to determine if the extension amounted to a "termination" of the original VPFCs within the meaning of § 1234A. With respect to the issue of long-term capital gain recognizable by the decedent-taxpayer in 2008, the IRS made the same argument that it had made in the Tax Court. Namely, that a constructive sale occurred with respect to the decedent-taxpayer's Monster.com shares in 2008 under § 1259 when the VPFCs were extended. Section 1259 provides for constructive sale treatment if a taxpayer holds an "appreciated financial position" in stock and enters into a "forward contract to deliver the same or substantially identical property." § 1259(c)(1)(C). A "forward contract" is defined for this purpose as "a contract to deliver *a substantially fixed amount of property* (including cash) at a substantially fixed price." § 1259(d)(1) (emphasis added). Neither the IRS nor the estate disputed that on the date the original VPFCs were extended the decedent-taxpayer's Monster.com stock was in an "appreciated financial position." The dispute centered upon whether the decedent-taxpayer's Monster.com shares were a "substantially fixed amount of property." Under the original VPFCs, the Monster.com shares to be delivered under the VPFCs were not substantially fixed because fluctuations in the value would affect the shares ultimately delivered to the banks. Nonetheless, the IRS argued that in 2008 when the original VPFCs were extended, new contracts were created under § 1259 and the amount of Monster.com shares to be delivered to the banks under the new VPFCs became "substantially fixed" before the decedent-taxpayer's death. The amount of Monster.com shares to be delivered became substantially fixed, according to the IRS, because of a dramatic drop in the market value of the Monster.com shares. Specifically, and based upon expert testimony, the IRS asserted that there was a probability of over 85 percent that all the Monster.com shares pledged under the VPFCs would be required to be delivered upon eventual settlement scheduled for 2010. The Second Circuit first agreed with the IRS that the extended VPFCs were new contracts for purpose of IRC § 1259, not merely "continuations" as the Tax Court had held. Next, acknowledging that no court had addressed whether probability analysis can be used to determine if an amount of property is "substantially fixed" for purposes of finding a constructive sale under § 1259, the Second Circuit decided (citing a deep-in-the-money option case, *Progressive Corp. v. United States*, 970 F.2d 188 (6th Cir. 1992), as precedent) that using probability analysis was appropriate in this case. On this basis, the Second Circuit decided that the 85 percent plus probability of all Monster.com shares being used to settle the amended VPFCs as found by the IRS's expert was sufficient to substantially fix the amount of property within the meaning of § 1259. Accordingly, the Second Circuit agreed with the IRS that under § 1259 a constructive sale of the decedent-taxpayer's Monster.com took place in 2008 before the decedent-taxpayer's death; however, the Second Circuit remanded the case to the Tax Court to determine the amount of long-term capital gain that the decedent-taxpayer should recognize in 2008. Judge Cabranes wrote a concurring opinion to clarify that the Second Circuit's analysis does not affect the application of Reg. § 1.1001-3 to holders and issuers of *debt* instruments.

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

D. Section 121

E. Section 1031

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

A. Fringe Benefits

B. Qualified Deferred Compensation Plans

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

1. The economic benefits resulting from an S corporation's payment of premiums on a shareholder-employee's life insurance policy under a compensatory split-dollar arrangement are treated as distributions to the shareholder, not as compensation. Machacek v. Commissioner, 906 F.3d 429 (6th Cir. 10/12/18), *rev'g* T.C. Memo. 2016-55 (3/28/16). The taxpayer and his wife were the sole shareholders of a subchapter S corporation. The taxpayer also was an employee of the S corporation. Pursuant to a benefit plan adopted by the S corporation, the corporation paid the $100,000 annual premium on a life insurance policy on the taxpayer's life under an arrangement that the parties agreed was a compensatory split-dollar arrangement. The Tax Court (Judge Laro) had held that the taxpayers had to include in income the economic benefit of the arrangement. In an opinion by Judge White, the Sixth Circuit reversed and remanded and held that the economic benefits of the arrangement must instead be treated as distributions of property by the S corporation. The court relied on Reg. § 1.301-1(q)(1)(i), which provides:

> the provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement, as defined in § 1.61-22(b)(1) or (2), of economic benefits described in § 1.61-22(d) . . . is treated as a distribution of property.

This provision, the court stated, applies whether the split-dollar arrangement is a shareholder arrangement or a compensatory arrangement and is dispositive. Thus, according to the court, when a shareholder-employee receives benefits under a compensatory arrangement, the "benefits are treated as a distribution of property and are thus deemed to have been paid to the shareholder in his capacity as a shareholder."

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

C. Liquidations

D. S Corporations

E. Mergers, Acquisitions and Reorganizations

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

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

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

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

IRA to the Roth IRA Corporation." Importantly, subsequent Tax Court decisions, *Polowniak v. Commissioner*, T.C. Memo 2016-31 and *Block Developers, LLC v. Commissioner*, T.C. Memo 2017-142, adopted the IRS's position in Notice 2004-8 and struck down tandem Roth IRA/related-party business arrangements like the one under scrutiny in *Summa I*.

The Sixth Circuit's decision (Summa (II)). In an opinion by Judge Sutton, the U.S. Court of Appeals for the Sixth Circuit reversed.[1] The court emphasized that "[t]he Internal Revenue Code allowed Summa Holdings and the Benensons to do what they did." The issue was whether the IRS's application of the substance-over-form doctrine was appropriate. The court first expressed a great deal of skepticism about the doctrine:

> Each word of the "substance-over-form doctrine," at least as the Commissioner has used it here, should give pause. If the government can undo transactions that the terms of the Code expressly authorize, it's fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is. "Form" is "substance" when it comes to law. The words of law (its form) determine content (its substance). How odd, then, to permit the tax collector to reverse the sequence—to allow him to determine the substance of a law and to make it govern "over" the written form of the law—and to call it a "doctrine" no less.

Although the court expressed the view that application of the substance-over-form doctrine makes sense when a "taxpayer's formal characterization of a transaction fails to capture economic reality and would distort the meaning of the Code in the process," this was not such a case. The substance-over-form doctrine as applied by the IRS in this case, the court stated, was a "distinct version" under which the IRS claims the power to recharacterize a transaction when there are two possible options for structuring a transaction that lead to the same result and the taxpayer chooses the lower-tax option. The court concluded that the IRS's recharacterization of Summa Holding's transactions as dividends followed by Roth IRA contributions did not capture economic reality any better than the taxpayer's chosen structure of DISC commissions followed by dividends to the DISC's shareholders.

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

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

stock and thus were not the true owners of the stock. Judge Thornton determined that, for federal income tax purposes, the taxpayers should be considered the owners of the stock, stating:

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

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

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

> After the Sixth Circuit released *Summa II* we told the parties here to submit supplemental briefs. The Mazzeis and the Commissioner agreed that the only difference between these cases and *Summa II* was that the Mazzeis used a FSC instead of a DISC. The Commissioner said this difference shouldn't affect our analysis, and he admitted that the Mazzeis followed all of the necessary formalities. He nevertheless said we should ignore *Summa II* because it's from a different circuit and only the commission payments' deductibility was properly before the court there. He said we should instead follow *Court Holding*, look at the transaction as a whole, and decide the cases based on his views of the statute's intent, not the Code's plain language.
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> The Mazzeis urged us to follow *Summa II*'s reasoning. They said they should get the FSC and Roth IRA tax benefits the Code explicitly provides and that the Commissioner shouldn't get to rewrite statutes based on his musings about congressional intent. And they said that their use of an FSC instead of a C corporation was enough to distinguish these cases from Repetto.

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

c. The First Circuit has agreed with the Sixth Circuit and declined to recharacterize a corporation's payments to a DISC held by a Roth IRA. Benenson v. Commissioner, 887 F.3d 511 (1st Cir. 4/6/18), *rev'g* T.C. Memo 2015-119 (6/29/15). In an opinion by Judge Stahl, the U.S. Court of Appeals for the First Circuit has upheld the same Roth IRA-DISC transaction considered by the Sixth Circuit in *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2/16/17). In that transation, members of the Benenson family established Roth IRAs that acquired shares of a Domestic International Sales Corporation (DISC), to which a subchapter C corporation (Summa Holdings) paid (and deducted) commissions to the DISC. The Tax Court upheld the IRS's recharacterization of the transaction under the substance over form doctrine. Under the IRS's view of the transaction, the C corporation's payments of commissions to the DISC should be recharacterized as nondeductible distributions by the C corporation to its shareholders, followed by the shareholders' contributions of those amounts to their Roth IRAs in excess of applicable limits, which triggered the 6 percent excise tax of § 4973 The Sixth Circuit addressed the C corporation's deductions and rejected the IRS's argument that the C corporation's deductions should be disallowed under the substance over form doctrine. In this case, the First Circuit considered the appeal of the Tax Court's decision by shareholders who were residents of Massachusetts, who appealed the Tax Court's decision that they should be treated as having made excess Roth IRA contributions. Like the Sixth Circuit, the First Circuit declined to apply the substance over form doctrine, which the court characterized as "not a smell test," but rather a tool of statutory interpretation. The court reasoned that Congress appeared to contemplate ownership of DISCS by IRAs when it enacted relevant statutory provisions such as § 995(g), which imposes unrelated business income tax on distributions that a DISC makes to tax-exempt organizations that own shares of the DISC. The court concluded:

> The Benensons used DISCs, a unique, congressionally designed corporate form their family's business was authorized to employ, and Roth IRAs, a congressionally designed retirement account all agree they were qualified to establish, to engage in long-term saving with eventual tax-free distribution. Such use violates neither the letter nor the spirit of the relevant statutory provisions.
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> …
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> Some may call the Benensons' transaction clever. Others may call it unseemly. The sole question presented to us is whether the Commissioner has the power to call it a violation of the Tax Code. We hold that he does not. … When, as here, we find that the transaction does not violate the plain intent of the relevant statutes, we can push the doctrine no further.

- In a dissenting opinion, Judge Lynch argued that the IRS's application of the substance over form doctrine should be upheld. In Judge Lynch's view, the parties had not used the DISC for the purpose intended by Congress, but rather to evade the Roth IRA contribution limits. Judge Lynch also disagreed with the majority that the relevant statutory provisions contemplated a Roth IRA holding stock in a DISC. At most, Judge Lynch noted, Congress might have intended to allow traditional IRAs to own DISC stock, but taxpayers have not used DISCs as a way to circumvent the contribution limits on traditional IRAs because, in contrast to Roth IRAs, distributions from a traditional IRA are not tax-free.

d. The Second Circuit has jumped on the bandwagon and declined to apply the substance-over-form doctrine to recharacterize a corporation's payments to a DISC held by a Roth IRA. Benenson v. Commissioner, 910 F.3d 690 (2d Cir. 12/14/18). In an opinion by Judge Raggi, the U.S. Court of Appeals for the Second Circuit has agreed with the First and Sixth Circuits that the government could not apply the substance-over-form doctrine to recharacterize as nondeductible dividends the commissions paid by Summa Holdings, Inc. to a DISC, the stock of which was held (indirectly) by Roth IRAs formed by some of Summa Holdings' shareholders. The court first rejected the taxpayers' argument that the Sixth Circuit's decision, which refused to uphold application of the substance-over-form doctrine with respect to Summa Holdings, precluded the government from relitigating the issue of recharacerization. The court observed that offensive collateral estoppel can preclude the government from relitigating an issue only when the parties opposing the government in the prior and subsequent action are the same. This requirement can be satisfied, the court stated, when the litigant in the subsequent action (the shareholders in this case) totally controlled and financed the litigant in the prior action (the corporation, Summa Holdings). According to the court, however, the taxpayers had failed to make this showing, and therefore the government was not precluded from litigating the issue of recharacterization. With respect to the issue of recharacterizing Summa Holdings' payment of commissions to the DISC, the court held that "the substance-over-form doctrine does not support recharacterization of Summa's payment of tax-deductible commissions to a DISC as taxable constructive dividends to Summa shareholders and, thus, cannot support the tax deficiency attributed to petitioners. The court also held that the step-transaction doctrine, when applied together with the substance-over-form doctrine, did not warrant a different conclusion.

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

1. The Tax Court gives the IRS a lesson on the intersection of partnership and international taxation: subject to the exception in § 897(g), a foreign partner's gain from the redemption of its interest in a U.S. partnership was not income effectively connected with the conduct of a U.S. trade or business. Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner, 149 T.C. No. 3 (7/13/17). The taxpayer, a corporation organized under the laws of Greece, held a 15 percent interest (later reduced to 12.6 percent) in Premier Chemicals, LLC, an LLC organized under Delaware law and classified for federal tax purposes as a partnership. The taxpayer accepted Premier's offer to redeem its partnership interest and received a total of $10.6 million, half of which was paid in 2008 and half in January 2009. The taxpayer and Premier agreed that the payment in January 2009 was deemed to have been paid on December 31, 2008, and that the taxpayer would not share in any profits or losses in 2009. The taxpayer realized $1 million of gain from the 2008 redemption payment and $5.2 million from the 2009 redemption payment. The taxpayer filed a return on Form 1120-F for 2008 on which it reported its distributive share of partnership items, but did not report any of the $1 million realized gain from the 2008 redemption payment. The taxpayer did not file a U.S. tax return for 2009 and thus did not report any of the $5.2 million realized gain from the 2009 redemption payment. The IRS issued a notice of deficiency in which it asserted that all of the $6.2 million of realized gain was subject to U.S. tax because it was U.S.-source income effectively connected with the conduct of a U.S. trade or business. The taxpayer conceded that $2.2 million of the gain was subject to U.S. taxation pursuant to § 897(g), which treats amounts received by a foreign person from the sale or exchange of a partnership interest as amounts received from the sale or exchange of U.S. real property to the extent the amounts received are attributable to U.S. real property interests. The taxpayer's concession left $4 million of realized gain in dispute. The Tax Court (Judge Gustafson) held that the $4 million of disputed gain was not income effectively connected with the conduct of a U.S. trade or business and therefore was not subject to U.S. taxation. (The court found it unnecessary to interpret the tax treaty in effect between the U.S. and Greece because U.S. domestic law did not impose tax on the gain and the IRS did not contend that the treaty imposed tax beyond U.S. domestic law.) In reaching this conclusion, the court addressed several issues.

The court first analyzed the nature of the gain realized by the taxpayer. Under § 736(b)(1), payments made in liquidation of the interest of a retiring partner that are made in exchange for the partner's interest in partnership property are treated as a distribution to the partner. Treatment as a distribution triggers § 731(a)(1), which provides that a partner recognizes gain from a distribution to the extent the amount of money received exceeds the partner's basis in the partnership interest and directs that the gain recognized "shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner." Pursuant to § 741, gain recognized from the sale or exchange of a partnership interest is "considered as gain or loss from the sale or exchange of a capital asset" except to the extent provided by § 751. (The IRS did not contend that § 751 applied.) The taxpayer asserted that these provisions lead to the conclusion that the taxpayer's gain must be treated as arising from the sale of a single asset, its partnership interest, which is a capital asset. The government argued that the taxpayer's gain must be treated as arising from the sale of separate interests in each asset owned by the partnership. Otherwise, the government argued, the rule in § 897(g), which imposes U.S. tax to the extent amounts received from the sale of a partnership interest are attributable to U.S. real property interests, would be rendered inoperable. The court agreed with the taxpayer. Section 897(g), the court explained,

> actually reinforces our conclusion that the entity theory is the general rule for the sale or exchange of an interest in a partnership. Without such a general rule, there would be no need to carve out an exception to prevent U.S. real property interests from being swept into the indivisible capital asset treatment that section 741 otherwise prescribes.

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

The court next addressed whether the $4 million of disputed gain was effectively connected with the taxpayer's conduct of a U.S. trade or business. Pursuant to § 875(1), the taxpayer was considered to be engaged in a U.S. trade or business because the partnership of which it was a partner, Premier, was engaged in a U.S. trade or business. Accordingly, the issue was narrowed to whether the disputed gain was effectively connected with that trade or business. Because foreign-source income is considered effectively connected with a U.S. trade or business only in narrow circumstances, which the IRS acknowledged were not present, the taxpayer's disputed gain could be considered effectively connected income only if it was U.S.-source income. Pursuant to the general rule of § 865(a), income from the sale of personal property by a nonresident is foreign-source income. The IRS asserted that an exception in § 865(e)(2) applied. Under this exception, if a nonresident maintains an office or other fixed place of business in the United States, income from a sale of personal property is U.S.-source if the sale is attributable to that office or fixed place of business. The court assumed without deciding that Premier's U.S. office would be attributed to the taxpayer under § 864(c)(5). Accordingly, the issue was whether the gain was attributable to Premier's U.S. office. Under § 864(c)(5)(B), income is attributable to a U.S. office only if the U.S. office is a material factor in the production of the income and the U.S. office "regularly carries on activities of the type from which such income, gain, or loss is derived." The court concluded that neither of these requirements was satisfied. The court examined Reg. § 1.864-6(b)(2)(i) and concluded that, although Premier's business activities might have had the effect of increasing the value of the taxpayer's partnership interest, those business activities did not make Premier's U.S. office a material factor in the production of the taxpayer's gain. Further, the court concluded, even if the U.S. office was a material factor, Premier did not regularly carry on activities of the type from which the gain was derived because "Premier was not engaged in the business of buying or selling interests in itself and did not do so in the ordinary course of business." Because the disputed gain was not U.S.-source income, it was not effectively connected with the conduct of a U.S. trade or business and therefore not subject to U.S. taxation.

- In reaching its conclusion that the taxpayer's gain was not effectively connected with the conduct of a U.S. trade or business, the court rejected the IRS's contrary conclusion in Rev. Rul. 91-32, 1991-1 C.B. 107. In that ruling, according to the court, the IRS concluded

> that gain realized by a foreign partner from the disposition of an interest in a U.S. partnership should be analyzed asset by asset, and that, to the extent the assets of the partnership would give rise to effectively connected income if sold by the entity, the departing partner's pro rata share of such gain should be treated as effectively connected income.

The court characterized the analysis in the ruling as "cursory" and declined to follow it.

- The taxpayer should have reported some of its gain in 2008, should have filed a 2009 U.S. tax return reporting gain in 2009, and should have paid tax with respect to both years because all of the gain realized from the 2008 distribution and some of the gain realized from the 2009 distribution was attributable to U.S. real property interests held by the U.S. partnership, Premier. Nevertheless, the court declined to impose either the failure-to-file penalty of § 6651(a)(1) or the failure-to-pay penalty of § 6651(a)(2) because the taxpayer had relied on the advice of a CPA and therefore, in the court's view, established a reasonable cause, good faith defense.

a. Grecian Magnesite may have won the battle, but the IRS has won the war with respect to a non-U.S. partner's sale of an interest in a partnership doing business in the U.S. (thereby codifying the IRS's position in Rev. Rul. 91-32). The 2017 Tax Cuts and Jobs Act, § 13501, amended § 864(c) by adding § 864(c)(8). New § 864(c)(8) provides that, effective for dispositions after November 27, 2017, gain or loss on the sale or exchange of all (or any portion of) a partnership interest owned by a nonresident alien individual or a foreign corporation in a partnership engaged in any trade or business within the U.S. is treated as effectively connected with a U.S. trade or business (and therefore taxable by the U.S. unless provided otherwise by treaty) to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The amount of gain or loss treated as effectively connected under this rule is reduced by the amount of such gain or loss that is already taxable under § 897 (relating to U.S. real property interests). TCJA § 13501 makes corresponding changes to the withholding rules for effectively connected income under § 1446. These changes to § 864(c) and § 1446 statutorily reverse the Tax Court's recent decision in *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner*, 149 T.C. No. 3 (7/13/17) and effectively adopt the IRS's position in Rev. Rul. 91-32, 1991-1 C.B. 107.

b. Proposed regulations implementing new § 864(c)(8) issued. REG-113604-18, Gain or Loss of Foreign Persons From Sale or Exchange of Certain Partnership Interests, 83 F.R. 66647 (12/27/18). Treasury and the IRS have issued proposed regulations that implement new § 864(c)(8). As required by § 864(c)(8), the proposed regulations adopt a two part analysis for determining effectively connected income or loss upon a foreign partner's sale or exchange of its partnership interest. First, § 864(c)(8)(A) requires a foreign partner to apply the normal rules of subchapter K to determine its overall gain or loss (including ordinary income or loss from "hot assets" under § 751) on the transfer of a partnership interest (''outside gain'' and ''outside loss''). Second, the outside gain or outside loss is compared to amounts determined under § 864(c)(8)(B), which can limit otherwise reportable effectively connected income or loss of the foreign partner. Consistent with the IRS's position in *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner*, 149 T.C. No. 3 (7/13/17), and Rev. Rul. 91-32, 1991-1 C.B. 107, § 864(c)(8)(B) uses a hypothetical partnership level sale or exchange analysis to derive inside ''aggregate deemed sale EC capital gain,'' ''aggregate deemed sale EC capital loss,'' ''aggregate deemed sale EC ordinary gain,'' and ''aggregate deemed sale EC ordinary loss.'' Outside gain or loss determined under § 864(c)(8)(A) then is compared to inside gain or loss determined under § 864(c)(8)(B) to derive the amount ultimately reportable by the foreign partner as effectively connected income or loss upon the sale or exchange of its partnership interest. Thus, for example, a foreign partner would compare its outside capital gain to its aggregate deemed sale EC capital gain, treating the former as effectively connected gain only to the extent it does not exceed the latter. The proposed regulations provide several examples illustrating the application of new § 864(c)(8). The proposed regulations do not, however, address the corresponding modifications to the withholding rules in § 1446(f), stating only that the latter regulations are to be issued "expeditiously."

E. Inside Basis Adjustments

F. Partnership Audit Rules

G. Miscellaneous

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. The taxpayer came to regret his decision to organize his business as a C corporation, and a midco transaction failed to solve the problem. Tricarichi v. Commissioner, T.C. Memo 2015-201 (10/14/15). The taxpayer was the sole shareholder of a C corporation, West Side Cellular, Inc. After lengthy litigation regarding network access, West Side received a settlement of $65 million and was required both to terminate its business as a retail provider of cell phone service and to end all service to its customers. To reduce the impact of corporate-level tax, the taxpayer engaged in a midco transaction in which a Cayman Islands affiliate of Fortrend International LLC purchased the stock of West Side for approximately $11.2 million more than the corporation's net asset value (the value of its assets less its estimated federal tax liabilities) and then used a distressed debt strategy to generate a bad debt deduction of $42.4 million to eliminate West Side's tax liabilities. In the notice of deficiency issued to West Side, the IRS determined a deficiency of $15.2 million based on its disallowance of the corporation's bad debt deduction and asserted an accuracy-related penalty of roughly $62,000 and a gross valuation misstatement penalty of $5.9 million. The Tax Court (Judge Lauber) held the taxpayer liable as a transferee for West Side's federal tax liability, the accuracy-related penalty, and the gross valuation misstatement penalty. In order for a shareholder to have transferee liability for a corporation's tax liability, the court stated, two requirements must be satisfied: (1) the shareholder must be liable for the corporation's debts under some provision of state law, and (2) the shareholder must be a "transferee" within the meaning of § 6901. With respect to the first requirement, the court held that the taxpayer was liable as a transferee under Ohio law (the Uniform Fraudulent Transfer Act) for the corporation's tax deficiency as well as the penalties:

> In sum, we find that petitioner had constructive knowledge of Fortrend's tax-avoidance scheme; that the multiple steps of the Midco transaction must be collapsed; and that collapsing these steps yields a partial or complete liquidation of West Side from which petitioner received in exchange for his stock a $35.2 million liquidating distribution. Under [Ohio law], petitioner is thus a direct transferee of West Side's assets under respondent's "de facto liquidation" theory as well as under the "sham loan" theory discussed previously.

With respect to the second requirement, the court disregarded the form of the transaction and concluded that the taxpayer was a transferee within the meaning of § 6901 because the taxpayer had in substance directly received West Side's cash. Any appeal of the court's decision will be directed to the Ninth Circuit.

a. How about a little salt in that wound? The taxpayer also is liable for pre-notice interest of $13.9 million. Tricarichi v. Commissioner, T.C. Memo. 2016-132 (7/18/16). In a supplemental opinion, the Tax Court (Judge Lauber) upheld the government's calculation of pre-notice interest, i.e., interest that accrued on the corporation's unpaid federal income tax liability from the date on which payment was due from the corporation in March 2004 to the date on which the IRS issued the notice of liability to the taxpayer in June 2012. The government asserted that the taxpayer's liability for pre-notice interest must be determined under federal law and computed in accordance with the rules for interest on underpayments in § 6601. According to the government, the pre-notice interest amounted to $13.9 million. The taxpayer contended that his liability for pre-notice interest must be determined under state law, and that under state law his liability for pre-notice interest was zero. The court reviewed prior decisions addressing liability for pre-notice interest, including *Lowy v. Commissioner*, 35 T.C. 393 (1960) and *Estate of Stein*, 37 T.C. 945 (1962), and concluded that courts have applied state law to determine liability for pre-notice interest only when the transferee has received an amount less than the transferor's liability:

> In short, the courts have consulted State law to ascertain whether the Government may recover from the transferee, in the form of pre-judgment interest, an amount larger than the value of the assets the transferee received. Petitioner has cited, and our own research has discovered, no case in which a court has invoked State law governing pre-judgment interest as a basis for reducing the Government's recovery to an amount smaller than the value of the assets the transferee received. That is what petitioner seeks to do here, and there is simply no precedent for it.

Because the taxpayer received from the corporation assets in the amount of $35.2 million, more than the $35.1 million total of the transferor corporation's liability for income tax, penalties, and pre-notice interest, the taxpayer's liability for pre-notice interest was properly determined under federal law. Accordingly, the court held the taxpayer liable as a transferee for $13.9 million in pre-notice interest.

b. The Ninth Circuit has affirmed the Tax Court's holding that the taxpayer was liable as a transferee. Tricarichi v. Commissioner, ___ Fed. Appx. ___ (9th Cir. 11/13/18), *aff'g* T.C. Memo. 2016-132 (7/18/16). In a brief, memorandum opinion, the U.S. Court of Appeals for the Ninth Circuit affirmed the Tax Court's decision that the taxpayer, who sold in a midco transaction the stock of West Side Cellular, Inc., a C corporation of which he was the sole shareholder, was liable as a transferee for the corporation's federal tax liability. The court cited its prior opinion in *Slone v. Commissioner*, 810 599 (9th Cir. 2015), for the two -prong test that must be satisfied for a shareholder to have transferee liability for a corporation's tax liability: (1) the shareholder must be liable for the corporation's debts under some provision of state law, and (2) the shareholder must be a "transferee" within the meaning of § 6901. The court held that the Tax Court had properly concluded that the corporation's cash had been "transferred" to the taxpayer within the meaning of the Ohio Uniform Fruadulent Transfer Act (thus satisfying the first prong), and that the Tax Court had "properly determined, looking through the form of the stock sale to consider its substance, that it lacked a non-tax business purpose or any economic substance other than the creation of tax benefits," which satisfied the second prong of the test.

c. The Ninth Circuit has affirmed the Tax Court's decision regarding the taxpayer's liability for pre-notice interest. Tricarichi v. Commissioner, 908 F.3d 588 (11/13/18). In an opinion by Judge Owens, the U.S. Court of Appeals for the Ninth Circuit has affirmed the Tax Court's decision that the taxpayer, who sold in a midco transaction the stock of West Side Cellular, Inc., a C corporation of which he was the sole shareholder, was liable as a transferee not only for the corporation's federal tax liability, but also for pre-notice interest. Pre-notice interest is interest that accrued on the corporation's unpaid federal income tax liability from the date on which payment was due from the corporation in March 2004 to the date on which the IRS issued the notice of liability to the taxpayer in June 2012. In its prior decision in *Edelson v. Commissioner*, 829 F.2d 828, 834 (9th Cir. 1987), the court had held that "[w]here transferee liability is found to exist but the transferred assets are insufficient to satisfy the transferor's total tax liability, a transferee's liability for interest is controlled by state law." The Ninth Circuit had not previously addressed the situation in which the transferee had received assets worth *more* thatn the transferor's total tax liability. The court took note of the Tax Court's prior decisions in *Lowy v. Commissioner*, 35 T.C. 393 (1960) and *Estate of Stein*, 37 T.C. 945 (1962), in which the Tax Court had held that, when the assets transferred are more than the federal tax liability of the transferor (including interest), it is unnecessary to look to state law to determine whether the transferee is liable for pre-notice interest. The court also discussed the First Circuit's opinion in *Schussel v. Werfel*, 758 F.3d 82 (1st Cir. 2014), in which the First Circuit followed *Lowy* and *Estate of Stein*. The Ninth Circuit agreed with the First Circuit's reasoning and held

> that because the value of assets transferred from West Side to Tricarichi is more than West Side's total federal tax liability, the federal Internal Revenue Code determines Tricarichi's pre-notice interest liability, and there is no need to consult state law regarding such interest.

Accordingly, in addition to being liable for the corporate transferor's federal tax liability, the taxpayer was liable for more than $13 million of pre-notice interest.

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

D. Tax Shelter Penalties

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Congress shoots a probable NCAA "airball": After TCJA, it will cost 21 percent more to pay big-time, private school coaches like Coach K (Duke-$7.2M); but Wildcat fans celebrate as Coach Calipari (Kentucky-$6.5M) gets an "assist" from Congress. Presumably believing that $1 million salaries at tax-exempt organizations are per se unreasonable, Congress decided to take a "shot" (*pun intended*) at curtailing them under TCJA. Specifically, the 2017 Tax Cuts and Jobs Act, § 13602, adds Code § 4960 to impose a 21 percent excise tax on "applicable tax-exempt organizations" ("ATEOs") and broadly-defined "related organizations" paying over $1 million annually to "covered employees." In addition to § 527 political organizations and § 521 farmers cooperatives, ATEOs include the following two additional types of organizations: (i) those exempt from tax under § 501(a) (most nonprofits, including churches, hospitals, and private schools); and (ii) those "with income excluded from taxation under § 115(l)" (income of certain public utilities and income derived from "any essential governmental function and accruing to a State or any political subdivision thereof"). A "covered employee" is defined as any one of the five highest compensated employees of an ATEO either (i) for the current taxable year or (ii) for any year beginning after December 31, 2016. Licensed medical or veterinarian professionals, however, are excluded from the definition of "covered employee." New § 4960 is permanent and effective for taxable years beginning after 2017. Given that many tax-exempt organizations have taxable years ending June 30 or October 31, many potentially affected organizations will have time to either comply or attempt to avoid new § 4960.

a. The probable NCAA "airball." Congress apparently thought that new § 4960 defined an ATEO so that both public and private colleges and universities would have to pay the 21 percent excise tax on compensation exceeding $1 million. The legislative history accompanying § 4960 states: "An [ATEO] is an organization exempt from tax under section 501(a), an exempt farmers' cooperative, *a Federal, State or local governmental entity with excludable income*, or a political organization." *See* H.R. Conf. Rep. No. 115-466, at 492 (Dec. 15, 2017) (emphasis added). At least one well-respected exempt organization scholar, however, has pointed out that, at least according to the IRS, "[i]ncome earned by a state, a political subdivision of a state, or an integral part of a state or political subdivision of a state" is not taxable regardless of § 115, citing Rev. Rul. 87-2, 1987-1 C.B. 18. Instead, it is the IRS's position that public colleges and universities are not taxable under our federalist system unless and until Congress enacts a specific statutory provision subjecting such state-affiliated organizations to tax like § 511(a)(2)(B) (state colleges and universities are subject to unrelated business income tax). *See* the blog post by Professor Ellen P. Aprill here, and her full law review article on the subject: Ellen P. Aprill, *The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Government Affiliates*, 23 J. Corp. Law 803 (1997).

b. And another thing … Churches are exempt from taxation under § 501(a) along with hospitals and private schools. But we wouldn't bet money that any church paying its pastor more than $1 million annually is going to pay an excise tax under new § 4960 without a fight based on the First Amendment. Ultimately, the church may lose such a fight because it is clear that churches are subject to the unrelated business income tax of § 511, but if a church can pay its pastor $1 million a year, it can pay a tax lawyer to litigate too.

c. Interim guidance on the § 4960 21 percent excise tax on applicable tax-exempt organizations. Notice 2019-9, 2019-__ I.R.B. __ (12/31/18). In this notice, the IRS announced that Treasury and the IRS will issue proposed regulations under § 4960, the provision enacted by the 2017 Tax Cuts and Jobs Act that imposes an excise tax at the highest rate in § 11 (currently 21 percent) on "applicable tax-exempt organizations" ("ATEOs") and broadly-defined "related organizations" paying over $1 million annually to "covered employees." The notice provides, in Q&A format, extensive interim guidance on new § 4960. Until further guidance is issued, taxpayers may base their positions upon a good faith, reasonable interpretation of § 4960, including its legislative history, to comply with the requirements of the statute. The notice provides that the positions reflected in it constitute a good faith, reasonable interpretation of the statute. The preamble to the notice describes certain positions that will be regarded as not consistent with a good faith, reasonable interpretation of the statutory language. Among other guidance, the notice provides in Q&A 5 that public universities with IRS determination letters recognizing their tax-exempt status under § 501(c)(3) *are* ATEOs and therefore subject to § 4960, but "a governmental unit (including a state college or university) that does not have a determination letter recognizing its exemption from taxation under section 501(a) and does not exclude income from gross income under section 115(1) is not an ATEO" and therefore is not subject to § 4960. Nevertheless, the notice provides that such a governmental unit may be liable for the excise tax imposed by § 4960 if it is a related organization under § 4960(c)(4)(B) with respect to an ATEO.

2. Oh goody! Changes to the UBIT rules too! The 2017 Tax Cuts and Jobs Act, §§ 13702 and 13703, also made certain changes to the determination of unrelated business income with respect to tax-exempt organizations. Most tax-exempt organizations are subject to federal income tax at regular rates (corporate rates for exempt corporations and trust rates for exempt trusts) on net income (i.e., after permissible deductions) from a trade or business, regularly carried on, that is unrelated to the organization's exempt purpose (other than its need for revenue). Exceptions exist for most types of passive, investment income as well as for narrow categories of other types of income (e.g., thrift store sales). *See* §§ 511-514.

Stop using good UBI money to chase bad UBI money! Under pre-TCJA law, if an exempt organization had unrelated business income from one activity, but unrelated losses from another activity, then the income and losses could offset, meaning that the organization would report zero or even negative UBI. Congress apparently doesn't like this result, so under new § 512(a)(6) income and losses from separate unrelated businesses no longer may be aggregated. This new UBI provision is effective for taxable years beginning after 2017, thus giving fiscal year nonprofits some time to plan. Moreover, under a special transition rule, unrelated business income net operating losses arising in a taxable year beginning before January 1, 2018, that are carried forward to a taxable year beginning on or after such date, are not subject to § 512(a)(6).

Congress doesn't like using UBI to help fund fringe benefits, so when your organization's employees are pumping iron at the charity's free gym, you can pump up your UBI too. Under new § 512(a)(7), an organization's unrelated business taxable income is increased by the amount of any expenses paid or incurred by the organization that are not deductible because of the limitations of § 274 for (i) qualified transportation fringe benefits (as defined in § 132(f)); (ii) a parking facility used in connection with qualified parking (as defined in § 132(f)(5)(C)); or (iii) any on-premises athletic facility (as defined in § 132(j)(4)(B)). New § 512(a)(7) is effective for amounts paid or incurred after 2017, so affected tax-exempt organizations need to deal with this change immediately.

Perhaps worth noting here: Because the TCJA reduced the top federal income tax rate on C corporations to 21 percent, it likewise reduced to 21 percent the top rate on UBI of tax-exempt organizations formed as nonprofit corporations, which are the vast majority. So, the news for tax exempts is not all bad.

a. A tax law oxymoron: nonprofit trades or businesses. *Huh?* Notice 2018-67, 2018-36 I.R.B. 409 (8/21/18). Organizations described in §§ 401(a) (pension and retirement plans) and 501(c) (charitable and certain other entities) generally are exempt from federal income taxation. Nevertheless, §§ 511 through 514 impose federal income tax upon the "unrelated business taxable income" ("UBTI") of such organizations including for this purpose state colleges and universities. The principal sources of UBTI are §§ 512 and 513 "unrelated trade or business" gross income (minus deductions properly attributable thereto) and § 514 "unrelated debt-financed income" (minus deductions), including a partner's allocable share of income from a partnership generating UBTI. Prior to TCJA, exempt organizations could aggregate income and losses from unrelated trades or businesses before determining annual UBTI potentially subject to tax. Excess losses (if any) after aggregating all UBTI-related items of an exempt organization created a net operating loss subject to the rules of § 172. [See Reg. § 1.512(a)-1(a) prior to enactment of TCJA. After TCJA, § 172 permits only carryforwards.] Effective for taxable years beginning after 2017, however, TCJA added new § 512(a)(6) to disaggregate unrelated trades or businesses of exempt organizations for purposes of determining UBTI. Specifically, new § 512(a)(6) provides that for any exempt organization with more than one unrelated trade or business: (1) UBTI must be computed separately (including for purposes of determining any net operating loss deduction) for each such unrelated "trade or business;" and (2) total annual UBTI is equal to (i) the sum of positive UBTI from each such separate "trade or business" minus (ii) the specific $1,000 deduction allowed by § 512(b)(12). Under a special transition rule, unrelated business income net operating losses arising in a taxable year beginning before January 1, 2018 and carried forward to a taxable year beginning on or after such date, are not subject to new § 512(a)(6).

Now we get to the crux of the matter. The logical result of new § 512(a)(6) is that every exempt organization must segregate its unrelated trade or business income and losses for purposes of determining its annual UBTI. Yet, Treasury and IRS have never defined separate "trades or businesses" for this purpose or, frankly, for any other federal income tax purpose. Further complicating matters, TCJA also enacted a related subsection, new § 512(a)(7), that increases an exempt organization's UBTI by expenses for which a deduction is disallowed under certain provisions of §§ 274 and 132 (specified transportation, parking, and athletic facility fringe benefits) *unless* the expense is "directly connected with an unrelated trade or business which is regularly carried on by the organization." Thus, new § 512(a)(7) also requires identification of each unrelated "trade or business" of an exempt organization, but § 512(a)(7) has the further deleterious effect of potentially creating UBTI for an exempt organization that otherwise has no unrelated trade or business. In Notice 2018-67, Treasury and IRS take the first step toward providing guidance with respect to both § 512(a)(6) and (7) and delineating separate trades or businesses for UBIT purposes.

What's in the Notice? Aside from requesting comments, Notice 2018-67 is lengthy (36 pages) and contains thirteen different "SECTIONS," ten of which address substantive, technical aspects of new § 512(a)(6) and (7). The high points are summarized below, but Notice 2018-67 is a must read for tax advisors to § 501(c) organizations, state colleges and universities, and § 401(a) pension and retirement plans, especially where those entities have UBTI from partnership interests they hold as investments. To summarize:

1. *General Rule.* Until proposed regulations are published, all exempt organizations affected by the changes to § 512(a)(6) and (7) may rely upon a "reasonable, good-faith interpretation" of §§ 511 through 514, considering all relevant facts and circumstances, for purposes of determining whether the organization has more than one unrelated trade or business. Because of the way § 512(a)(6) operates, exempt organizations will be inclined to conclude that they have only one unrelated trade or business, but that is not easy to do given the so-called "fragmentation" principle of § 513(c) and Reg. § 1.513-1(b). For example, advertising income earned by an exempt organization (e.g., National Geographic) from ads placed in the organization's periodical is UBTI even if subscription income is not UBTI. For an exempt organization this general rule includes using a reasonable, good-faith interpretation when determining: (a) whether to separate debt-financed income described in §§ 512(b)(4) and 514; (b) whether to separate income from a controlled entity described in § 512(b)(13); and (c) whether to separate insurance income earned through a controlled foreign corporation as described in § 512(b)(17). The use of the 6-digit code North American Industry Classification System ("NAICS") for segregating trades or businesses will be considered a reasonable, good-faith interpretation until regulations are proposed.

2. *Partnership Interests*. In general, partnership activities are attributable to partners such that holding a partnership interest can result in multiple lines of UBTI being considered allocable to an exempt organization partner. Until proposed regulations are issued, however, exempt organizations (other than § 501(c)(7) social clubs) may rely upon either of two rules for aggregating multiple lines of UBTI from a partnership, including UBTI attributable to lower-tier partnerships and unrelated debt-financed income:

   - The "interim rule" that permits the aggregation of multiple lines of UBTI from an exempt organization's interest in a single partnership if the partnership meets either a "de minimis test" or a "control test." The de minimis test generally is met if the exempt organization partner holds a 2 percent or less capital and profits interest in a partnership. The control test generally is met if the exempt organization partner holds a 20 percent or less capital interest in a partnership and does not have "control or influence" over the partnership. Control or influence over a partnership is determined based upon all relevant facts and circumstances. For purposes of determining an exempt organization's percentage interest in a partnership under the interim rule, partnership interests held by disqualified persons (as defined in § 4958), supporting organizations (as defined in § 509(a)(3)), and controlled entities (as defined in § 512(b)(13)(D)) must be considered.

   - The "transition rule" that permits the aggregation of multiple lines of UBTI from an exempt organization's interest in a single partnership if the interest was acquired prior to August 21, 2018. For example, if an organization has a 35 percent interest in a partnership [acquired] prior to August 21, 2018, it can treat the partnership as being in a single unrelated trade or business even if the partnership's investments generated UBTI from various lower-tier partnerships that were engaged in multiple types of trades or businesses (or, presumably, from debt-financed income).

3. *IRC § 512(a)(7)*. Income under § 512(a)(7) [i.e., the UBIT increase for expenses not directly connected with an unrelated trade or business regularly carried on by the organization and for which a deduction is disallowed under certain provisions of §§ 274 and 132 (specified transportation, parking, and athletic facility fringe benefits)] is not income from a trade or business for purposes of § 512(a)(6). Thus, such UBIT appears to be entirely separate from § 512(a)(6) income and therefore not offset by any deductions or losses.

4. *GILTI*. An exempt organization's inclusion of global intangible low-taxed income ("GILTI") under § 951A is treated as a dividend which is not UBTI (pursuant to § 512(b)(1)) unless it is debt-financed (and thus included in UBIT under § 512(b)(4)).

b. Guidance on determining the increase to UBTI for employer-provided parking. Notice 2018-99, 2018-52 I.R.B. 1067 (12/10/18). In this notice, the IRS announced that Treasury and the IRS will issue proposed regulations under §§ 274 and 512 that will include guidance on determining the calculation of increased unrelated business taxable income (UBTI) of tax-exempt organizations that provide qualified transportation fringes (and also the nondeductible parking expenses and other expenses for qualified transportation fringes provided by non-tax-exempt employers). Until further guidance is issued, employers that own or lease parking facilities where their employees park can rely on interim guidance provided in the notice to determine the increase in the amount of UBTI under § 512(a)(7) attributable to nondeductible parking expenses. The guidance in the notice for determining the increase in UBTI mirrors the guidance for determning the nondeductible parking expenses of non-tax-exempt employers summarized earlier in this outline. The notice explains that an increase to UBTI is not required "to the extent the amount paid or incurred is directly connected with an unrelated trade or business that is regularly carried on by the organization" because, in sich a case, the expenses for qualified transportation fringes are disallowed by § 274(a)(4) as a deduction in calculating the UBTI of the unrelated trade or business. The notice confirms that the effect of the increase in UBTI can be to require a tax-exempt organization to file Form 990-T, *Exempt Organization Business Income Tax Return*, if the organization's gross income included in computing UBTI is $1,000 or more. The rules for determining the increase in UBTI are illustrated by examples 9 and 10 in the notice.

B. Charitable Giving

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. Updated instructions on how to rat yourself out. Rev. Proc. 2019-9, 2019-2 IRB 292 (12/20/18). This revenue procedure updates Rev. Proc. 2018-11, 2018-5 I.R.B. 335 (1/26/18), 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 applies to any income tax return filed on a 2018 tax form for a taxable year beginning in 2018 and to any income tax return filed on a 2018 tax form in 2019 for a short taxable year beginning in 2019.

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

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

XIII. TRUSTS, ESTATES & GIFTS

Financial institutions
Energy
Infrastructure, mining and commodities
Transport
Technology and innovation
Life sciences and healthcare

Federal Tax Practice Ethics and Circular 230

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I. INTRODUCTION

A. This presentation focuses on administrative practice before the Internal Revenue Service. It addresses Federal statutes and regulations that govern or relate to practice before the IRS, especially 31 C.F.R. Subtitle A, Part 10, which is known as Circular 230.

B. Failure to observe the norms of these statutes and regulations can result in the imposition of penalties and other sanctions upon individual practitioners and a firm and can jeopardize a firm's continued ability to engage in this practice area.

II. IN GENERAL – ASPIRATIONAL STANDARDS (UNDER CIRCULAR 230)

A. **Best Practices**. Circular 230 § 10.33(a) provides that tax advisors "should" adhere to best practices, including:

1. Communicating clearly with the client regarding the terms of the engagement.
2. Establishing the relevant facts, relating applicable law, and arriving at a conclusion supported by the law and the facts.
3. Advising the client regarding the import of the conclusions reached, including penalties.
4. Acting fairly and with integrity in practice before the IRS.

B. Circular 230 § 10.33(b) provides that persons with responsibility for overseeing a firm's Federal tax practice "should" take reasonable steps to ensure procedures consistent with best practices.

C. These standards are directory rather than mandatory.

III. IN GENERAL – MANDATORY STANDARDS

A. Procedures to ensure compliance. Circular 230 § 10.36 requires the head of a firm's tax practice to put adequate procedures in place.

B. Knowledge of client's noncompliance, error, or omission. Circular 230 § 10.21 provides that a practitioner must advise the client promptly of the fact of noncompliance, error, or omission and of consequences under the Code and regulations.

C. Diligence as to accuracy. Circular 230 § 10.22 provides that practitioners must exercise due diligence:

1. in preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers;
2. in determining the correctness of oral or written representations made by the practitioner to the IRS; and
3. in determining the correctness of oral or written representations made by the practitioner to clients.

D. **Tax Compliance by Practitioners.** Circular 230 § 10.51(a)(6) makes it a violation of Circular 230 to willfully fail to make a Federal tax return, or to willfully evade, attempt to evade, or participate in any way in evading or attempting to evade assessment or payment of any Federal tax.

E. **Taxpayer Checks.** Circular 230 § 10.31 prohibits a practitioner from endorsing or negotiating any check issued to a client by the government in respect of a Federal tax liability.

F. **Notaries.** Circular 230 § 10.26 provides that an attorney may not take acknowledgments, administer oaths, certify papers, or perform any official act as a notary public with respect to any matter administered by the IRS and for which the attorney is employed as a representative or is in any way interested.

G. Contingent Fees. Circular 230 § 10.27 prohibits a practitioner from charging a contingent fee (as broadly defined in subsection 10.27(c)(1)), except:

1. For services rendered in connection with the IRS's examination of, or challenge to —
   a. An original tax return; or
   b. An amended return or claim for refund or credit where it was filed within 120 days of the taxpayer receiving a written notice of examination of, or a written challenge to the original tax return.
2. For services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the IRS.
3. For services rendered in connection with any judicial proceeding arising under the Code.

IV. STANDARDS FOR WRITTEN TAX ADVICE

A. Minimum standards for written tax advice. Circular 230 § 10.37(a) requires that a practitioner:

1. base the written tax advice on reasonable factual and legal assumptions;
2. reasonably consider all relevant facts and circumstances;
3. use reasonable efforts to identify and ascertain the relevant facts;
4. not rely upon representations, statements, findings or agreements if reliance would be unreasonable;
5. relate applicable law and authorities to facts; and
6. not take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.

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B. Reliance in connection with written tax advice

1. Reliance on representations, assumptions, statements, findings, or agreements is unreasonable if the practitioner knows or reasonably should know that one or more are incorrect, incomplete, or inconsistent. Circular 230 § 10.37(a)(3).
2. Per Circular 230 § 10.37(b), a practitioner may rely on the advice of another person only if the advice was reasonable and the reliance is in good faith. Reliance is not reasonable when the practitioner knows or reasonably should know that:
   a. the opinion of the other person should not be relied on;
   b. the other person is not competent or lacks the necessary qualifications; or
   c. the other person has a conflict of interest.

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V. STANDARDS FOR TAX RETURNS AND REFUND CLAIMS, AND FOR DOCUMENTS, AFFIDAVITS, AND OTHER PAPERS

A. **Preparer tax identification numbers**. Regulations under I.R.C. § 6109 and Circular 230 § 10.8(a) require an individual who for compensation prepares or assists with the preparation of all or substantially all of a Federal tax return or claim for refund to have a preparer tax identification number ("PTIN").

B. **Tax Return Preparers**. Practitioners should be aware of the broad definition of "tax return preparer" under Circular 230, I.R.C. § 7701(a)(36)(A) and Treas. Reg. § 301.7701-15. A tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any Federal tax return or claim for refund. This can include advising with respect to a position on a return or claim for refund. Rev. Proc. 2009-11 provides current lists of what IRS considers to be tax returns or claims for refund.

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C. Prospective versus completed transactions. IRS regulations that provide the definitions of tax return preparers make a distinction between advice regarding prospective transactions (which is usually not viewed as tax return preparation) and advice regarding completed transactions (which can be viewed as tax return preparation). See Treas. Reg. §§ 301.7701-15(b)(2), 1.6694-1(b)(6).

- Advice given after the transaction which represents less than 5% of the aggregate time is disregarded.
- Ramifications. If advice constitutes return preparation:
  - the advisor must have a PTIN
  - the advice can be subject to penalties under I.R.C. sections 6694 and 6695 (discussed below).

D. Penalties with respect to positions on returns/claims for refund.

1. I.R.C. § 6694(a) imposes a penalty (greater of $1,000 or 50% of income derived) on a tax return preparer who prepares a tax return or claim for refund that takes an "unreasonable position" that results in an understatement of tax. A position is unreasonable unless:
   a. there is substantial authority for the position; or
   b. there is a reasonable basis for the position and it is adequately disclosed; or
   c. in the case of a tax shelter or reportable transaction, it is reasonable to believe that the position would more likely than not be sustained.
2. I.R.C. § 6694(b) and the regulations thereunder provide a penalty (greater of $5,000 or 75% of income derived) for any understatement of tax on a return or claim for refund that results from (a) a willful attempt to understate liability or (b) reckless or intentional disregard of rules or regulations.

E. Circular 230 § 10.34(a)(1). The standards under section 6694 are reiterated in Circular 230 § 10.34(a)(1).

F. Other penalties with respect to preparation of returns/claims for refund. I.R.C. § 6695 imposes various other penalties with respect to preparation of a return or claim for refund. E.g., $50 penalty failure to furnish a copy to the taxpayer, failure to sign the return, failure to furnish a PTIN, and failure to retain copies or lists of returns. E.g., $500 penalty for failure to exercise due diligence in determining eligibility for head of household status, child tax credit, opportunity tax credit, earned income credit. Penalties indexed for inflation.

G. E-Filing. I.R.C. § 6011(e)(3) and the regulations and rules thereunder impose electronic filing requirements on tax return preparers with respect to "individual income tax returns".

- If the preparer obtains a hand-signed and dated statement from the taxpayer that the taxpayer chooses to file the return in paper format and will submit it to the IRS, the return will not be counted.
- Circular 230 § 10.51(a)(16) makes it a violation of Circular 230 to willfully fail to file electronically a return prepared by a practitioner when the practitioner is required to do so.

H. **Restrictions on Disclosure or Use of Tax Return Information**. I.R.C. §§ 6713 and 7216 and regulations thereunder prohibit the disclosure or use of information obtained in connection with tax return preparation except in certain circumstances, including, in summary:

1. to prepare a taxpayer's state, local or foreign tax returns;
2. preparation of returns of certain related taxpayers;
3. disclosure pursuant to a court order, or a government summons or subpoena;
4. disclosure to the IRS;
5. disclosure to other members of tax return preparer's firm located within U.S. for purposes of tax return preparation;
6. disclosure to other tax return preparers located within U.S. for certain tax return preparation purposes (not substantive determinations or advice);
7. disclosure to "contractors" for certain tax return preparation purposes (see regulations);
8. disclosure to an attorney for purposes of securing legal advice;
9. for law and accounting firms, use of or disclosure to other members of firm for purposes of providing other legal or accounting services;
10. disclosure to the taxpayer's fiduciary in certain circumstances;
11. maintaining a list of the tax return preparer's customers for certain purposes;
12. to produce certain kinds of statistical compilations of data;
13. for quality, peer or conflict reviews;
14. pursuant to written consent of the taxpayer in the manner set out in Treas. Reg. § 301.7216-3.

I. **Definitions of Tax Return and Tax Return Information**. For purposes of sections 6713 and 7216:

1. Tax return – An original or amended income tax return.
2. Tax return preparer – Any person who: (a) is engaged in the business of preparing or assisting in preparing tax returns, (b) is engaged in the business of providing auxiliary services, (c) is compensated for preparing or assisting in preparing a tax return for any other person, or (d) employees of any such foregoing person who assist in preparation.
3. Tax return information – This means any information furnished in any form or manner for, or in connection with, the preparation of a tax return of the taxpayer.

J. Standards for documents, affidavits, and other papers. Circular 230 § 10.34(b) provides:

1. A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the IRS unless the position is not frivolous.
2. A practitioner may not advise a client to submit a document, affidavit or other paper to the IRS—
   a. The purpose of which is to delay or impede the administration of the Federal tax laws;
   b. That is frivolous; or
   c. That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

K. Advising clients concerning potential penalties and disclosure. Circular 230 § 10.34(c) provides:

1. A practitioner must inform a client if there are any penalties that are reasonably likely to apply to the client with respect to:
   a. A position taken on a tax return; or
   b. Any document, affidavit or other paper submitted to the IRS.
2. The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.

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L. Relying on information furnished by clients. Under Circular 230 § 10.34(d), a practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the IRS may rely in good faith without verification upon information furnished by the client. Regulations under I.R.C. § 6694 also allow a tax return preparer to rely in good faith on information or advice from others.

- The practitioner may not ignore the implications of information furnished to, or actually known by, the practitioner.
- The practitioner must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

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VI. MATERIAL ADVISORS

A. Requirements.

1. I.R.C. § 6111 requires that a material advisor with respect to a reportable transaction make a return.
2. I.R.C. § 6112 requires that a material advisor with respect to a reportable transaction maintain a list of advisees.

B. Material Advisor. Defined in I.R.C. § 6111(b)(1) as a person who provides material aid, assistance or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out a reportable transaction, and who derives gross income in excess of:

1. $50,000, if substantially all the tax benefits provided to natural persons, or
2. $250,000, in any other case.

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C. Reportable Transaction. Defined in Treas. Reg. § 1.6011-4(b). Reportable transactions include:

1. Transactions identified by the IRS as listed transactions;
2. Transactions where confidentiality is imposed on the taxpayer client and the advisor receives a fee of at least:
   a. $250,000 if the taxpayer is a corporation, or a partnership or trust all of the owners or beneficiaries of which are corporations;
   b. $50,000 for all other transactions;
3. Transactions with contractual protection as to fees;
4. Transactions identified by the IRS as transactions of interest; or
5. Section 165 loss transactions:
   a. $10 million in one taxable year or $20 million in a combination of taxable years for corporations, or partnerships that have only corporations as partners;
   b. $2 million in one taxable year or $4 million in a combination of taxable years for partnerships, individuals, S corporations, or trusts; or
   c. $50,000 in one taxable year for individuals or trusts if the loss arises from a section 988 transaction.

D. Penalties.

1. I.R.C. § 6707 imposes a penalty on a material advisor for failure to file a return, or for filing a false or incomplete return, with respect to a reportable transaction:
    - $50,000
    - But for a listed transaction: greater of $200,000 or 50 percent of income derived from transaction (75% if failure was intentional)
2. I.R.C. § 6708 imposes a penalty on a material advisor for failure to maintain a list of advisees with respect to a reportable transaction:
    - For failure to provide within 20 business days of IRS request, $10,000 per day for each day of such failure after the 20th day

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VII. OTHER STANDARDS

A. Other requirements or standards not covered in detail in this outline that practitioners should be aware of are set out more fully within the authorities referenced below:

1. standards under Circular 230 § 10.29 and applicable rules of professional conduct regarding conflicts of interest;
2. standards under Circular 230 § 10.25, applicable rules of professional conduct, and Federal laws regarding practice by former government employees;
3. standards under Circular 230 § 10.30, applicable rules of professional conduct, and American Bar Association and applicable State bar requirements regarding solicitation or advertising;
4. standards under Circular 230 §§ 10.28 and 10.51(a)(8) and applicable rules of professional conduct regarding returning or safekeeping a client's records or other property;
5. standards under Circular 230 § 10.51 regarding incompetence and disreputable conduct for which an attorney may be sanctioned; and
6. to the extent applicable (and not overridden by more stringent standards subsequently imposed by statutes, regulations or Circular 230), standards under ABA and State Bar ethics opinions.

VIII. CASE LAW REGARDING "PRACTICE" BEFORE IRS

A. *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014), *aff'g* 917 F. Supp. 2d 67 (D.D.C. 2013). Involved tax return preparers who were not attorneys, CPAs or enrolled agents. The court held that the statute defines practice before the IRS as representing persons before the IRS; mere preparation and filing of returns does not constitute practice before the IRS and could not be regulated under Circular 230.

B. *Ridgely v. Lew*, 55 F. Supp. 3d 89 (D.D.C. 2014). Followed *Loving* and held that preparation of an ordinary refund claim before filing a power of attorney with the IRS does not constitute practice before the IRS, so the IRS cannot prohibit charging a contingent fee under Circular 230 § 10.27.

VIII. CASE LAW REGARDING "PRACTICE" BEFORE IRS (Continued)

C. Sexton v. Hawkins, 119 A.F.T.R. 2d 2017-1187, 2017-1 U.S.T.C. ¶ 50,181 (D. Nev. 2017). Individual who was previously disbarred as lawyer and suspended from practice before IRS became tax return preparer. Court followed *Loving* and held that preparation of tax returns did not constitute practice before IRS.

D. **Ramifications.** Not advisable to rely on these cases.

1. They constitute binding precedent only in D.C. Circuit, District of Columbia, and District of Nevada. IRS has not acquiesced.
2. Only the *Ridgely* case addressed a situation where a person who was engaged in tax return preparation also happened to represent taxpayers before the IRS. IRS asserts that it can regulate tax return preparation and other activities by a person who happens to represent taxpayers before the IRS, not just the person's representation of taxpayers before the IRS.

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CHOICE OF ENTITY:
TAX, LIABILITY AND FUNCTION DRIVERS FOR ENTITY SELECTION

Austin C. Carlson, JD, CPA

Objectives

1. Understand how state **<u>choice of entity</u>** interacts with federal **<u>tax status</u>** and the voluntary and involuntary ways to change tax status.

2. Understand the main drivers for choice of entity:
   - Tax;
   - Liability; and
   - Entity Functionality.

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OBJECTIVE ONE

Understand how state **choice of entity** interacts with federal **tax status** and the voluntary and involuntary ways to change tax status.

Texas Legal Entity Choices

1. Corporations
   a) For-Profit
   b) Non-Profit
   c) Professional
2. Partnerships
   a) General Partnership (GP)
      i. LLP Registration (LLP)
   b) Limited Partnership (LP)
      i. LLP Registration (LLLP)
3. Limited Liability Companies
   a) LLC
   b) PLLC
4. Associations
   a) Cooperative
   b) Professional

Federal Taxation Types (Federal Tax Form)

- Corporation
  - C Corporation (1120)
  - S Corporation (1120S)
  - REIT (1120-REIT)
  - Tax Exempt (990)
- Partnership
  - General (1065)
  - Limited (1065)
  - MLP (1065)
- Sole Proprietorship (Schedule C)

Federal Tax Treatment of Domestic Entities

Default Treatment

a) Corporations and "Associations" = C Corporation

b) Partnerships = Partnership *(unless partners are disregarded)*

c) LLCs

   i. One Member = Disregarded entity (sole proprietorship)

   ii. Two or More Members = Partnership

<u>Note</u> – Rules for state tax and foreign entities are different

Federal Tax Treatment of Domestic Entities (Continued)

- Check The Box Flexibility (Form 8832): ONLY Associations, Partnerships, and LLCs
  a) Can only elect once every 5 years
  b) Foreign rules are different
  c) Corporations cannot check the box

- Corporations: S Corporation Elections (Form 2553)

Federal Tax Treatment of Foreign Entities

- A foreign entity which is not a “per se” corporation is an “eligible” entity classified as:
  - A partnership if it has two or more members (i.e., owners) and at least one member does not have limited liability,
  - A corporation (“association”) if all members have limited liability, or
  - A DRE if it has a single owner that does not have limited liability.
- A foreign business entity is a “per se” corporation, not eligible to elect, if it is specifically enumerated type of foreign entity listed in the regulations dealing with foreign organized entities

Taxation Type Example: LLC

Single Member Texas LLC

a) Default Tax Status: Disregarded entity

b) Election Options: C or S Corporation

c) Admission of Member: Keeps default taxation, but next year gets a second member. Taxation type?

   i. Must file as a partnership.

   ii. Partial year as disregarded entity, partial year as partnership.

   Deemed Transaction – Rev. Rul. 99-5

d) Effect of two member LLC losing one during year *See* Rev. Rul. 99-6

OBJECTIVE TWO

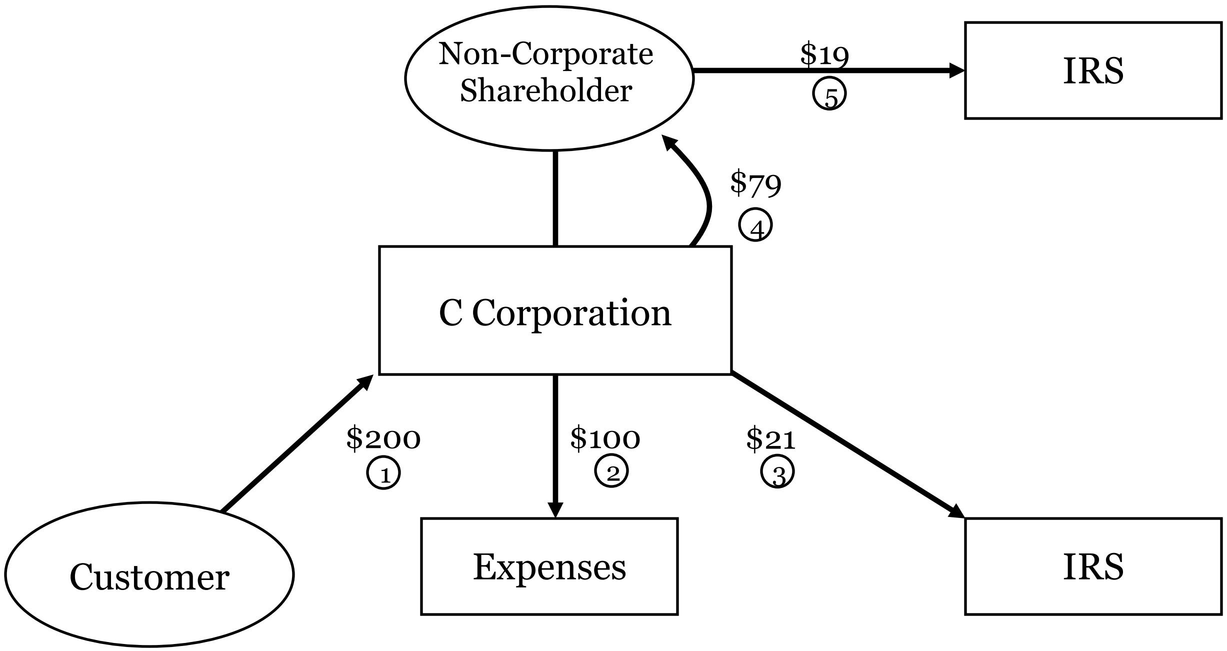
Understand the main drivers for entity selection:

- Tax;
- Liability; and
- Entity Functionality

Common Tax Drivers

1. Federal Taxation: Double Taxation (Entity and Owner) v. Single Taxation (Owner Only)
2. State Taxation of Entity
3. Taxation of In Kind Distributions
4. Tax-Free Merger

Double Tax Example: Ordinary Income



Revenue	200
Expenses	-100
Net Income	100
Less: 21% Corporate Tax	-21
After-Tax (Corporate)	79
Less: 23.8% Dividend Tax	-19
To Shareholder After All Taxes	60
Aggregate Tax Rate	**40%**

If the $79 of after-tax earnings are retained in the C Corporation, Shareholder's Tax Basis in the Shares does not increase.

Assuming top capital gains rate of 20% and application of 3.8% Net Investment Tax.

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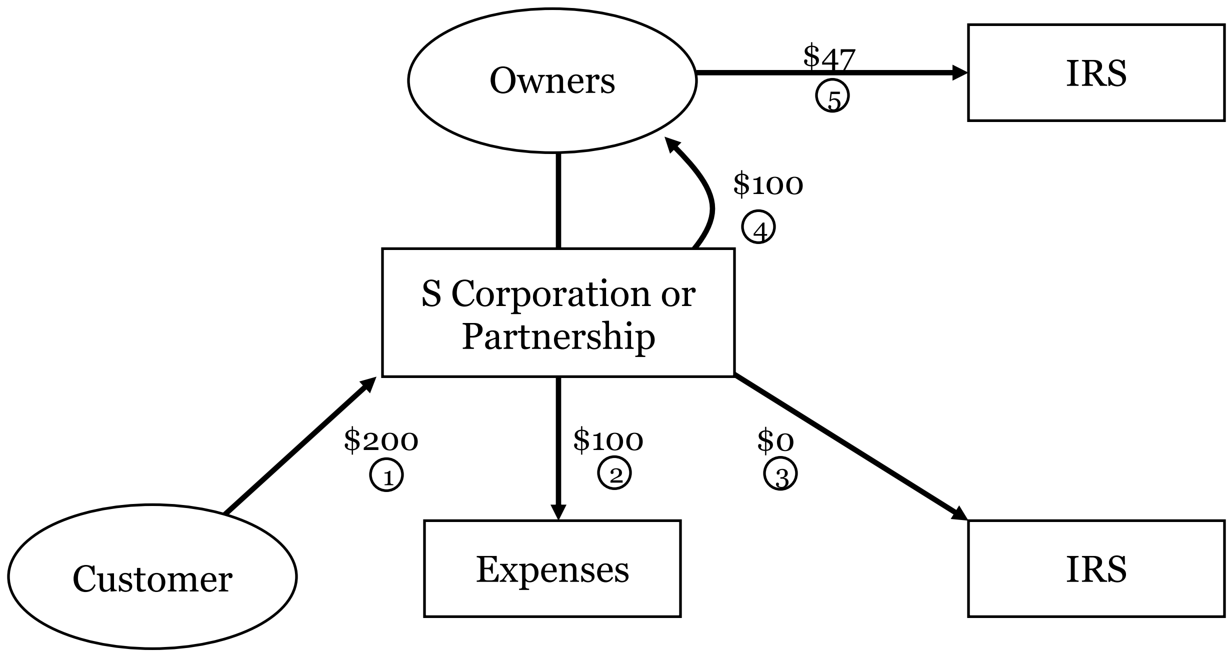
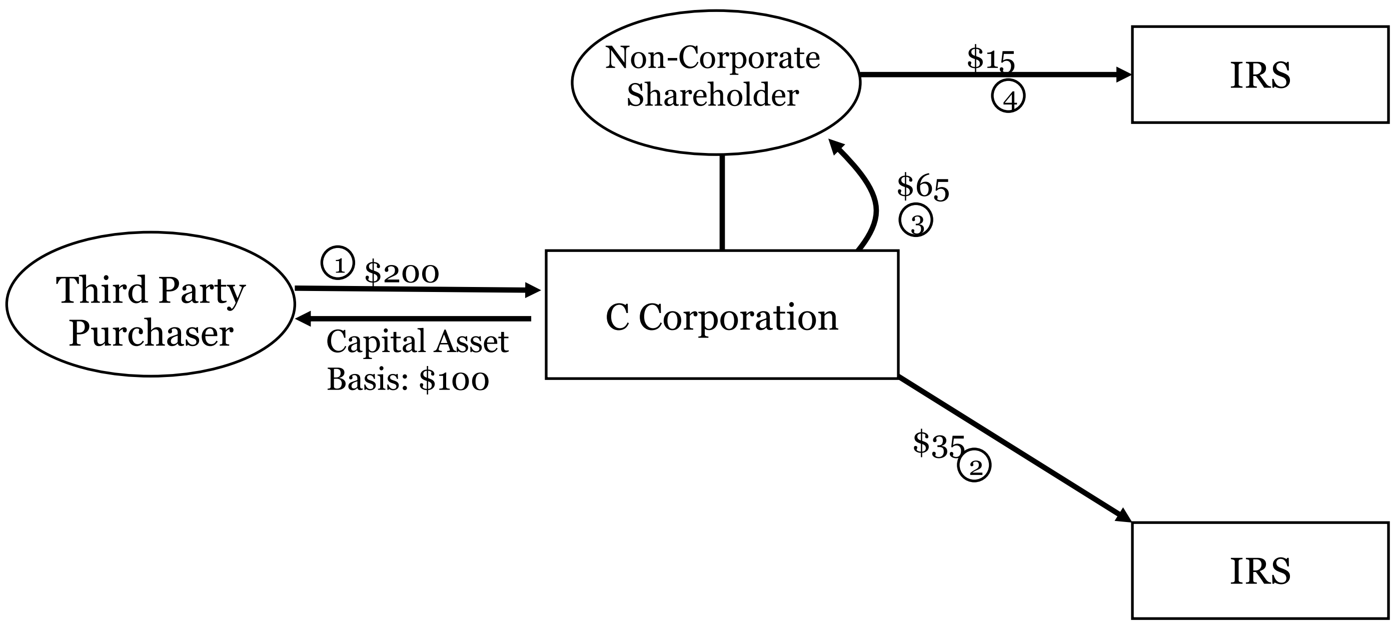
Single Tax Example: Ordinary Income



Revenue	200
Expenses	-100
Net Income	100
Less: Corporate Tax	-0
After-Tax (Corporate)	100
Less: 37% Shareholder Tax	-37
Retained Earnings	63
Aggregate Tax Rate	**40%**

Pass through entity distributes $100 to Owners Taxes; Owners pay $37 in tax at ordinary income rates, retains $64.

Double Tax Example: Capital Gain

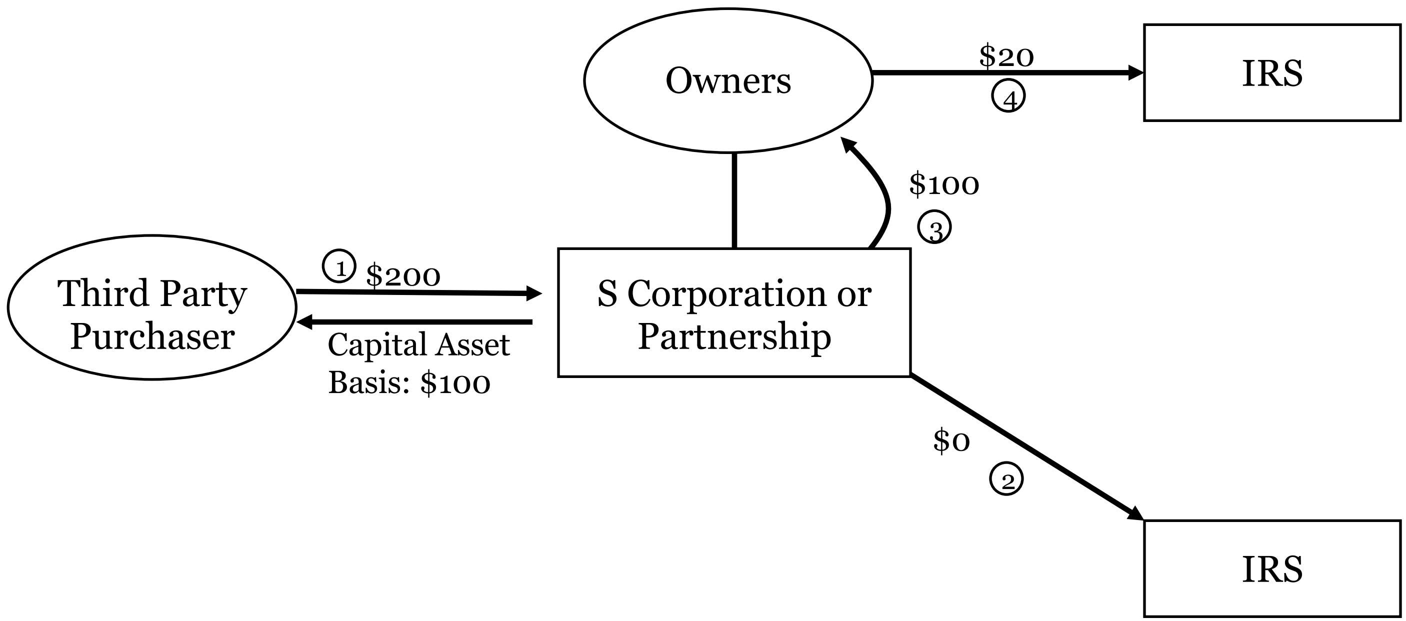


Revenue	200
Expenses	-<u>100</u>
Net Income	100
Less: 21% Corporate Tax	-<u>21</u>
After-Tax (Corporate)	79
Less: 23.8% Dividend Tax	-<u>19</u>
To Shareholder After All Taxes	60
Aggregate Tax Rate	**40%**

If the $65 of after-tax earnings are retained in the C Corporation, Shareholder's Tax Basis in the Shares does not increase.

Assuming top capital gains rate of 20% and application of 3.8% Net Investment Tax.

Single Tax Example: Capital Gain



Revenue	200
Basis in Capital Asset	-100
Net Income	100
Less: Corporate Tax	-0
After-Tax (Corporate)	100
Less: 20% Shareholder Tax	-20
Retained Earnings	80
Aggregate Tax Rate	**20%**

Pass through entity distributes $100 to Owners Taxes; Owners pay $20 in capital gain tax, retain $80.

Assumes active participation by owners to avoid application of 3.8% Net Investment Tax.

Tax Driver Comparison By Tax Status

Taxation Attribute	*Federal Tax Status* C Corp	S Corp	Partnership	Sole Proprietorship	Tax Exempt
Levels of Taxation	Entity AND Owner	Owner; Sometimes Entity	Owner ONLY	Owner ONLY	Sometimes Entity
In-Kind Distributions Taxed	Yes	Yes	No	No	N/A - Distributions prohibited
Eligible for Tax-Free Merger	Yes	Yes	Yes	N/A - Sole proprietor is tax owner of assets	Yes

Taxation Attribute	*State Entity* Corporation	LLC	Partnerships	Sole Propr. (No Entity)	Non-Profit Corp.
Subject to Texas Franchise Tax	Yes	Yes	Yes, unless liability is not limited or meets passive entity exception	No	No (if also tax exempt for state tax purposes)

Liability Drivers

1. Limited liability for owners. What's at stake?

2. General partnership (unless LLP registration)

3. Limited Partnership (unless LLLP registration)

4. All other entities

Common Function Drivers

1. Entity Formalities Required (State Law Issue)
   a) State formation certificate filing.
   b) Written agreement required.
   c) Corporate minutes.
2. Management of Entity (State Law Issue)
3. Ownership Restrictions (State Law and Tax Issue)
   a) Professional licenses (State Law Issue)
   b) Number of shareholders (Tax Issue)
   c) Foreign ownership (Tax Issue)
4. Allocation of Income Restrictions (Tax Issue)
   a) Different classes of stock
   b) Disproportionate allocations
   c) Profits Interests

Common Function Driver Comparison By Entity

Table One: Corporate Formalities and Management

<u>*State Entity Type*</u>

<u>*Functional/Structural Attribute*</u>	Corporation	General Partnership	Limited Parntership	Limited Liability Company	Non Profit Corporation
Formation Document must be Filed with State	Yes	No	Yes	Yes	Yes
Written Organizational Agreement Required	Yes	No	No	No	Yes
Corporate Formalities Required (Issued shares, minutes, resolutions)	Yes	No	No	No (unless required by agreement)	Yes
Governing Persons	Board of Directors; Shareholders; President & Secretary required, other Officers optional.	General Partner; Officers are optional.	General Partner; Officers are optional.	Managers (optional); Members; Officers are optional.	Directors; Members (optional); President & Secretary required, other Officers optional.

Common Function Driver Comparison By Entity
Table Two: Ownership Restrictions and Income Allocation

	Federal Tax Status				
Functional/Structural Attribute	**C Corp**	**S Corp**	**Partnership**	**Sole Proprietorship**	**Tax Exempt**
Number of Owners Allocated	Unlimited	100 or Less	Unlimited[1]	1	N/A (in Texas may have "Members")
Foreign Owner Allowed	Yes	No	Yes	Yes	Yes
Different Classes of Stock Allowed	Yes	No	N/A	N/A	N/A
Disproportionate Distribution of Cash Allowed	Yes (Through preferred stock)	No	Yes	N/A	N/A - Distributions prohibited

[1]Note, however, that an established market for the purchase and sale of partnership interests may create a publicly traded partnership, which is subject to numerous special tax rules (like REITs).

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Other International Concerns

- Foreign ownership into a S Corp (not allowed – S Corp bust)
- Foreign ownership into a US partnership
- Foreign ownership into a Corporation
- Gift and estate tax considerations of any ownership into a U.S. entity
- Form W-8BENs, Income, and Estate tax treaties

A Word of Caution on Entity Selection

- Business objectives should be the top priority.

- Long term flexibility and exit planning:
  - Distributions of property.
  - Adding additional owners.
  - Planning for ultimate sale of business.

- Topic for another presentation: many structures will require multiple entities.

TAX REFORM CONSIDERATIONS

The Passthrough Deduction

- What's at stake?

- Up to a 20% deduction on qualified business income (doesn't include wages or guaranteed payments).

- For a taxpayer paying at the 37% rate, the deduction can lower their taxes up to 7.4% down to an effective rate of 29.6%

<u>BUT WAIT – It's damn hard to get the full 7.4% benefit.</u>

Section 199A Passthrough Deduction

	Specified Service Businesses	Other Businesses
Above AGI Limit	Disallowed Completely Phase Out Between Limit and $415k AGI MFJ/$207.5k Single	Subject to W-2/Deployed Capital Limitation
ADJUSTED GROSS INCOME ("AGI") LIMIT: $315k MFJ, $157.5k Single		
Below AGI Limit	Allowed in Full	Allowed in Full

W-2/Capital Limitation

- W-2 wages paid and capital limitation equals the <u>greater</u> of
  - 50% of W-2 wages paid by the QTB.
  - 25% of W-2 wages paid by the QTB plus 2.5% of the unadjusted basis of qualified property.

Can you restructure to take advantage of this?

- If you are subject to the W-2/Deployed Capital Limitations, as the law is written right now, S Corporations can maximize the benefit of the deduction.

- There may also be planning for separating businesses between Specified and Non-Specified ("Crack and Pack").

BEAT

- New base erosion anti-abuse tax (BEAT)
- BEAT is an alternative minimum tax on U.S. corporations (other than REITs, RICs or S corporations) that have annual gross receipts for the three prior years of at least $500 million and that make certain "base erosion" payments to foreign related parties equal to at least 3 percent of total deductible payments (with certain exclusions)
- Gross receipts of foreign entities not included if not U.S. effectively connected income
- BEAT imposed if 10 percent of the corporation's "modified taxable income" exceeds its regular tax liability reduced by certain allowable credits
  - For 2018, the percentage is 5 percent; and after 2025 it is 12.5 percent
  - Modified taxable income is equal to the corporation's taxable income without regard to base erosion payments or a specified percentage of any allowable net operating loss deduction

GILTI

- Global intangible low-taxed income (GILTI) is a new concept to the U.S. tax system designed to prevent erosion of the U.S. tax base after shifting to a participation exemption regime
- Absent GILTI, if foreign earnings were all in a tax-haven and could be repatriated tax-free under the 100 percent DRD, this would erode the U.S. tax base
- U.S. shareholder who owns 10 percent or more of the stock of a CFC must currently include in income such shareholder's pro rata share of the CFC's GILTI

GILTI

- GILTI is generally treated in manner similar to Subpart F income
- GILTI is defined as the excess (if any) of the U.S. shareholder's "net CFC-tested income" over the shareholder's "net deemed tangible income" return
- Net CFC-tested income is the excess (if any) of:
  - Aggregate of the U.S. shareholder's pro rata share of any "tested income" of each CFC owned by the shareholder, over
  - Aggregate of the U.S. shareholder's pro rata share of any "tested loss" of each CFC owned by the U.S. shareholder

GILTI

- Tested income of a CFC is equal to the CFC's gross income less allocable deductions (including taxes), but excluding the following:
  - Income which is effectively connected with a U.S. trade or business (which is already generally taxable)
  - Subpart F gross income (which is already generally taxable)
  - Amounts excluded from Subpart F income under the high-tax exception
  - Dividends received from a foreign related-party
  - Foreign oil and gas extraction income

GILTI

- Net deemed tangible income return (the second part of the main equation in determining a CFC's GILTI) is equal to the excess (if any) of:
  - 10 percent of the aggregate of the U.S. shareholder's pro rata share of the "qualified business asset investment" of each CFC, over
  - The U.S. shareholder's interest expense taken into account previously in measuring tested income (but only to the extent interest income associated with the expense is not part of tested income)

GILTI

- Qualified business asset investment is equal to the quarterly average of the CFC's adjusted basis in tangible depreciable property used in its trade or business

- U.S. corporate shareholder of a CFC (other than an S corporation, REIT or RIC) is allowed to deduct 50 percent of GILTI for tax years through 2025 and 37.5 percent of GILTI after 2025
  - Effective corporate rate on GILTI is 10.5 percent before 2026 and 13.125 percent thereafter

- U.S. corporate shareholder of a CFC can claim a foreign tax credit for 80 percent of the foreign taxes attributed to the included GILTI amount
  - GILTI treated as a separate foreign tax credit basket
  - Any unused GILTI foreign tax credits cannot be carried forward or carried back to other tax years

GILTI

- U.S. individuals, partnerships and S corporations are not entitled to the 50 percent deduction for GILTI allowed to C corporations
  - Consequently, individual shareholders of CFCs are subject to full U.S. income tax on GILTI inclusions at ordinary rates (subject to possible mitigation with a Section 962 election)

- Effective for tax years of CFCs beginning after Dec. 31, 2017, and for tax years of U.S. shareholders in which or with which such taxable years end

GILTI

- The Big Issue:

Individuals owning a CFC may have GILTI income but will not be eligible for the FTC.

Solution: Check the box

FDII

- Provision intended to encourage retention of intangibles and production activities assets in the U.S. by providing favorable corporate income tax rates
- U.S. corporation (other than a RIC, REIT or S corporation) allow to deduct 37.5 percent of its foreign-derived intangible income (FDII) for taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2026
  - For taxable years beginning after 2025, the FDII deduction percentage is reduced to 21.875 percent
  - Thus, FDII will be taxed at a 13.125 percent effective rate through 2025 and 16.406 percent beginning in 2026
- Deduction for FDII is not available to S corporations and non-corporate taxpayers

FDII

- U.S. corporation's FDII is determined under the following formula:

Deduction eligible income – Deemed tangible income return

X

Foreign-derived deduction eligible income/ Deduction eligible Income

FDII

- Deduction eligible income of a U.S. corporation is the gross income of the corporation less allocable deductions (including foreign taxes)--- excluding the following:
  - Subpart F income
  - GILTI
  - Financial services income
  - Dividends received from CFCs
  - Domestic oil and gas extraction income
  - Foreign branch income

International Tax Withholding

A Primer

Presented By:

DENTON & FAHRING PLLC

TAX LAW, CONTROVERSY, AND LITIGATION

Questions can be directed to:

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Outline

1. Why Does Withholding Exist?
2. Types of Withholding
   A. FDAP
   B. FATCA
   C. FIRPTA
   D. Foreign Partner

OUTLINE

- Why Does Withholding Exist?
- Types of Withholding
  - FDAP
  - FATCA
  - FIRPTA

Why Does Withholding Exist?

So, What's The Deal With International Tax Withholding?

THE PROBLEM:

- U.S. persons subject to U.S. tax on worldwide income
- Nonresident aliens and foreign corporations subject to U.S. tax on:
  1. U.S. source FDAP income at a 30% rate; and
  2. Effectively connected income at normal graduated rate
- U.S. has limited jurisdiction to force a foreign person to:
  1. Pay U.S. tax on repatriated income if the foreign person has no assets in the U.S.; or
  2. Provide info about foreign accounts, entities, or assets owned by U.S. persons

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So, What's The Deal With International Tax Withholding?

THE SOLUTION:

International Tax Withholding

a.k.a.,

Make it Somebody Else's Problem

The Gist of International Tax Withholding

U.S. persons making certain payments to certain foreign payees must either:

- **Withhold certain amounts from such payments and deposit with IRS; or**
- **Be able to reliably associate payment with documentation showing payee is exempt from withholding or qualifies for reduced rate; or**

Said U.S. persons will be on the hook for:

- **Amounts that should've been withheld**
- **Penalties**
- **Interest**

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OUTLINE

- Why Does Withholding Exist?
- Types of Withholding
  - FDAP
  - FATCA
  - FIRPTA

Types of Withholding

A Tale of Two Chapters (A Couple Sections More or Less)

CHAPTER 3 WHITHHOLDING	
FDAP	I.R.C. §
• Nonresident Aliens	1441
• Foreign Corporations	1442
FIRPTA	1445
Foreign Partner	1446
CHAPTER 4 WHITHHOLDING	
• a.k.a. FATCA	1471-74

→

CHAPTER 3 WHITHHOLDING	
FDAP	I.R.C. §
Nonresident Aliens	1441
Foreign Corporations	1442
CHAPTER 4 WHITHHOLDING	
a.k.a. FATCA	1471-74
FIRPTA WITHHOLDING (§ 1445)	
FOREIGN PARTNER WITHHOLDING (§ 1446)	

OUTLINE

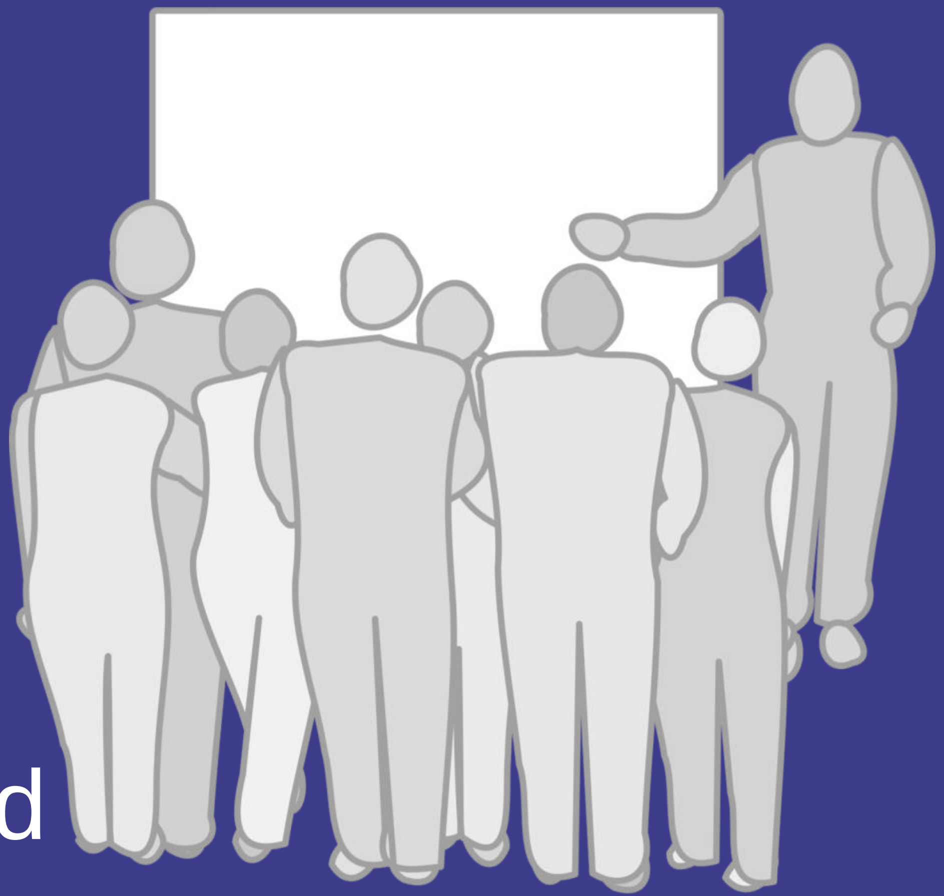
- Why Does Withholding Exist?
- Types of Withholding
  - FDAP
  - FATCA
  - FIRPTA

FDAP Withholding

Elements of FDAP Withholding

FDAP withholding generally applies if there's:

- A **withholding agent** in receipt of a payment
- To a **foreign payee**
- Of **U.S. source income**
- That is **FDAP** and **not ECI**, and
- No exception applies



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What's a Withholding Agent?

- *Any* person
  - Domestic or foreign
- Who has control, custody, disposal, or payment of
- An item of income of a foreign person
  - That is U.S. source income
  - That is FDAP and not ECI

More Fun Facts

- Is usually the last U.S. person to have custody over payment to foreign payee
- Each item subject to withholding can have more than one withholding agent
- Withholding only has to happen once for each item

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What's a U.S. Person?

- **U.S. Citizen**
- **U.S. Resident**
- **Domestic Partnership**
  - A partnership formed under laws of U.S., any state, or D.C.
- **Domestic Corporation**
  - A corporation formed under laws of U.S., any state, or D.C.
- **Domestic Estate**
  - An estate whose income is U.S. source or effectively connected with a U.S. trade or business
- **Domestic Trust**
  - U.S. court can have primary supervision + U.S. person controls all substantial decisions

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What's a Foreign Payee?

- A foreign payee is a payee that is a foreign person
- Examples of foreign persons:
  - **Nonresident aliens** –not U.S. citizen or resident alien
  - **Foreign corporations** & **partnerships** – corporations or partnerships not formed under the laws of the United States, any State, or D.C.
  - **Foreign estates** – estates whose income is foreign source & not effectively connected with U.S. trade or business
  - **Foreign trusts** – trusts over which a U.S. court cannot exercise primary administrative supervision or for which no U.S. person has authority to control all substantial decisions of the trust

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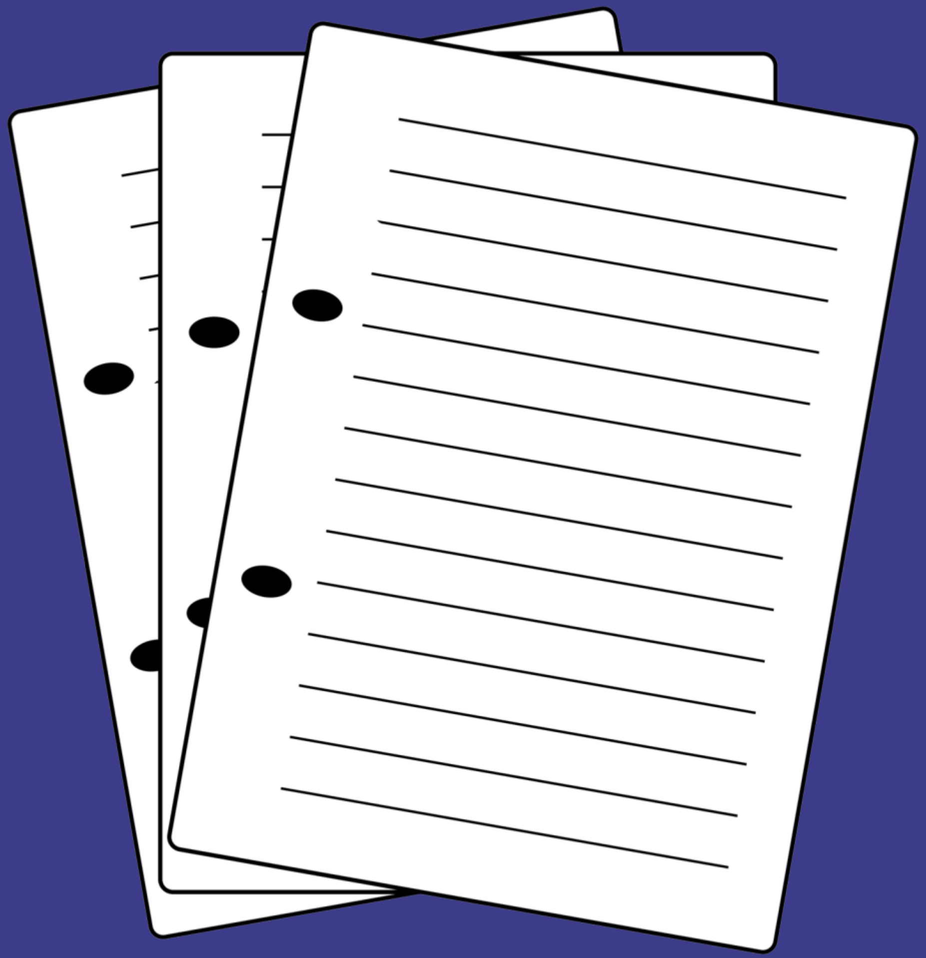
How to Tell if a Payee is U.S. or Foreign?

- With documentation:
  - W-8 – Foreign person
  - Form 8233 – Nonresident alien
  - W-9 – U.S. person
- In absence of documentation, relying on a presumption regarding status
  - Presumptions are used only to determine status of payee – not used to determine whether reduced rate of withholding applies



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Of Agents and Partnerships . . .

- If withholding agent makes a payment to a U.S. person that withholding agent knows or reasonably should know is an agent of a foreign person, needs to treat payment as if to a foreign payee
- If withholding agent makes a payment to a partnership (or chain of partnerships) disregard until get to a partner that is not a partnership

What is U.S. Source Income?

- Have to look I.R.C. §§ 861-65 to determine source
- Examples of U.S. source rules:
  - Interest paid by a domestic corporation or a resident of the United States
  - Dividends paid by a domestic corporation
  - Rents, royalties for the use of property or the right to use property in the United States

What's FDAP?

- Interest
- Dividends
- Rents
- Salaries
- Wages
- Premium
- Annuities
- Compensations

- Remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income

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What Income is Not ECI?

- If the foreign payee has no trade or business in the U.S., then U.S. source income is not ECI
- If the foreign payee has a trade or business in the U.S., then U.S. source FDAP may not be ECI if:
  - Such income isn't derived from activities of the trade or business; and
  - Such income isn't derived from assets used in the trade or business

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What are the Obligations of a Withholding Agent?

- Withhold 30% of payment to foreign payee
  - (unless foreign payee provides W-8 BEN that qualifies for reduced treaty rate)
  - If withholding agent withholds on payment he/she reasonably believes subject to withholding, relieved from liability to foreign payee
- Remit withheld amount to IRS within specified time frame:
  - If less than $200 in year, then by March 15 of the following yea
  - In month where amount withheld equals or exceeds $200, then within 15 days of end of month
  - In quarter month where amount withheld exceeds $2,000, then within 3 days of end of quarter month
- File Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons by March 15 of the following year
- File Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding by March 15 of the following year (copies to foreign payees)

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What if Making Payment to a Foreign Intermediary?

Foreign Intermediary: Foreign person who receives payment & isn't beneficial owner (i.e., bank)

1. **Non-Qualified Intermediary (NQI)**
2. **Qualified Intermediary, No Primary Withholding Responsibility (QI, Non-PWR)**
3. **Qualified Intermediary, Primary Withholding Responsibility (QI, PWR)**
4. **Withholding Foreign Partnership (WFP)**

Withholding agent must obtain documentation from NQI for the portions of payment allocable to each person for whom NQI is collecting payment and withhold on portions subject to withholding

- If NQI doesn't provide this documentation, withholding agent withholds at statutory rate on that portion of payment for which NQI hasn't provided documentation

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Provides withholding agent with info regarding portion of payment subject to withholding

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Foreign intermediary withholds on payment instead of withholding agent

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WFP withholds on payments instead of withholding agent

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Exceptions to FDAP Withholding

Withholding agent may not have to withhold if payee provides certification that:

- W-9 = Request for Taxpayer Identification Number and Certification
- W-8BEN = Certificate of Foreign Status of Beneficial Owner for United States Withholding and Reporting (Individuals)
- W-8BEN-E = Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)
- W-8ECI = Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States
- W-8EXP = Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding and Reporting
- W-8IMY = Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding and Reporting
- Form 8233 = Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual

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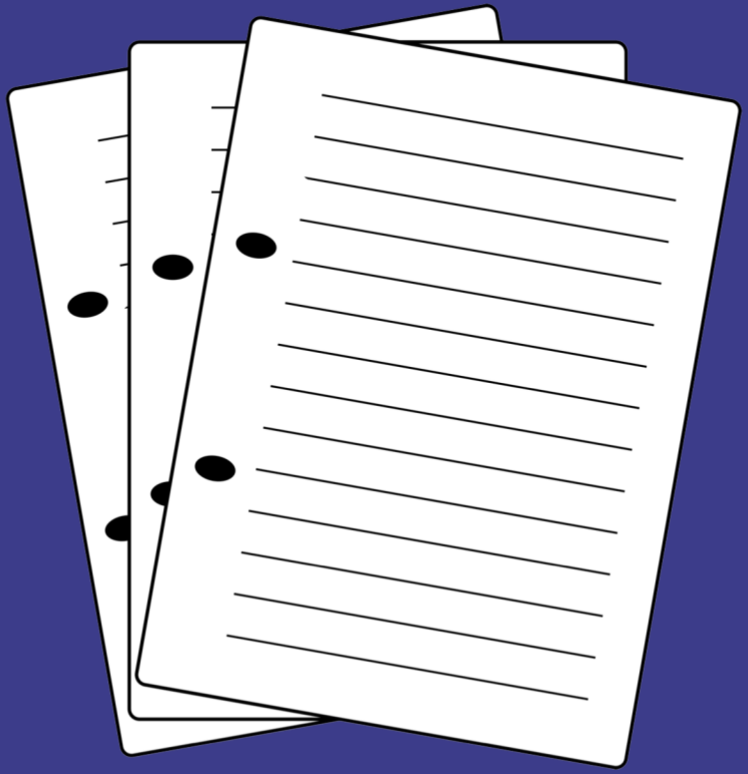
Returns Withholding Agent Has to File

- Form 1042
  - Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
- Form 1042-S
  - Foreign Person's U.S. Source Income Subject to Withholding
- Form 1042-T
  - Annual Summary and Transmittal of Forms 1042-S



OUTLINE

- Why Does Withholding Exist?
- Types of Withholding
  - FDAP
  - FATCA
  - FIRPTA

FATCA Withholding

What Are The Requirements of FATCA Withholding?

A withholding agent must withhold 30% of withholdable payments to:

- foreign financial institutions (“FFI”) or
- nonfinancial foreign entities (“NFFE”)

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What's a Withholdable Payment?

Generally, any payment of non-ECI from the US of the following types:

- Interest
- Dividends
- Rent
- Salaries
- Wages
- Premiums
- Annuities
- Compensations
- Remunerations
- Emoluments;
- Other FDAP; and
- **Any gross proceeds on the sale of any property that can produce interest or dividends from sources within the US**
  - Set to kick in after **December 31, 2018**

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What’s a Foreign Financial Institution (FFI)?

- Any **financial institution** that is a foreign entity, but does not include any entity that is formed under the laws of a possession of the US
- A **financial institution** means any entity that:
  - Accepts deposits in the ordinary course of a banking or similar business,
  - As a substantial portion of its business, holds financial assets for the account of others, or
  - Is engaged (or holding itself out as engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest (including a furthers or forward contract or option) in such securities, partnership interests, or commodities.

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What are the Withholding Requirements for FFIs?

A withholding agent must withhold 30% of a withholdable payment to a FFI unless the FFI:

- Is a type of entity that is deemed compliant with FATCA
- Participates in an agreement with the U.S. government to share information about U.S. account holders & U.S. substantial owners

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What's an NFFE?

- FATCA withholding does not apply if the beneficial owner of the payment is:
  - A corporation:
    - Whose stock is regularly traded on an established securities market
    - That is a member of the same affiliated group as a corp. that is regularly traded on an established securities market
  - An entity organized under the laws of a possession of the US & which is wholly owned by one or more *bona fide* residents of such possession

<u>Defined:</u>

Any foreign entity that is not an FFI

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What's an NFFE? (cont'd)

- FATCA withholding does not apply if the beneficial owner of the payment is any:
  - Foreign government, political subdivision of a foreign government, or wholly owned agency or instrumentality of any of the foregoing
  - International organization or any wholly owned agency or instrumentality thereof
  - Foreign central bank of issue
  - Other class of persons identified by the Secretary

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What are the Withholding Requirements for NFFEs?

A withholding agent is required to deduct & withhold 30% of any withholdable payment to an NFFE if the NFFE or any NFFE is the beneficial owner of the payment UNLESS:

- The beneficial owner or the payee provides the withholding agent with either:
  - o A certification that the beneficial owner does not have any substantial U.S. owners, or
  - o Name, address, and TIN of each substantial U.S. owner of such beneficial owner, &
- The withholding agent doesn't know or have reason to know that any of this info is incorrect, &
- The withholding agent reports this info to the Secretary

30%

or

or

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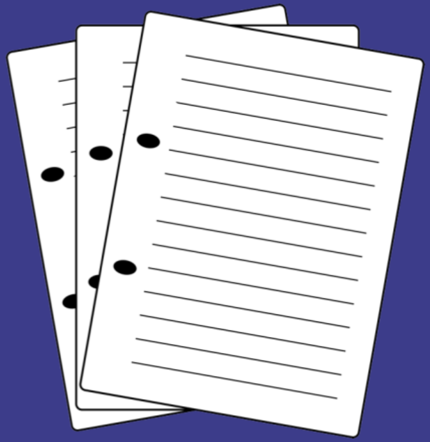
Requirements for Not Withholding Under FATCA?

- FFIs:
  - FFI provides certification that it has entered into an agreement with IRS to provide information regarding U.S. persons who are account holders

- NFFEs:
  - NFFE provides the withholding agent with information regarding all of the NFFE's substantial U.S. owners (which the withholding agent then provides to the IRS)
    - Substantial U.S. owner = U.S. person who owns 10% of the vote or value of the NFFE



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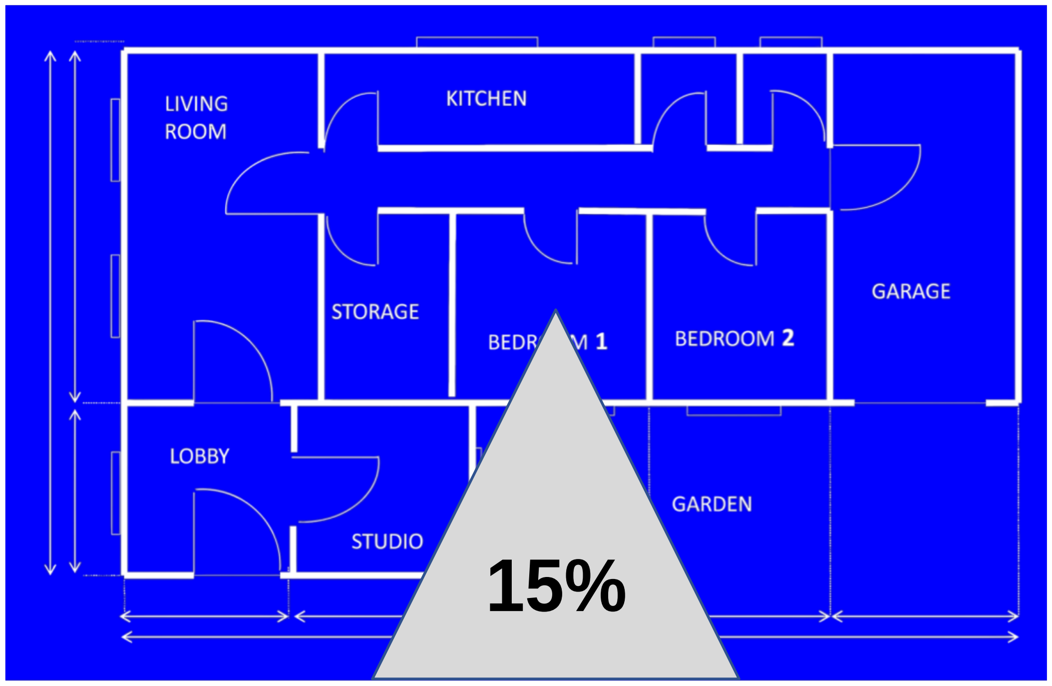
OUTLINE

- Why Does Withholding Exist?
- Types of Withholding
  - FDAP
  - FATCA
  - FIRPTA

FIRPTA Withholding

FIRPTA Withholding

- A transferee of a U.S. real property interest must withhold 15% of the total amount realized from the transfer if the transferor is a foreign person
- The transferee must remit the withheld amount to the IRS by the 20th day following the transfer



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What is a U.S. Real Property Interest?

- "U.S. real property interest" is defined as:
  - An interest in real property located in the United States; or
  - Any interest in any domestic corporation unless the taxpayer establishes that the corporation was never a <u>U.S. real property holding corporation</u> within 5 years of the date of disposition of the interest

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Exceptions to FIRPTA Withholding

- No withholding if:
  - Transferor provides an affidavit that is a U.S. person
  - Provides buyer with an affidavit that corporate seller is not a U.S. real property holding corporation
  - Transferee acquires property as a personal residence & purchase price is less than $300,000
  - IRS provides a statement that transferor is exempt from tax or has made satisfactory arrangements

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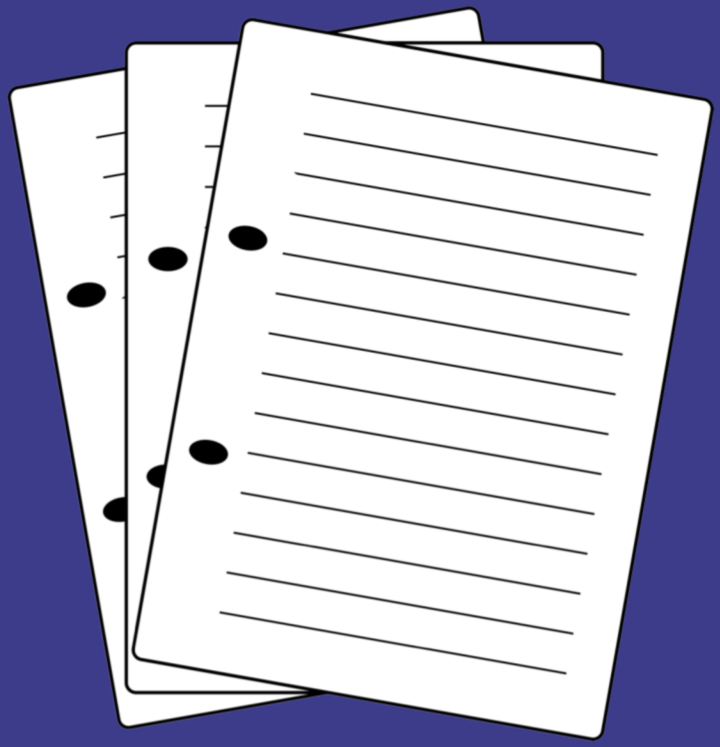
Forms for FIRPTA Withholding

- Form 8288
  - U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests within 20 days after date of transfer



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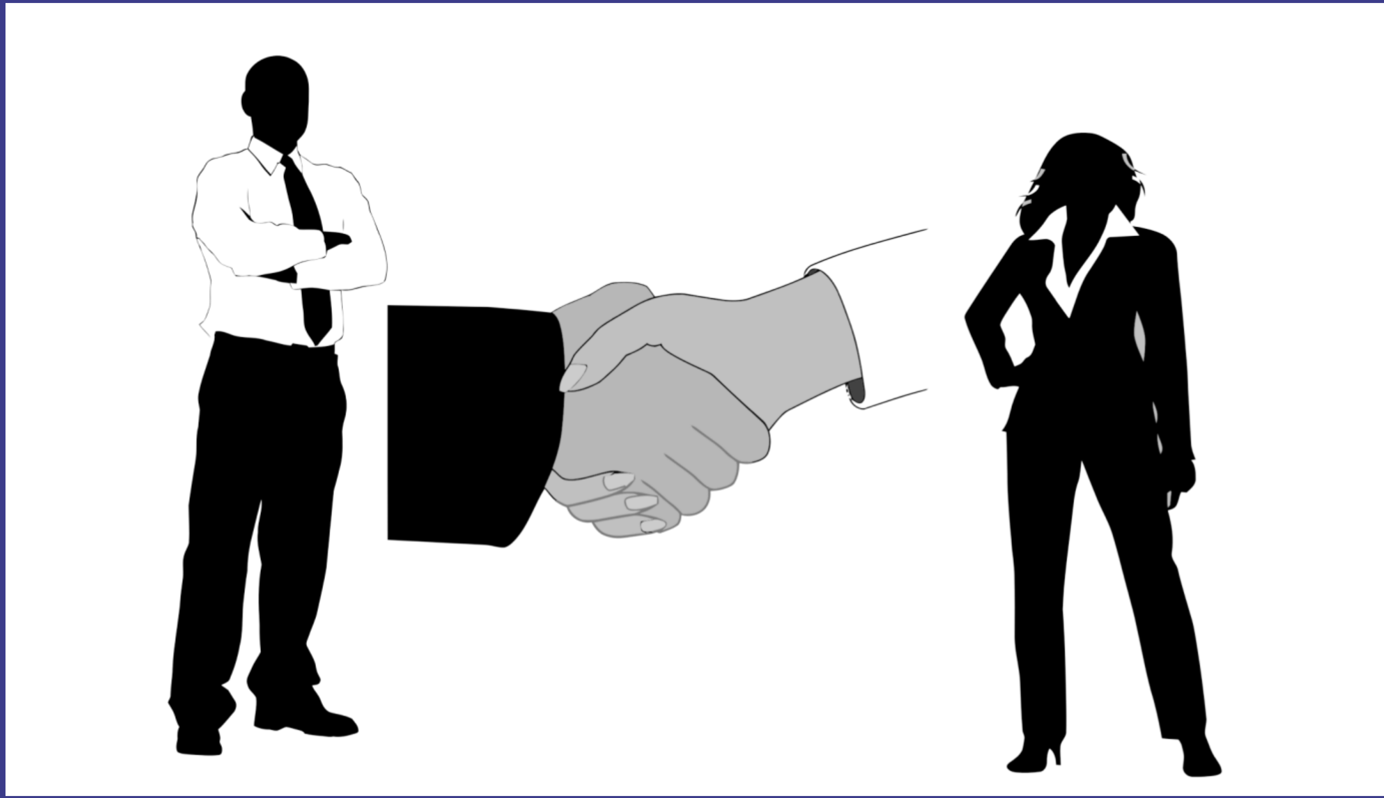


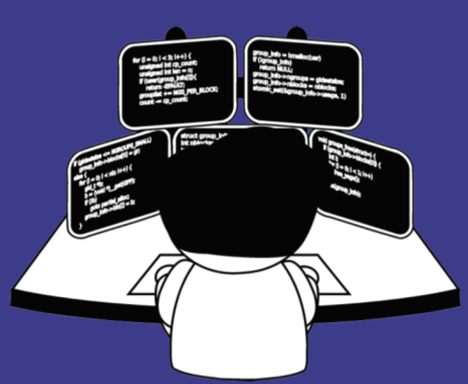
OUTLINE

- Why Does Withholding Exist?
- Types of Withholding
  - FDAP
  - FATCA
  - FIRPTA

Foreign Partner Withholding

Foreign Partner ECI Withholding – Background

- Partnerships are taxed at the partner level, not the partnership level
- When U.S. source payment is FDAP, not ECI, domestic partnership must withhold from payments to any foreign partner
- Tax on ECI to a foreign partner may not be collected absent foreign partner ECI withholding



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What is Foreign Partner ECI Withholding?

- Foreign partner withholding applies to partnership payments of ECI to foreign partner
- Applies to both foreign & domestic partnerships
- The rate is the highest applicable rate for each partner on the type of income being paid:
  - Withholding rate on ordinary income to foreign corporate partners is 21%
  - Withholding rate on ordinary income to foreign individual partners is 37%
- Due on the 15th day of 4th, 6th, 9th, and 12th months

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In Conclusion, International Tax Withholding is a Study in Contrasts

Withholding Type	Section	Payees Affected	Type of Income	Rate	Date for Remitting Withheld Funds
Chapter 3	1441, 1442	Nonresident aliens, foreign corporations	FDAP	30%	• < \$200 in year – March 15 of following year • ≥ \$200 in month – 15 days of month end • ≥ \$2,000 in quarter month – 3 days of quarter month end
FIRPTA	1445	Foreign persons	Gross proceeds from transfer of U.S. real property interest	15%	20 days after transfer
Foreign Partner	1446	Foreign partners	ECI allocable to foreign partner	Highest rate	15th day of 4th, 6th, 9th, and 12th months
FATCA	1471 thru 1474	FFIs and NFFEs	FDAP + gross proceeds (maybe)	30%	• < \$200 in year – March 15 of following year • ≥ \$200 in month – 15 days of month end • ≥ \$2,000 in quarter month – 3 days of quarter month end

Questions can be directed to:

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Bldg 3, Ste 400
Austin, TX 78746

Questions

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IC-DISCs: Structuring to Maximize Tax Benefits

Presented by

Robert Misey, Esq.

Chair, International Department
Reinhart Boerner Van Deuren, s.c.

(312) 207-5456; (414) 298-8135

rmisey@reinhartlaw.com

Reinhart
Boerner Van Deuren s.c. Attorneys at Law

Today's Discussion Topics

- Tax benefits of the IC-DISC
- Tests to qualify as an IC-DISC
- Requirements—manufacturing, destination, content
- Determining and maximizing the IC-DISC benefit
- A multitude of structuring techniques, including
  - The use of trusts for exporters whose ownership percentage changes
  - The use of IC-DISCs to compensate certain employees

Introduction to IC-DISC

- Formation of the IC-DISC
  - A single class of stock
  - A minimum par value of $2,500
  - Elect to be an IC-DISC with a Form 4876-A

Introduction to IC-DISC (cont.)

- Taxation of an IC-DISC and its shareholders
  - An IC-DISC is not subject to corporate tax
  - When the IC-DISC pays a dividend, its owners will pay income tax at a 20% rate
  - The tax savings to the manufacturing entity's owners is approximately 17 percentage points

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The Tests to Qualify as an IC-DISC

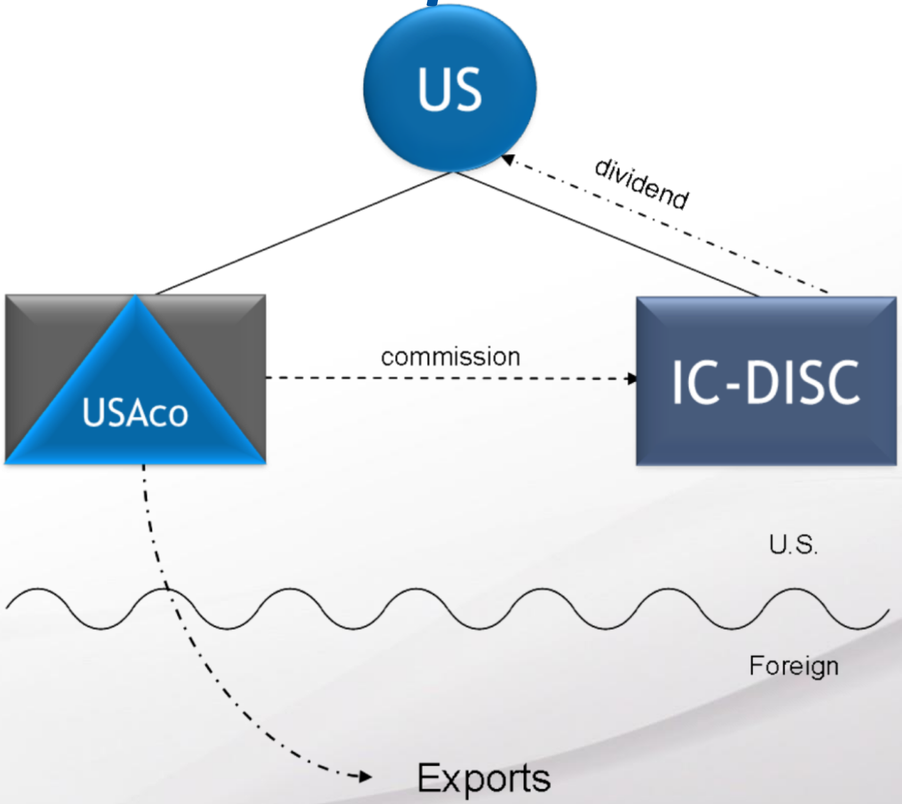
- Qualified Export Receipts Test
- Qualified Export Assets Test

The Tests to Qualify as an IC-DISC (cont.)

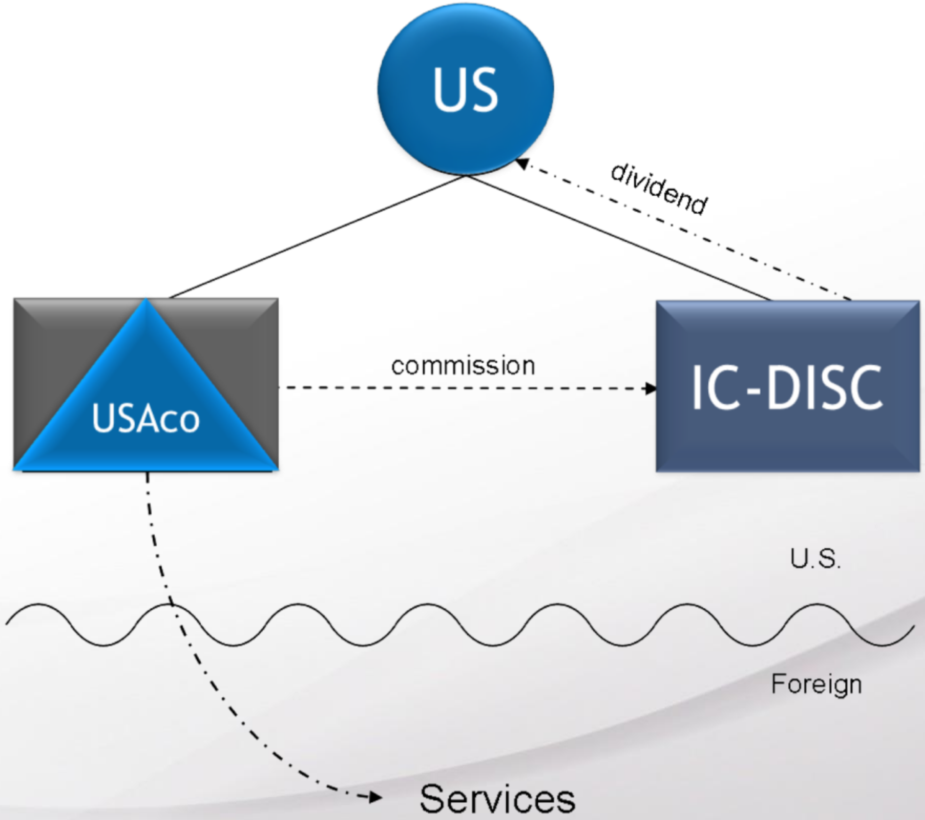
- 95% of its gross receipts must constitute qualified export receipts
  - Sales of export property
  - Rents for use of export property outside the United States
  - Services related to exports
  - Engineering or architectural services for construction projects abroad, and
  - Commissions

Example 1

Sales Produce GrossReceipts



Example 2
Services Produce GrossReceipts



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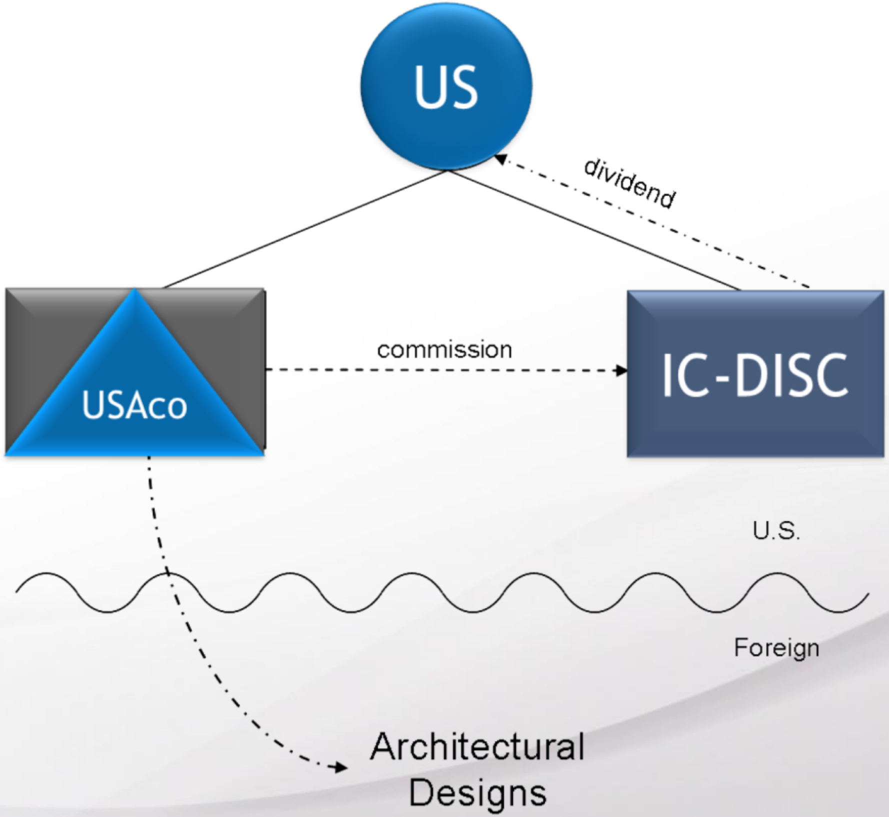
Example 3
Architectural Services Produce GrossReceipts



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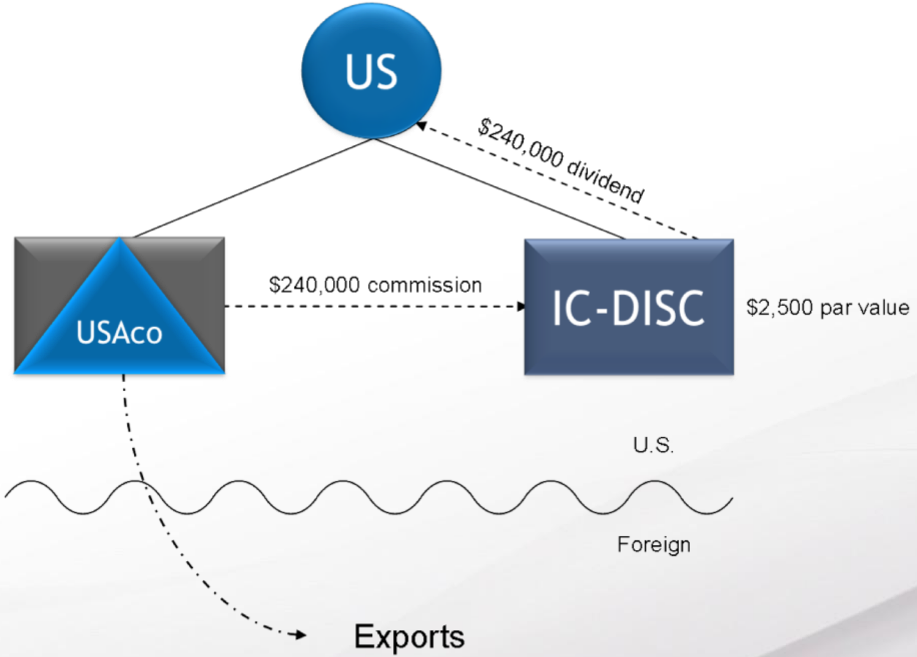
The Tests to Qualify as an IC-DISC

- 95% of the assets of the IC-DISC must be qualified export assets
  - Temporary investments
  - Export property
  - Accounts receivable
  - Loans to producers

Example 4
Working Capital as Qualified Export Assets



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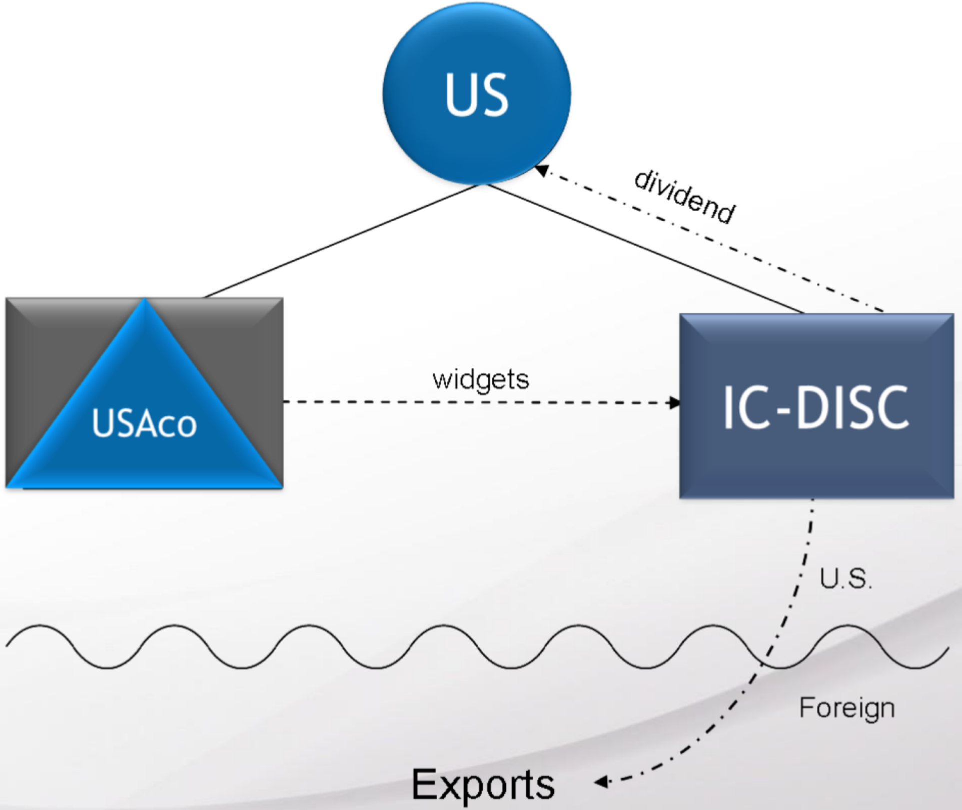
Example 5

Export Property as Qualified Export Assets



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Qualification as Export Property

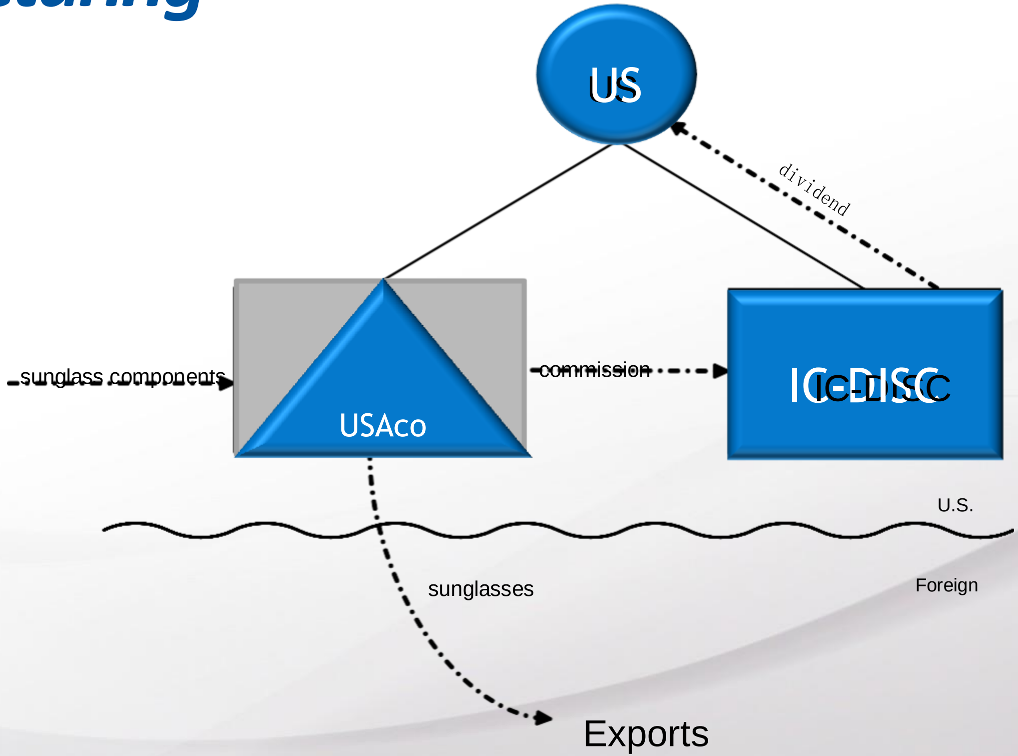
- The property must be manufactured in the U.S. by a person other than the IC-DISC
- The export property must be held primarily for use outside the U.S.
- The property must have a maximum of 50% foreign content

Qualification as Export Property (cont.)

- Property is manufactured within the U.S. if either
  - U.S. conversion costs incurred constitute 20% of the cost of goods sold
  - There is a substantial transformation in the United States, or
  - The operations in the U.S. are generally considered to constitute manufacturing

Example 6

Generally Considered to Constitute Manufacturing



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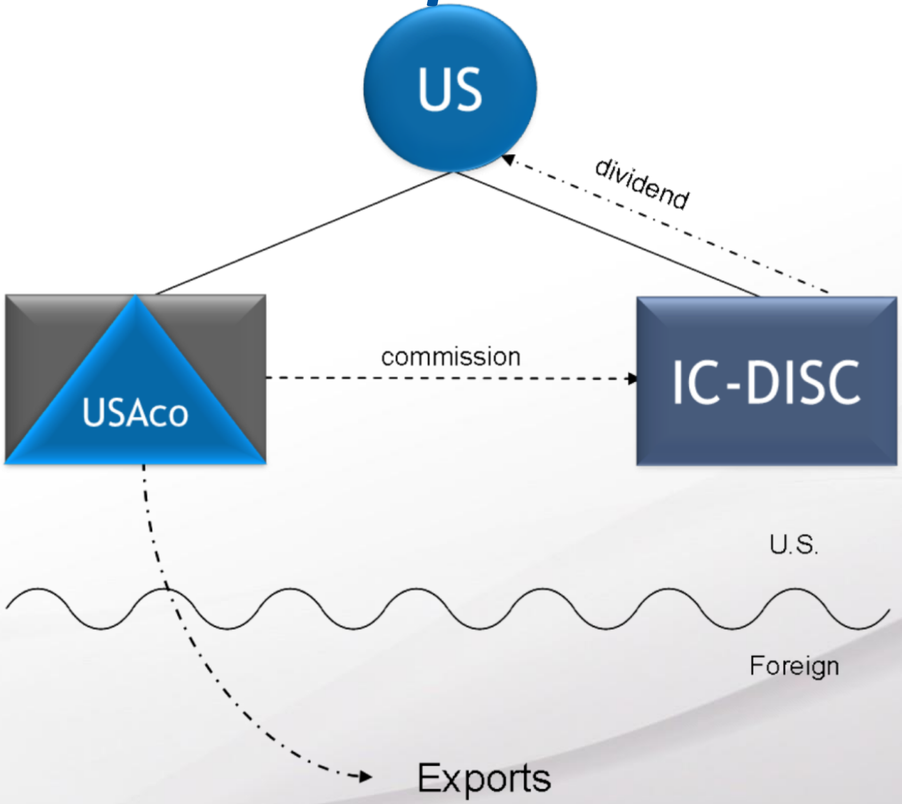

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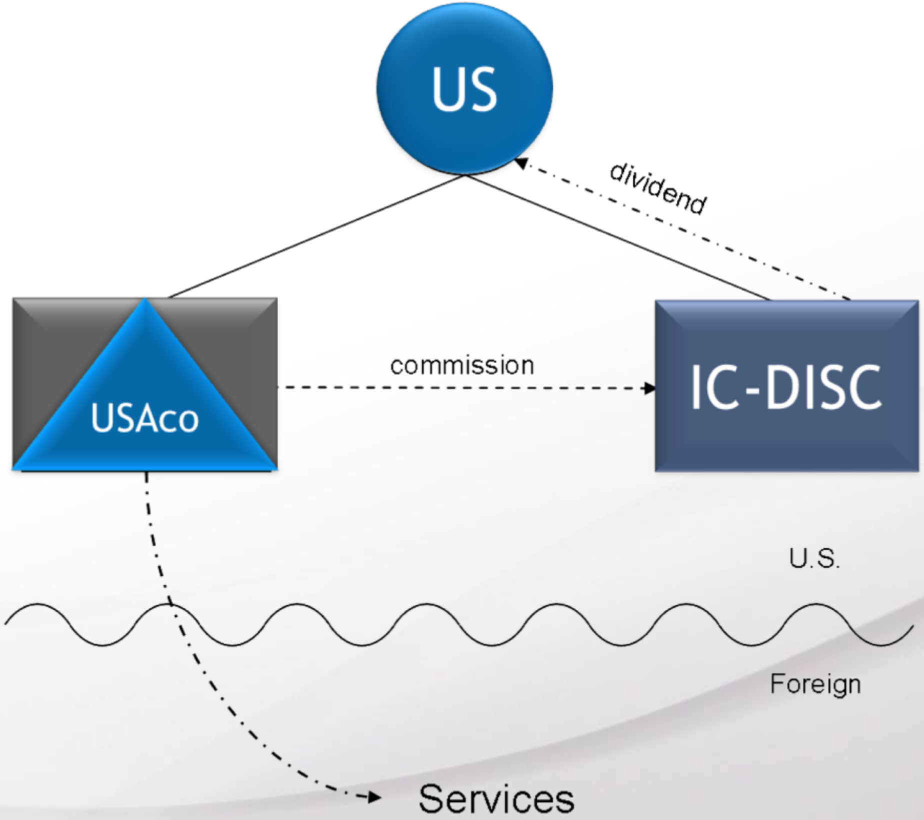
Example 2
Services Produce GrossReceipts



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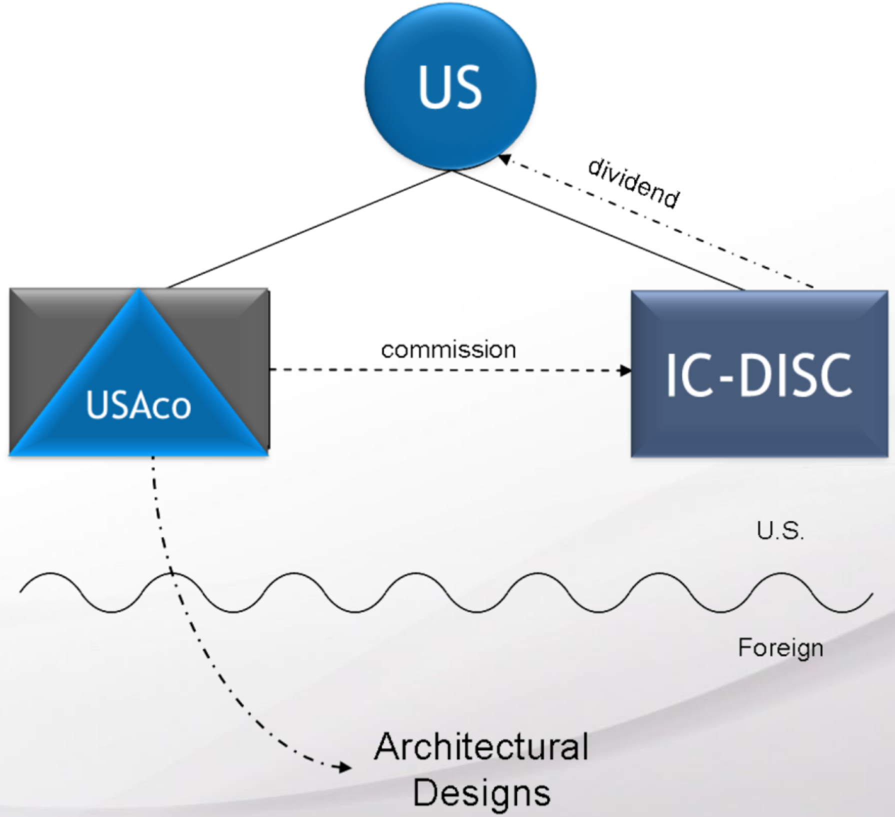
Architectural Services Produce GrossReceipts



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Robert Misey

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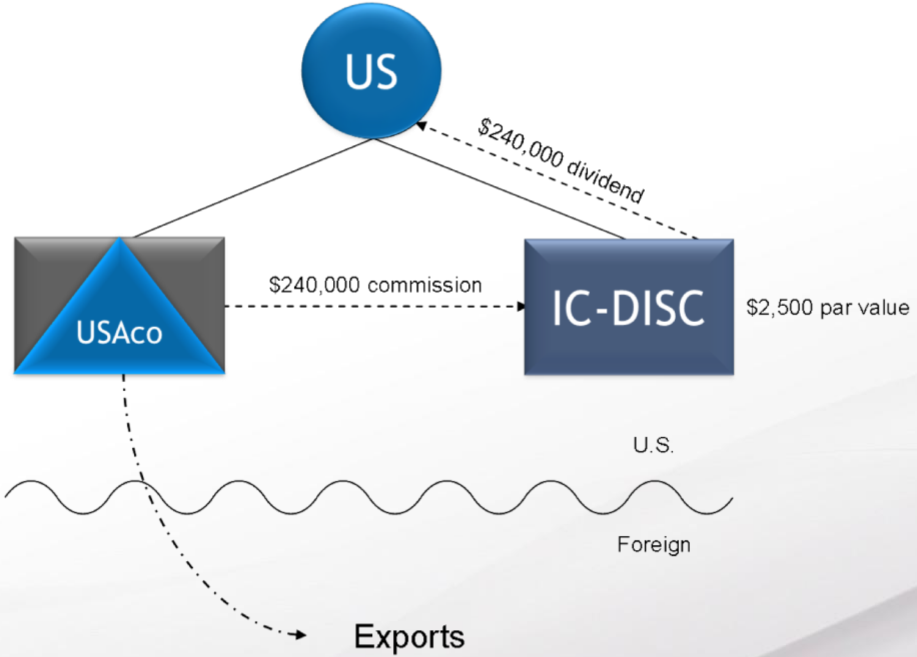

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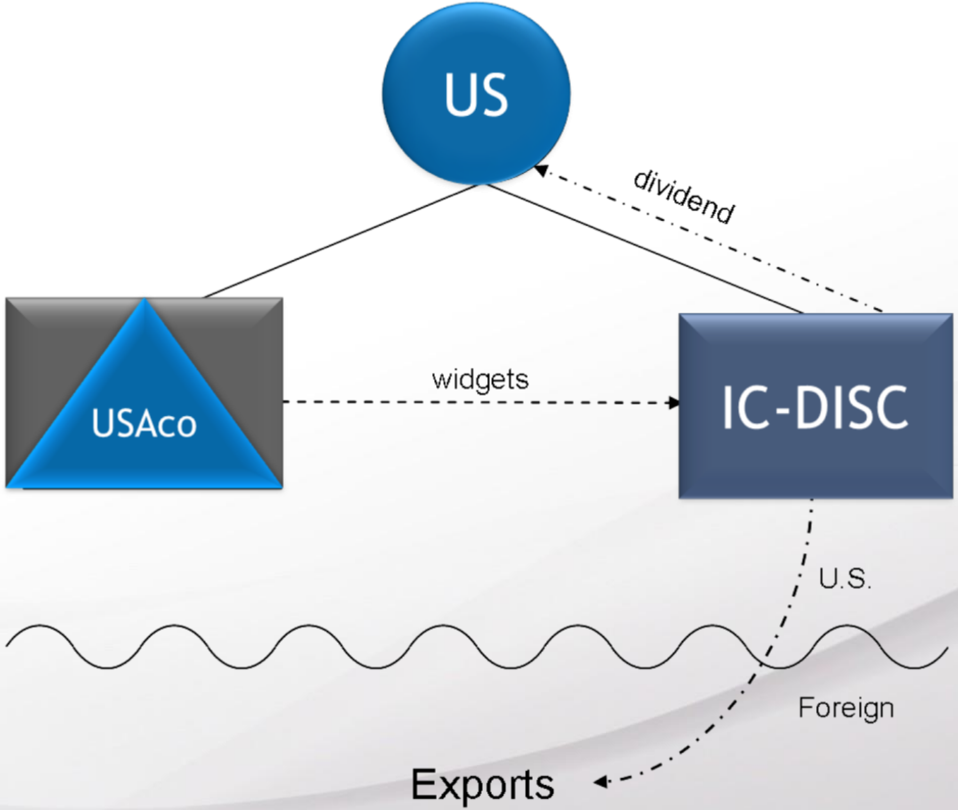

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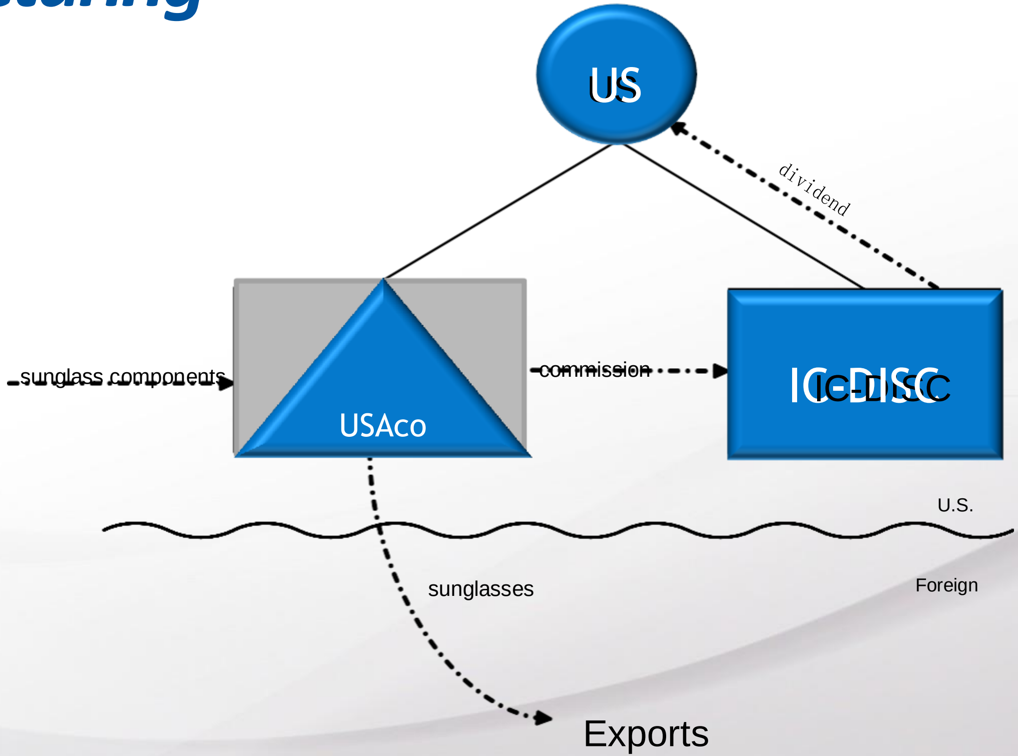

Qualification as Export Property

- The Destination Requirement
  - The destination test requires being held for use outside the United States

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Qualification as Export Property

- The Destination Requirement
  - The destination test requires being held for use outside the United States

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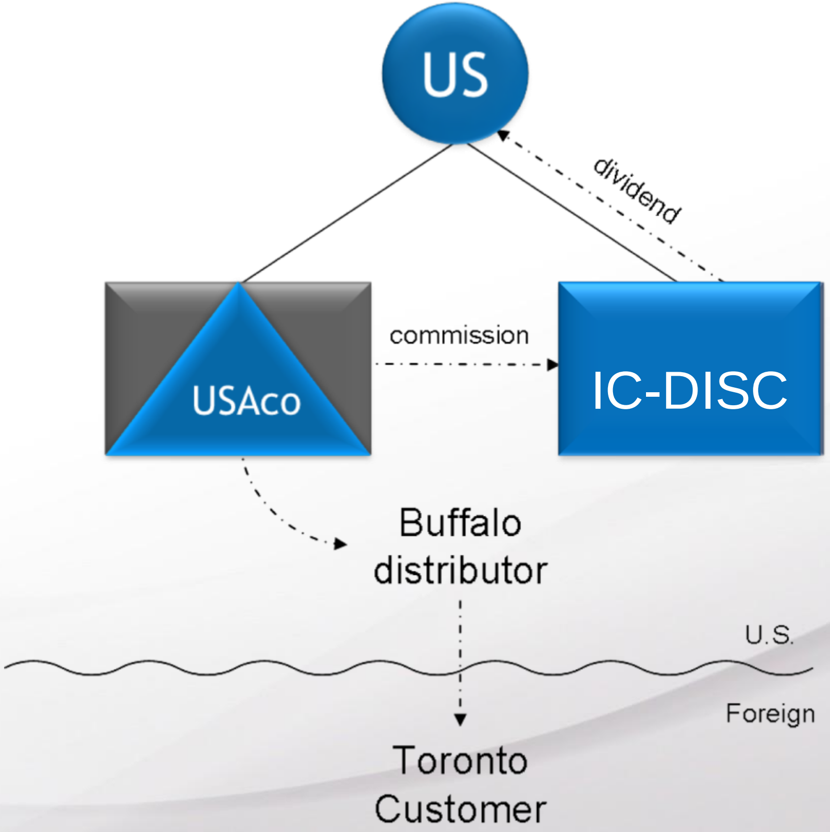
Example 7

Satisfying the Destination Test



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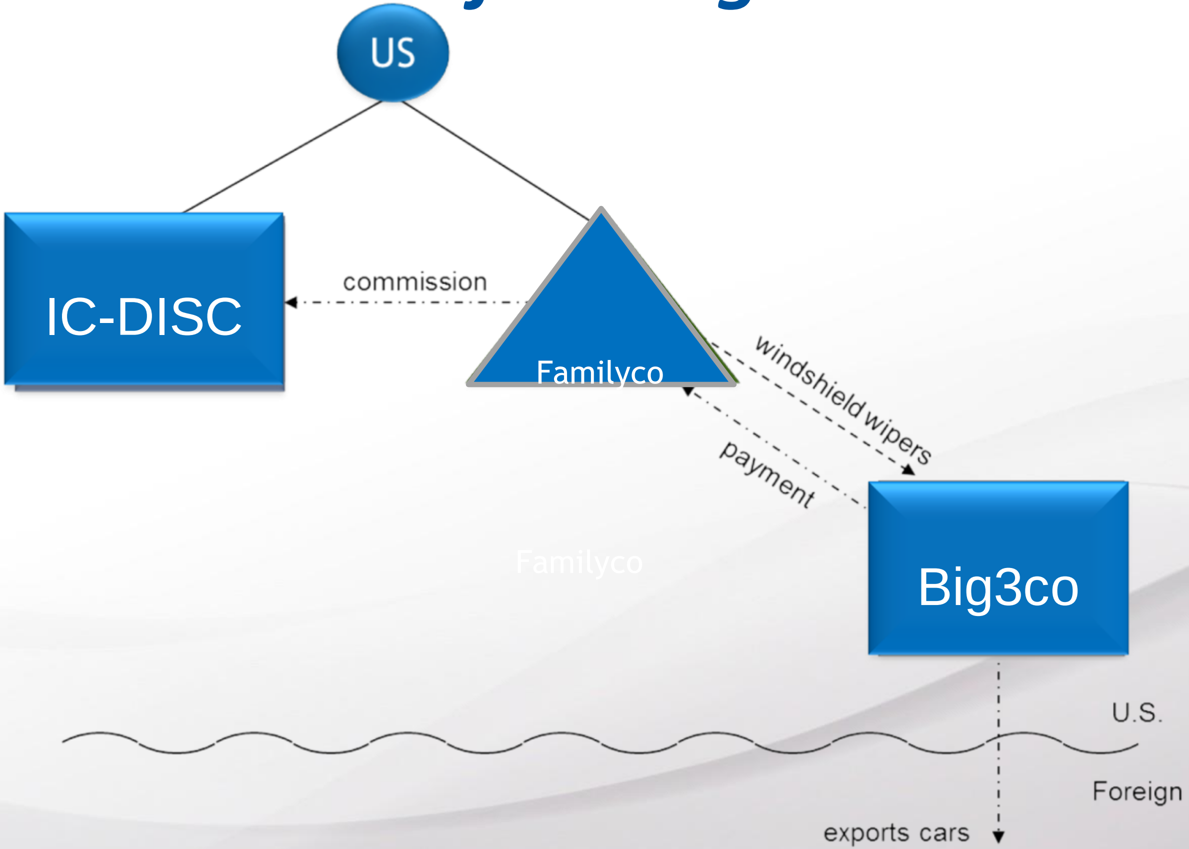
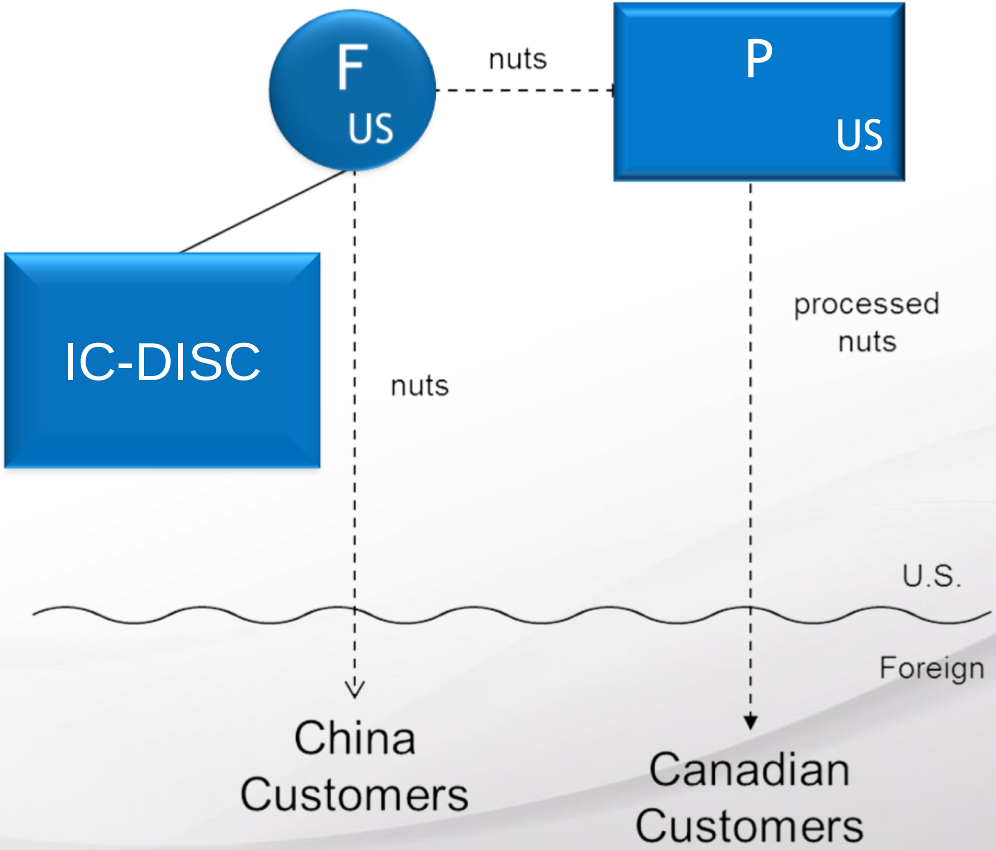
Example 8

No Further U.S.Manufacturing



Example 9



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Qualification as Export Property (cont.)

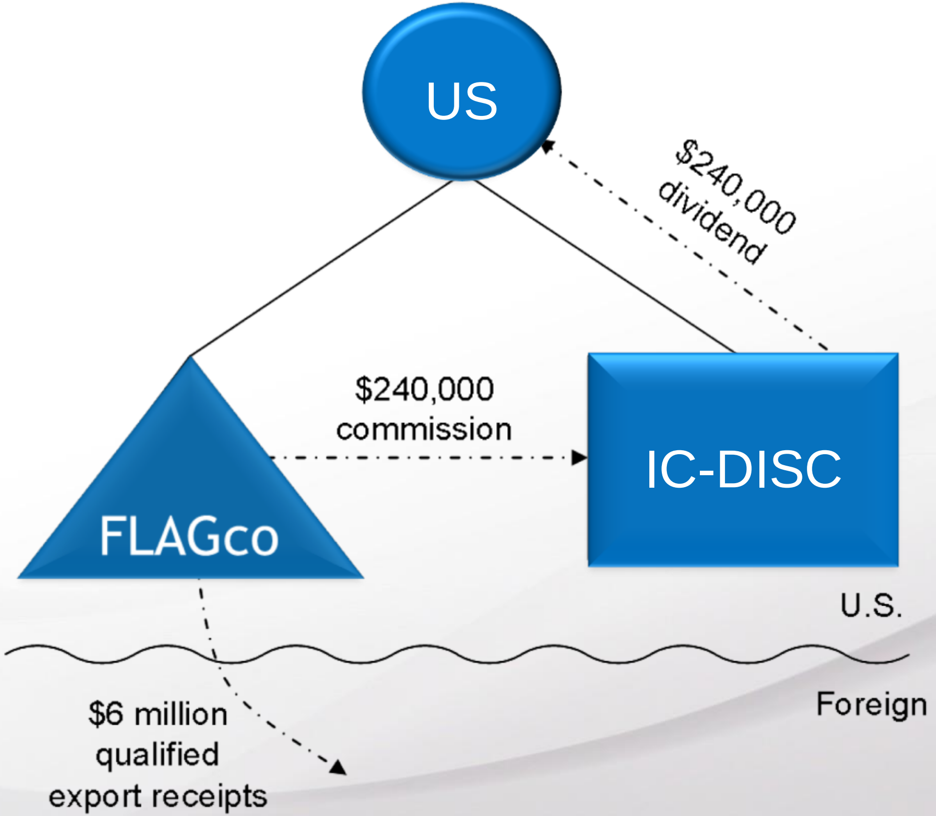
- The Maximum of 50% Foreign Content Requirement
  - No more than 50% of the fair market value of export property may be attributable to the fair market value of imported articles
  - The fair market value of the foreign content is determined by its dutiable value

Determining the IC-DISC Benefit

- The commission is the greater of
  - 4% of the qualified export receipts
  - 50% of the combined taxable income, or
  - The arm's-length amount determined under the transfer pricing principles of Section 482

Example 10

4% of the Qualified Export Receipts



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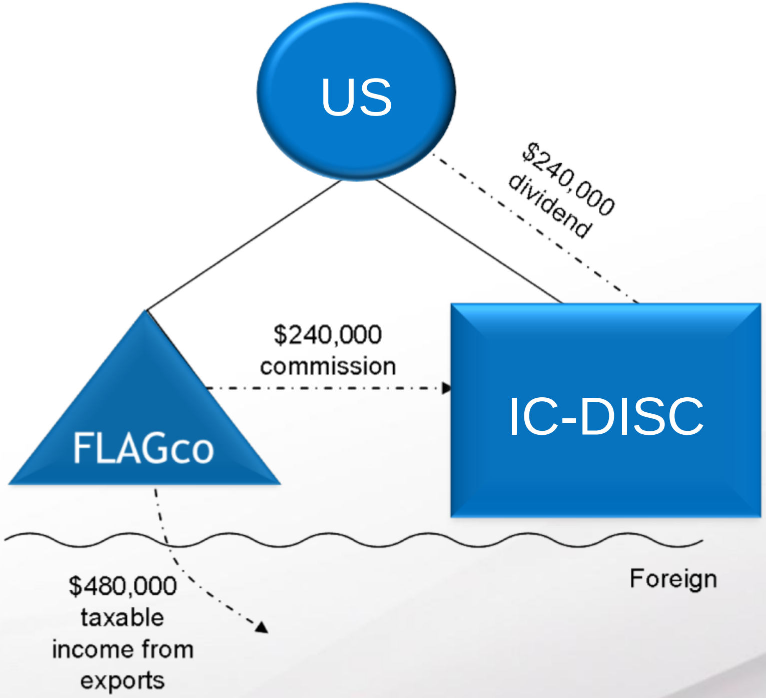
Example 11
50% of Combined Taxable Income



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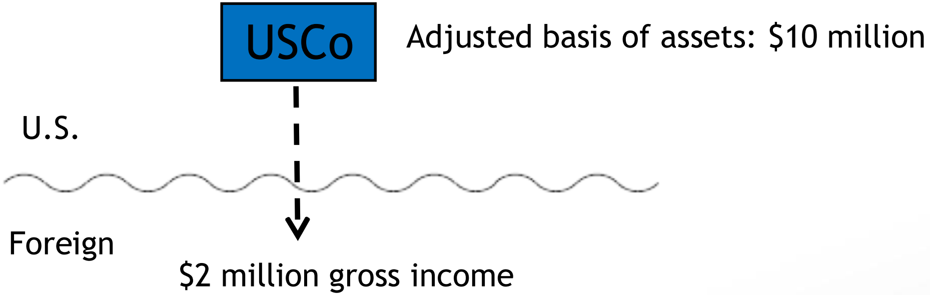
Example 12: 37.5% Deduction for FDII of a C Corporation Only (non-routine return taxed at 13.125%)



37.5% of (2M – 10% of $10M) X ($2M/$2M)
$93,750 deduction

Effective rate of 13.125% on exports or foreign services of a C corporation beyond a routine 10% return on assets

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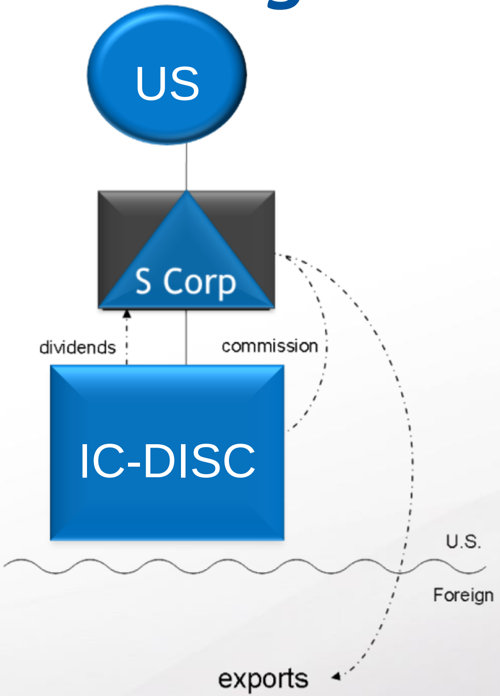
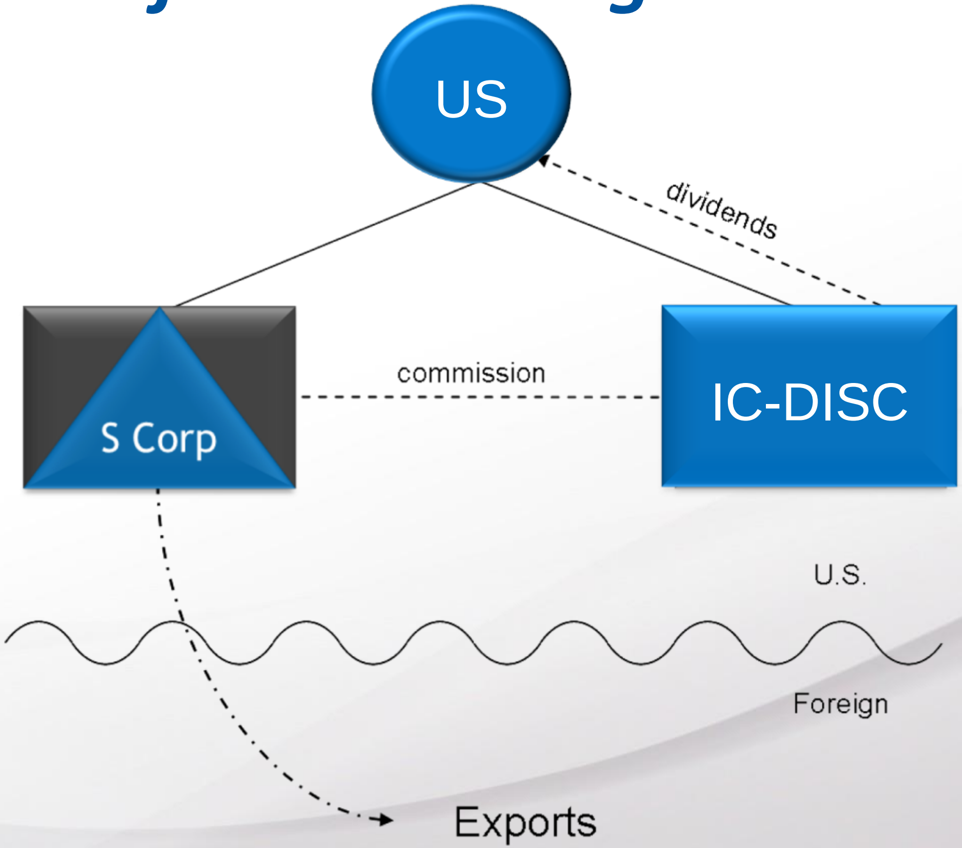
Structuring the IC-DISC

Subsidiary of a Flow-Through



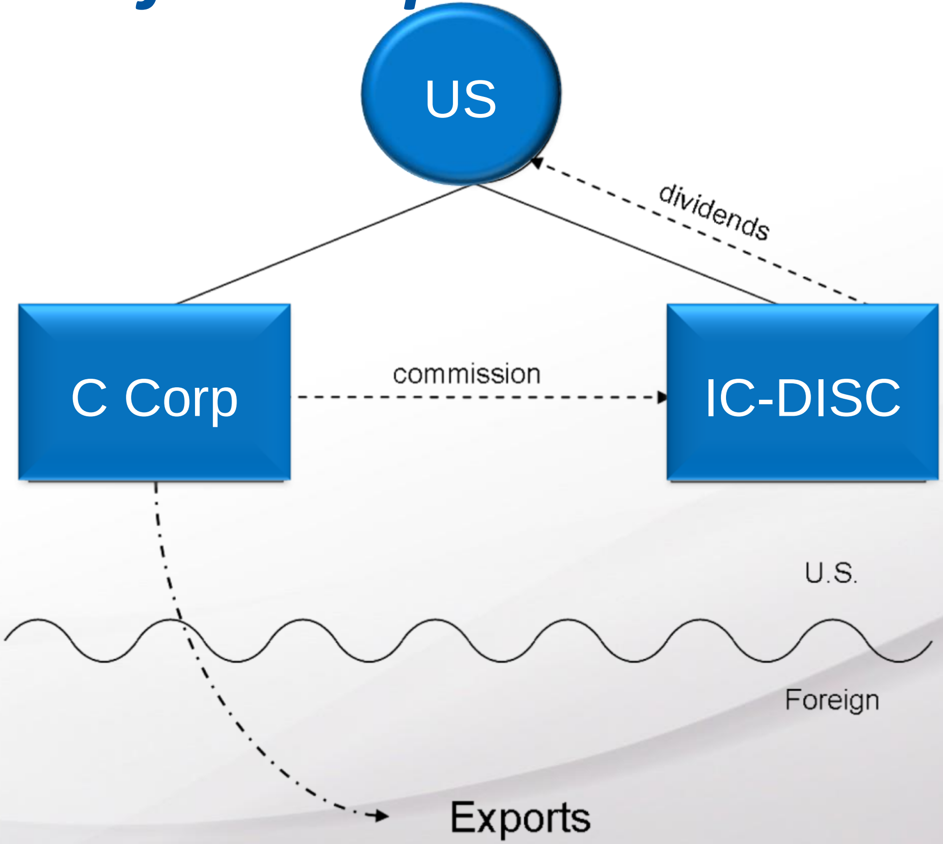
Structuring the IC-DISC

Brother-Sister of a Flow-Through



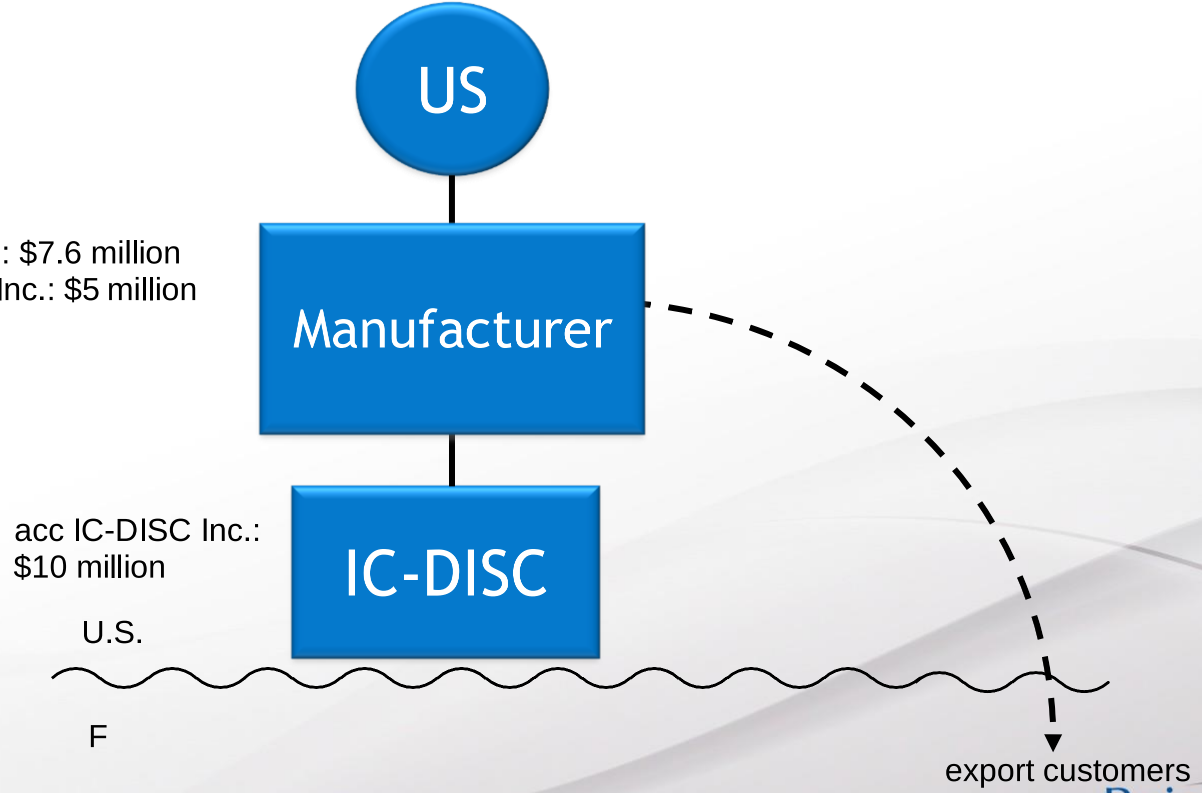
Structuring the IC-DISC

Brother-Sister of a C Corporation



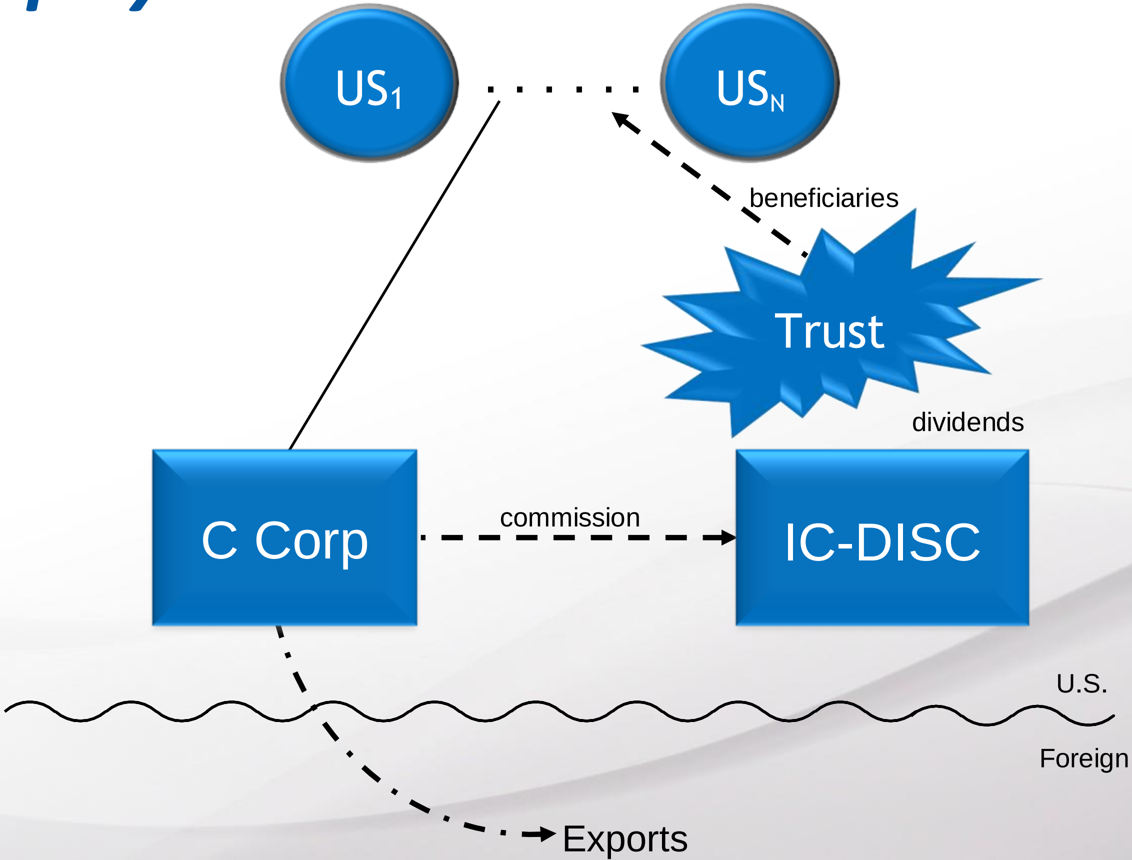
The Interest Charge in IC-DISC

U.S. tax with acc IC-DISC Inc.: $7.6 million
U.S. tax without acc IC-DISC Inc.: $5 million
Deferred U.S. tax: $2.1 million
AFR: 1%
Interest: $21,000



Structuring the IC-DISC

Ownership by a Trust



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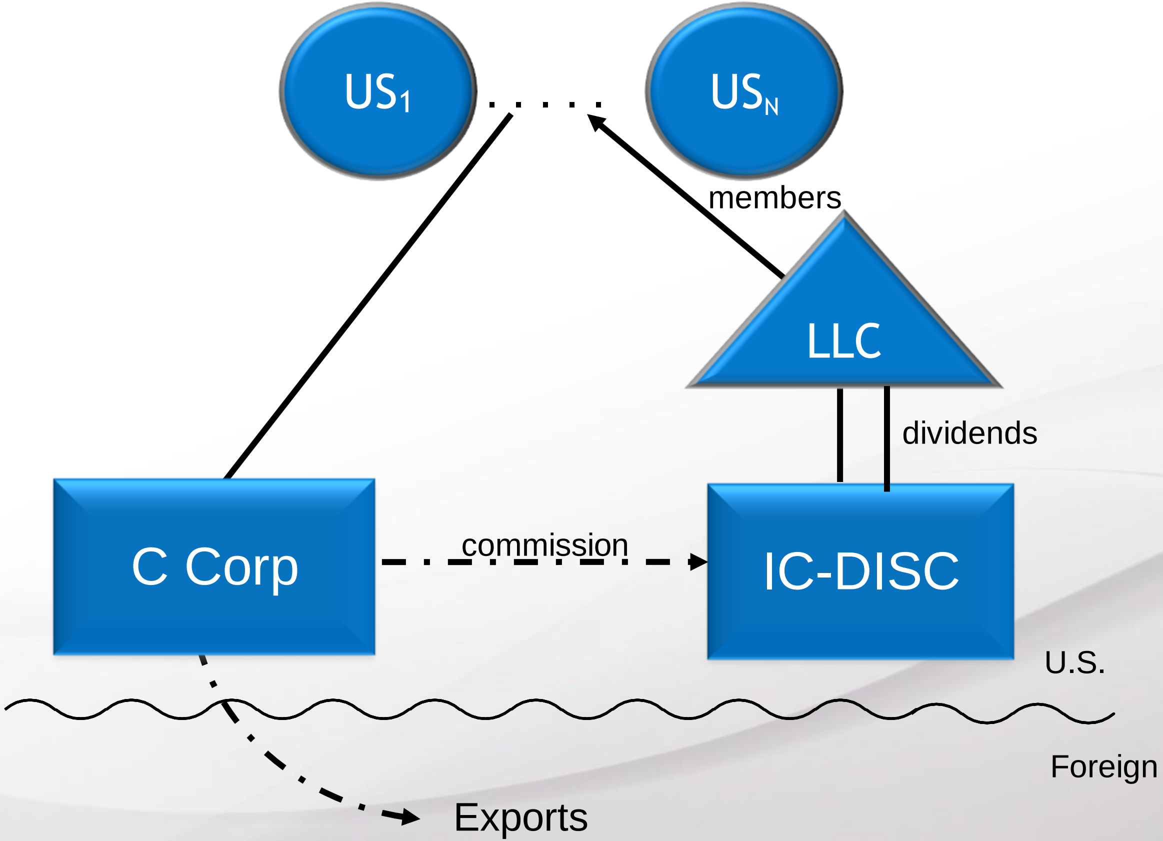
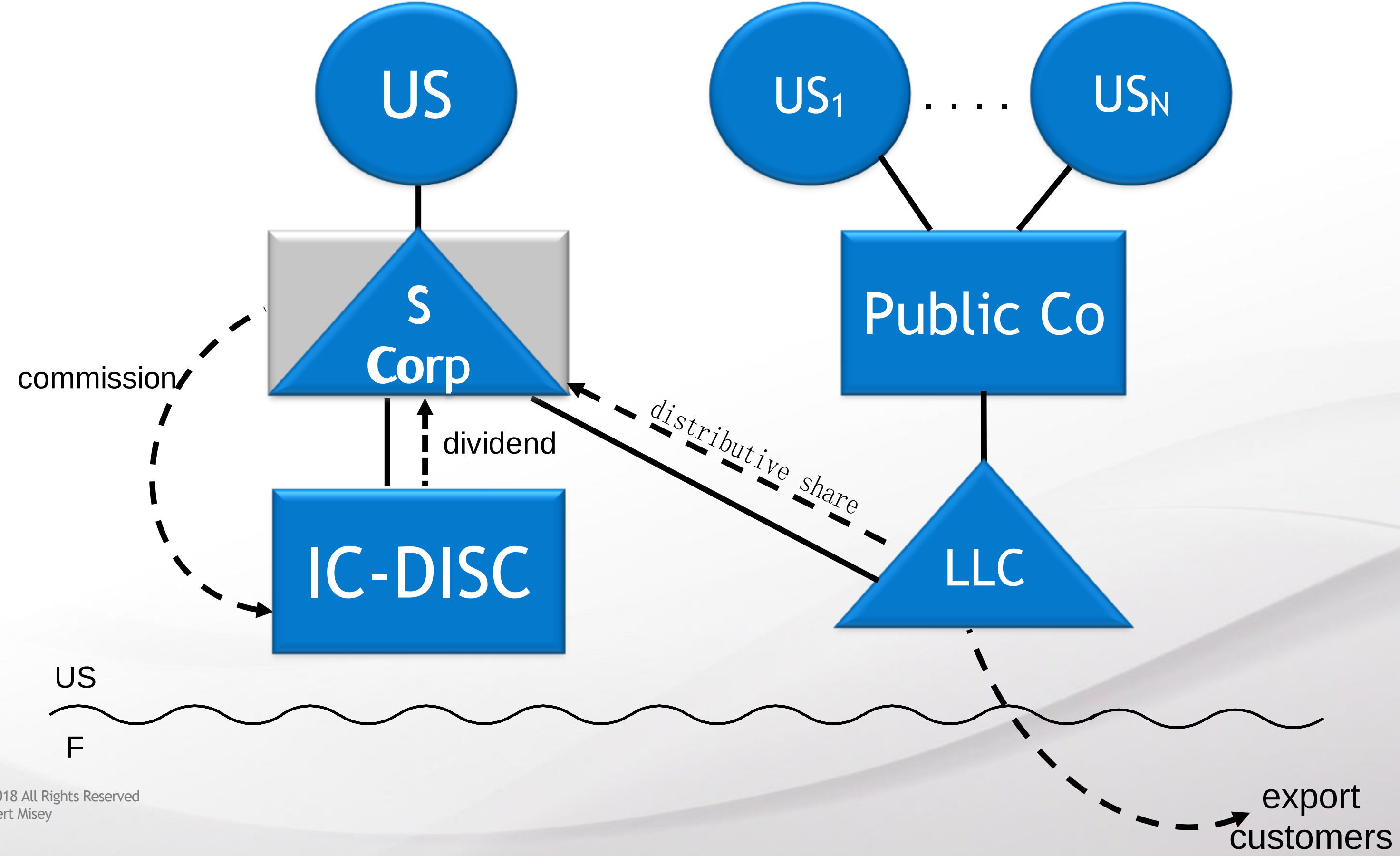
Structuring the IC-DISC
Ownership by an LLC



Joint Venture: S Corp and Public Co



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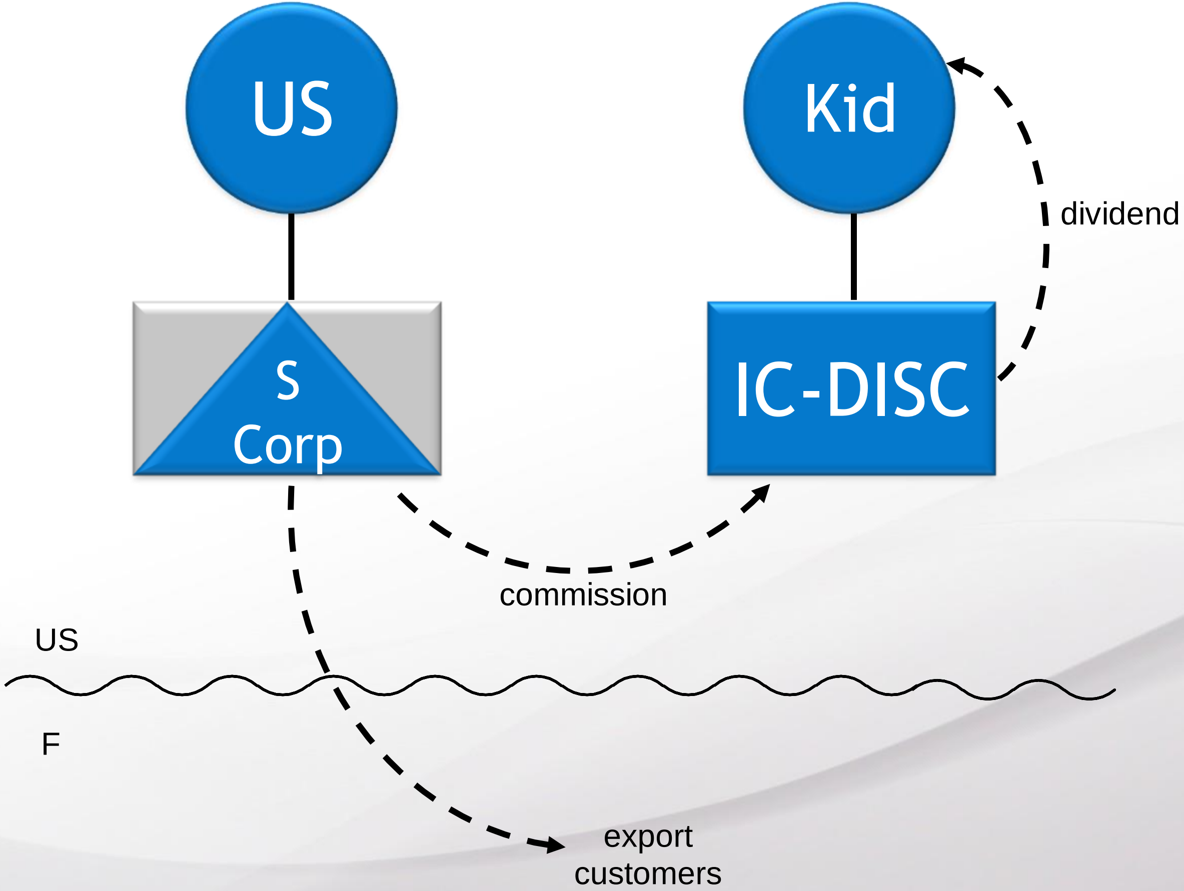
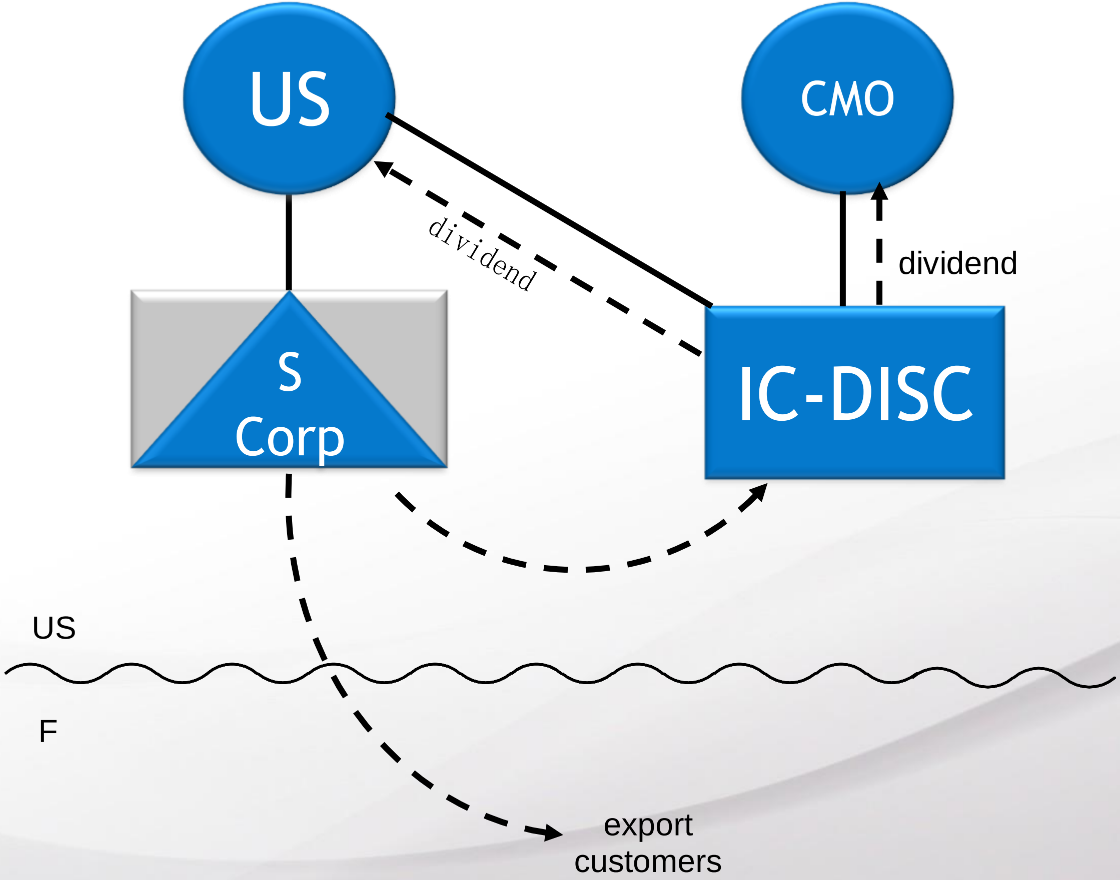
Gift Tax Implications?



Non-Family Members



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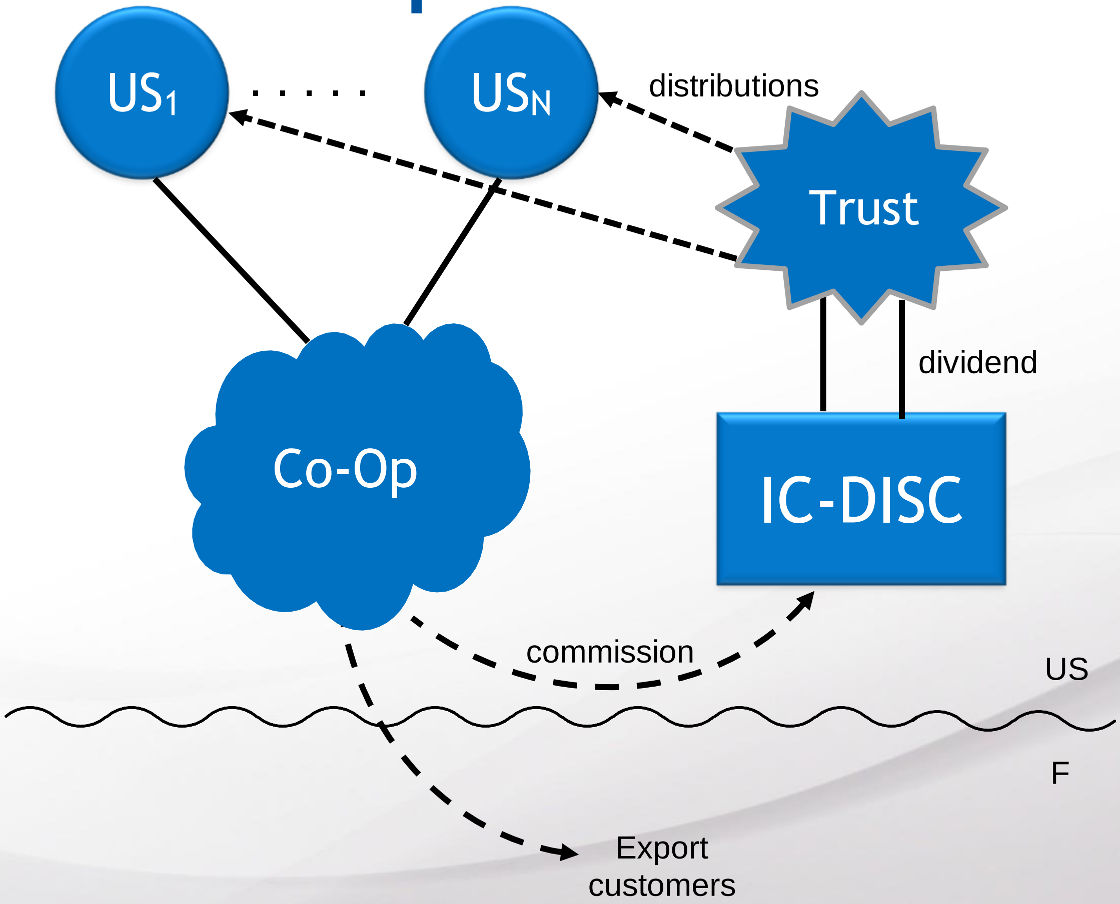
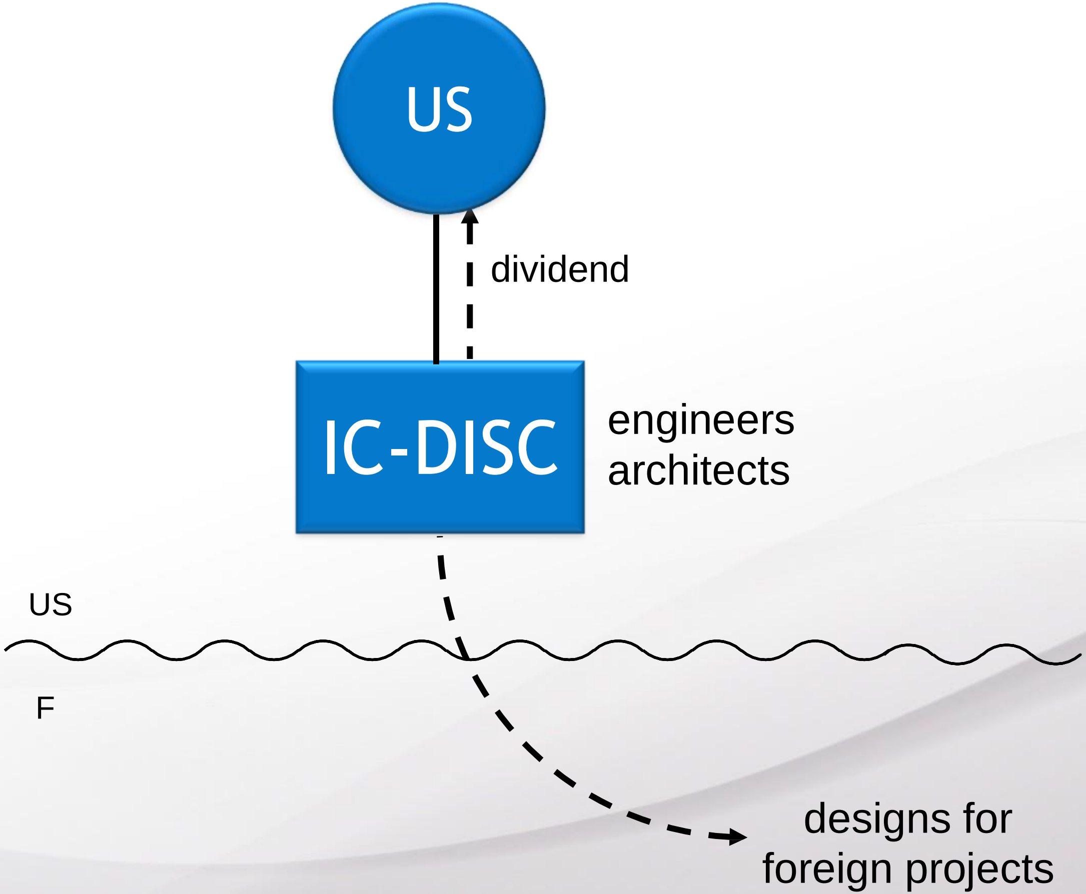
Trust For a Co-Op's Members



Architects and Engineers



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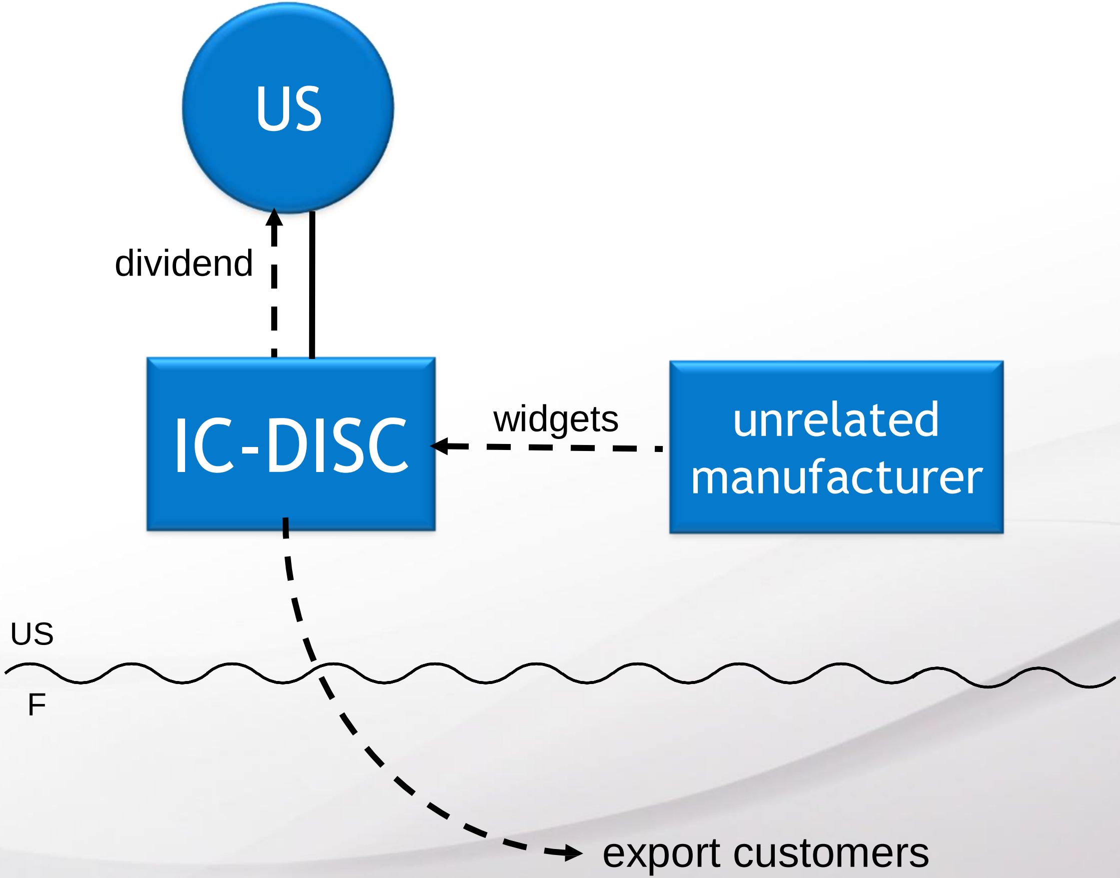
Pure Distributor



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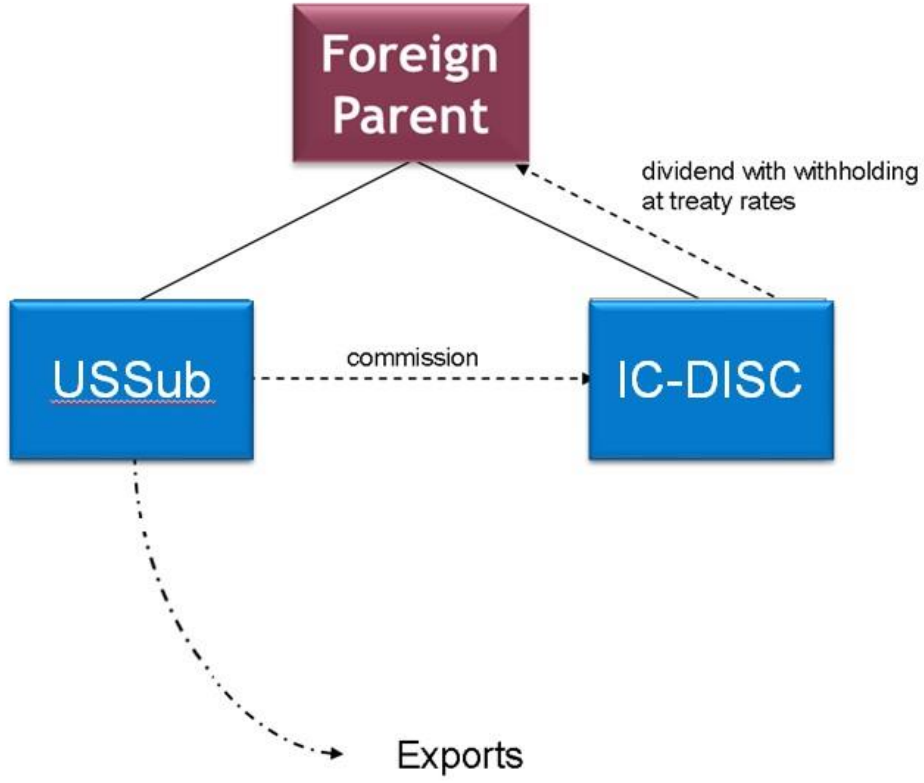
Inbound Treaty Benefits



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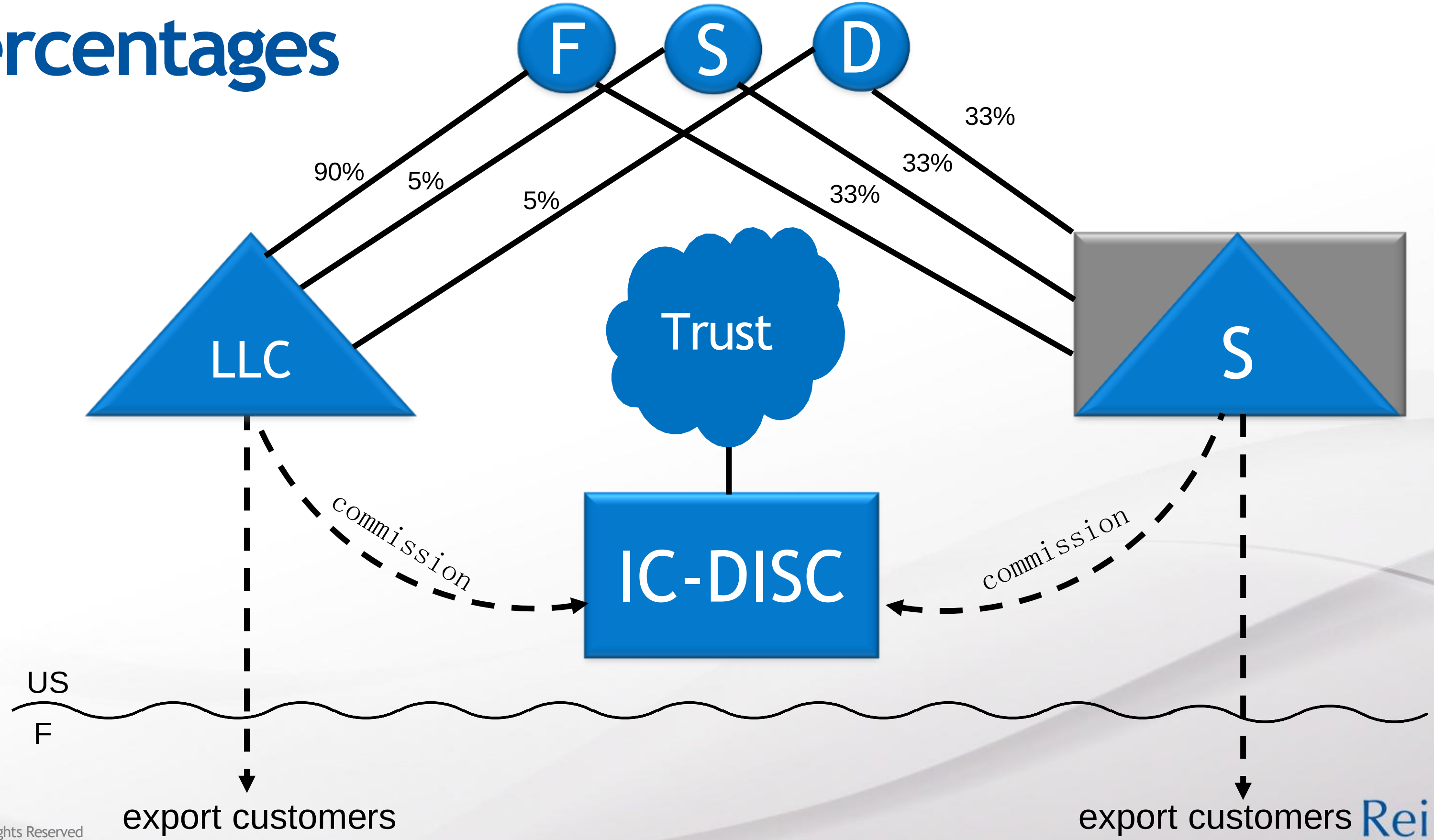
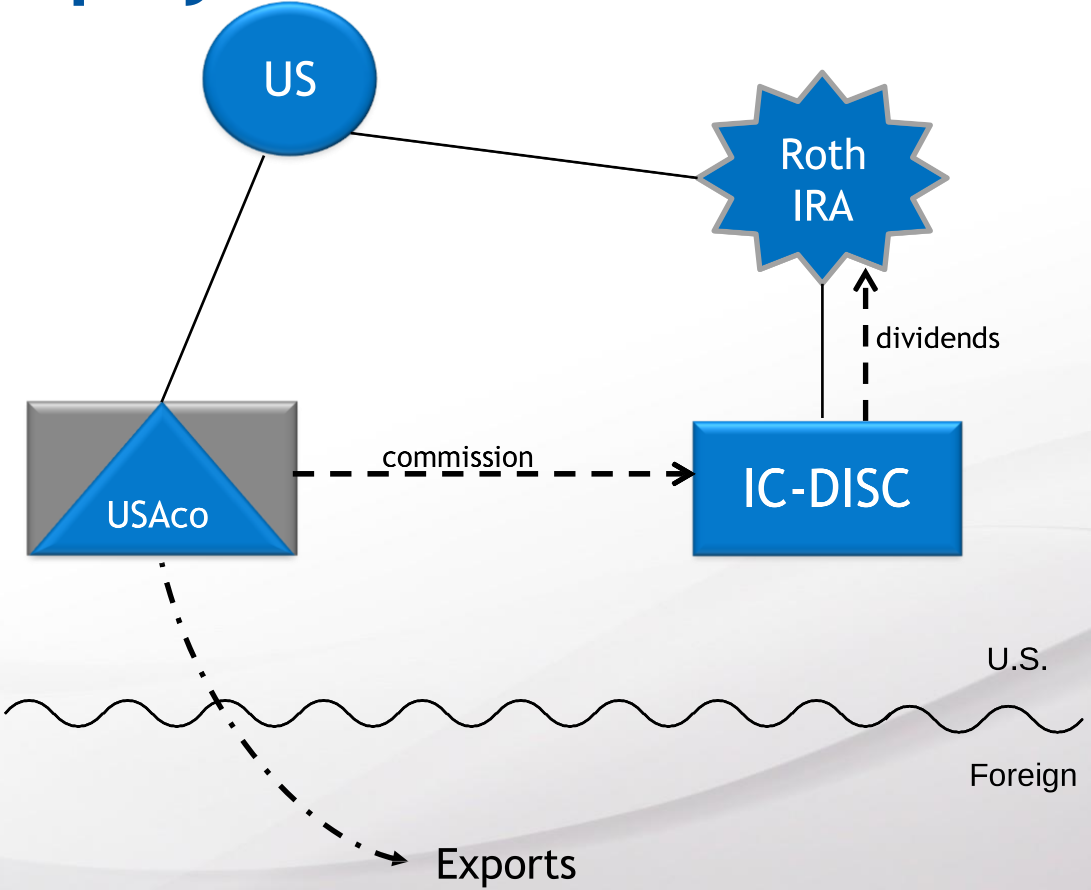
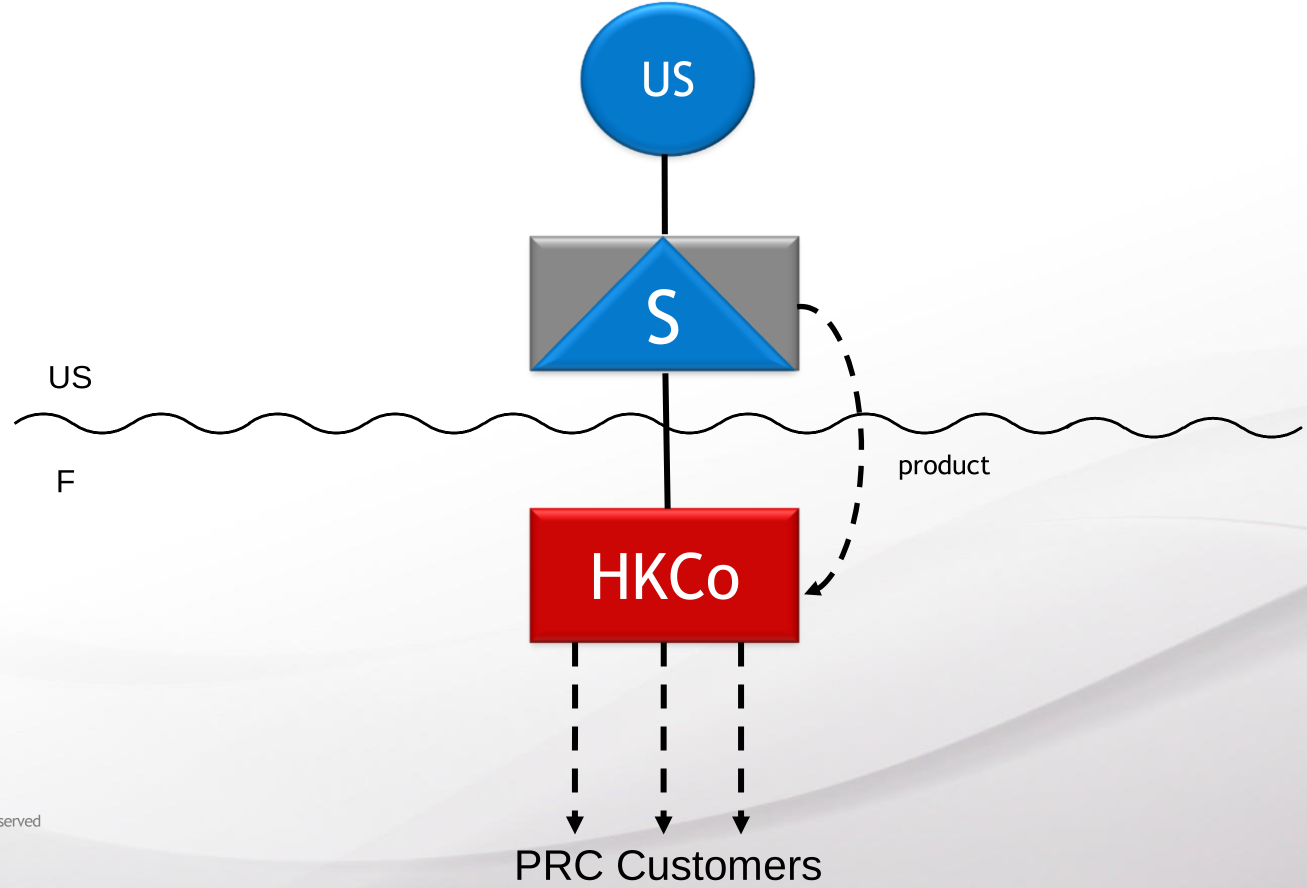
Use of a Trust With Varying Ownership Percentages



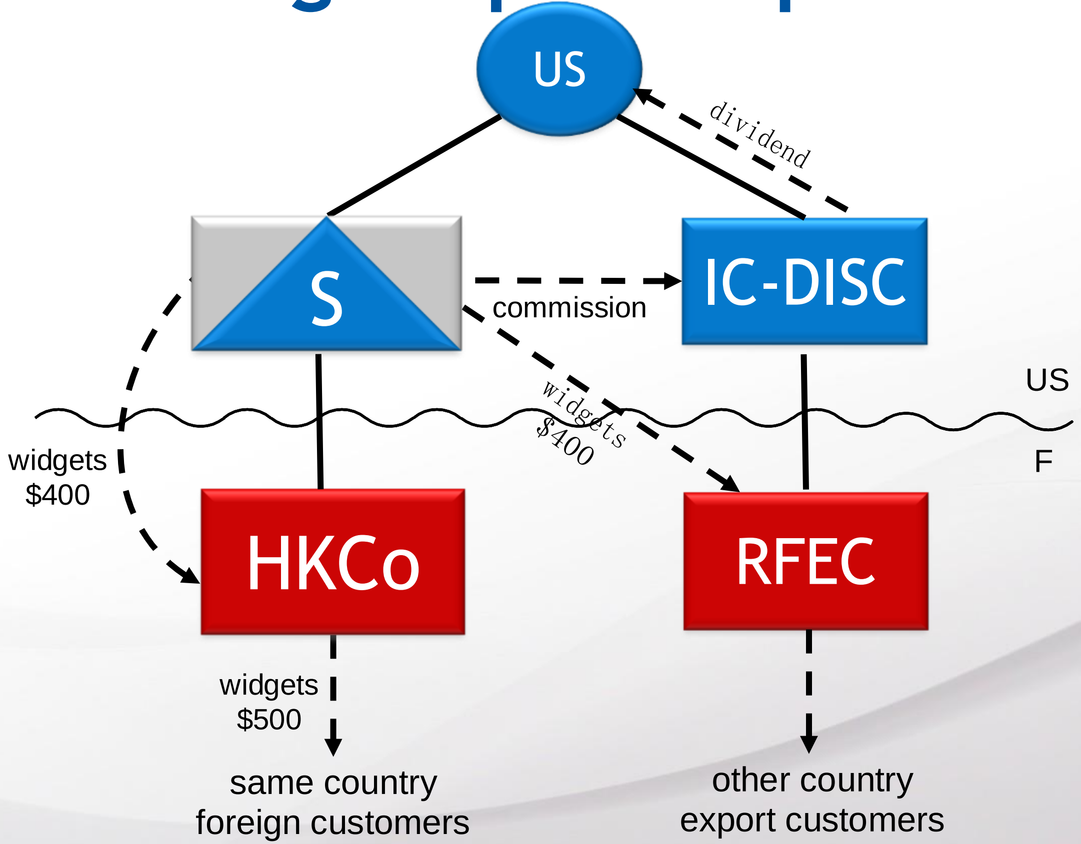
Ownership by a Roth IRA



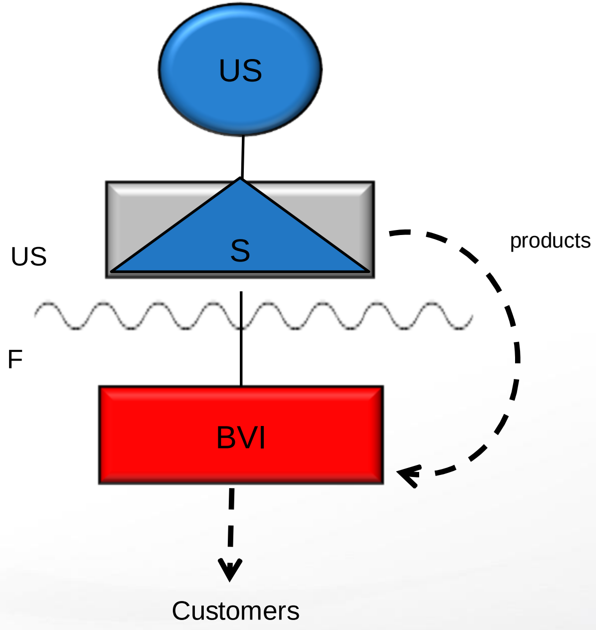
Subpart F Income or GILTI Created

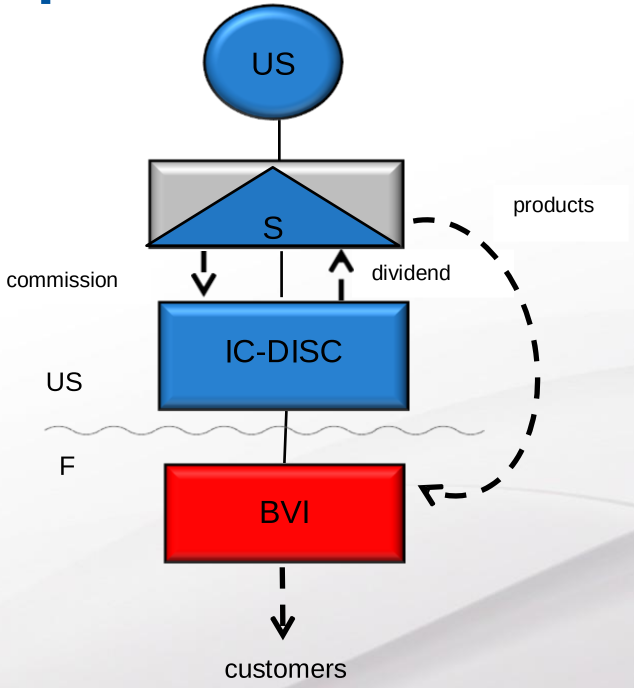


Avoid Subpart F Income With a Related Foreign Export Corporation



Avoid GILTI by Making a Foreign Distributor in a Haven a Related Foreign Export Corporation





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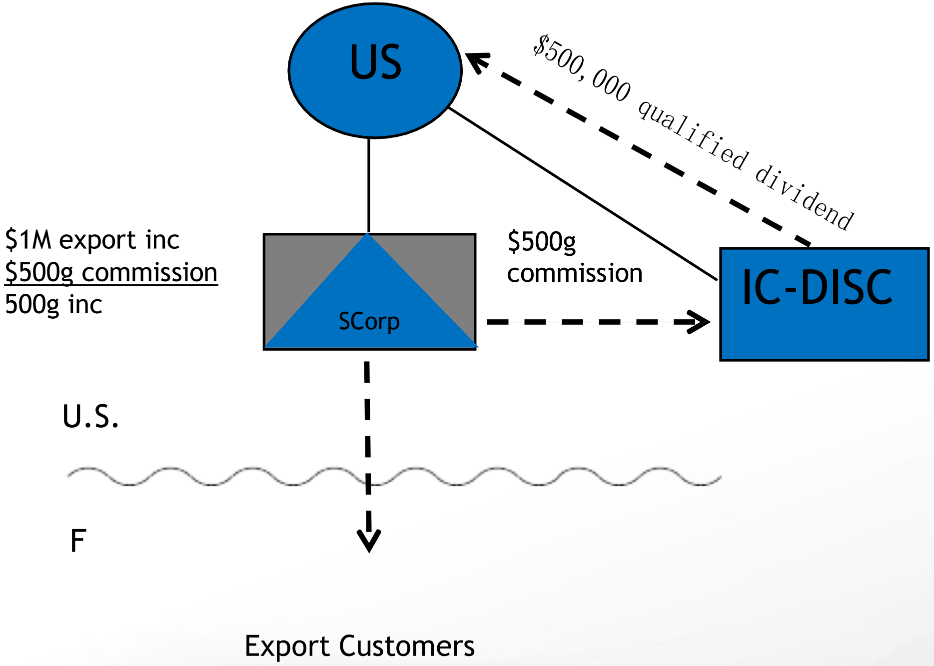
Classic IC-DISC and Section 199A



Total Tax with 37% Rate

$500g @ 37% =$185g
$500g @ 20% =$100g
$285g

w/o IC-DISC: $370g

Total Tax with 29.6% Rate

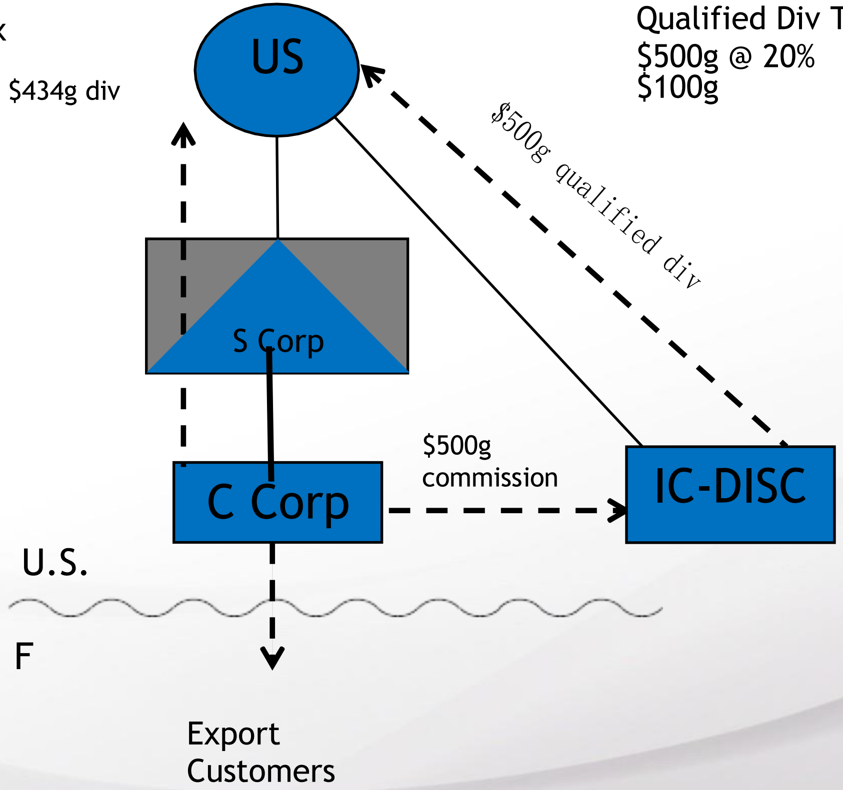
$500g @ 29.6% = $148g
$500g @ 20% = $100g
$248g

w/o IC-DISC: $296g

- The Domestic Production Deduction Didn't Survive

Super-Charged IC-DISC Combines an IC-DISC with a C Corporation's Foreign-Derived Intangible Income

Qualified Div Tax
$434g @ 20%
$87g



Qualified Div Tax
$500g @ 20%
$100g

	Total Tax
C Corp Tax:	$66g
Indiv Inc Tax:	$87g
Qualified Div Tax:	<u>$100g</u>
	$253g

$1M export inc
<u>($500g commission)</u>
$500g inc

C Corp tax
$500g @ 13.125%
$66g

E&P
$500g-$66g
$434g

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Implementation Considerations for the IC-DISC

- Incorporate the IC-DISC before the export sales begin
- Analyze the export sales
- Draft the commission agreement
- Prepare and timely file the Form 4876-A that elects IC-DISC status
- Prepare a manual that contains guidelines and a checklist/calendar

About Rob Misey

Robert Misey is Chair of the International Department for Reinhart Boerner Van Deuren and a Chair of the International Tax Committee for the American Bar Association.

A graduate of the law schools at Vanderbilt University and Georgetown University, he is a former trial attorney for the Internal Revenue Service Chief Counsel (International) in Washington, DC. He is also the author of the books *A Practical Guide to U.S. Taxation of International Transactions* and *Federal Taxation: Practice and Procedure*.

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39938685

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IC-DISCs: Structuring to Maximize Benefits

By Robert J. Misey, Jr.
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I. INTRODUCTION TO THE IC-DISC

A. Formation of the IC-DISC.

1. The IC-DISC must be a U.S. corporation with a single class of stock.[1]

2. The IC-DISC stock must have a minimum par value of $2,500.[2]

3. The U.S. corporation elects to be an IC-DISC by filing a Form 4876-A.[3]

   (a) For an existing corporation to elect IC-DISC status, the Form 4876-A must be filed during the 90 days preceding the first day of the corporation's taxable year.

   (b) For a newly-formed corporation, the Form 4876-A must be filed within 90 days after the beginning of the corporation's first taxable year.

B. Taxation of an IC-DISC and Its Shareholders.

1. An IC-DISC is not subject to the regular U.S. corporate income tax.[4] As a result, the IC-DISC does not pay income tax on the commission received from the manufacturing entity.

   (a) When the IC-DISC pays a dividend to its owners, the owners will pay income tax at a 20% rate. In effect, the owners are converting a 37% tax on income representing the amount of the commission to a 20% individual tax.

   (b) If the manufacturing entity is a flow-through entity, such as an S corporation, partnership, or most limited liability companies ("LLCs"), the reduction in income tax is seventeen percentage points.[5]

(c) If the manufacturing entity is a C corporation, the reduction in tax is 28 percentage points.[6]

2. Although the IC-DISC itself is not a taxable entity, the IC-DISC's U.S. shareholders are subject to tax on deemed dividend distributions from the IC-DISC.[7] These deemed distributions do not include commissions earned on the first $10 million of the IC-DISC's qualified export receipts each year.[8] Anything beyond the $10 million threshold is deemed distributed.

3. The IC-DISC was designed as a means by which a U.S. exporter could borrow funds from the U.S. Treasury at a low interest rate.

(a) More specifically, the U.S. shareholder must pay an interest charge on its IC-DISC-related deferred tax liability, which equals the difference between the shareholder's tax for the taxable year computed first with, and then without, the accumulated IC-DISC income of the shareholder that has been deferred.[9]

(b) Nevertheless, if the IC-DISC distributes cash representing all of its income, the interest charge is inapplicable.

4. As a practical matter, because the rate of tax on qualified dividends is only 20%, individual owners of the IC-DISC should want to take a dividend as soon as possible.

5. Does the Net Investment Income tax of 3.8% apply to dividends from an IC-DISC?[10]

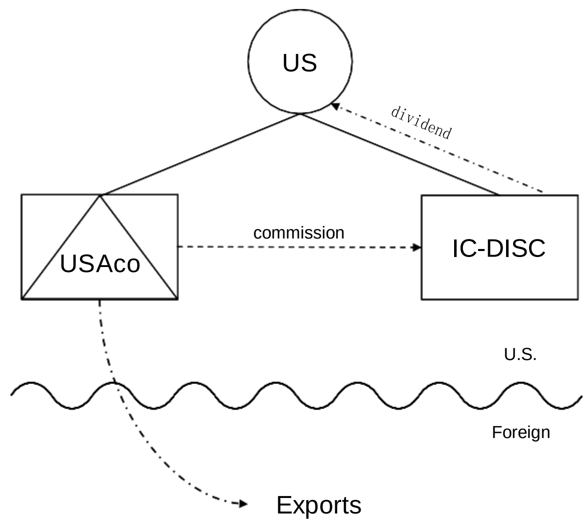
II. THE TESTS TO QUALIFY AS AN IC-DISC

A. To qualify as an IC-DISC, the domestic corporation must pass both the qualified export receipts and qualified export assets tests.

B. The qualified export receipts test states that 95% of the gross receipts of the IC-DISC must constitute qualified export receipts.[11]

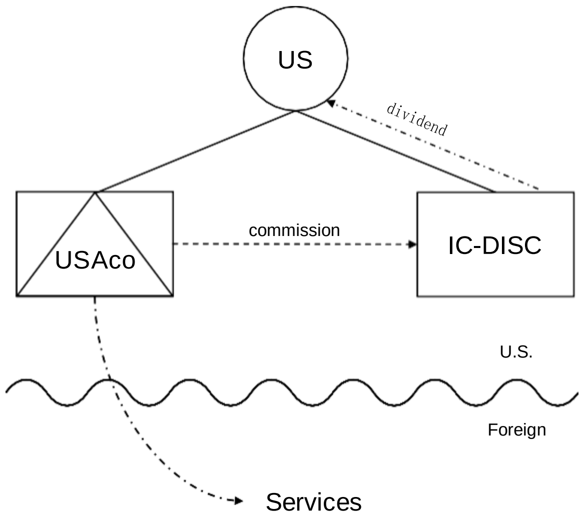
1. Qualified export receipts include gross receipts from sales of export property, rents for the use of export property outside the United States, services related to export sales, engineering or architectural services for construction projects located abroad, and commissions thereon.

Example 1: Uncle Sam wholly-owns USAco, an S corporation that manufactures widgets. Due to burgeoning export sales, Uncle Sam forms an IC-DISC whose only activity results in receiving commissions on qualified export receipts. Because 100% of the IC-DISC's gross receipts constitute qualified export receipts, the IC-DISC satisfies the gross receipts test.



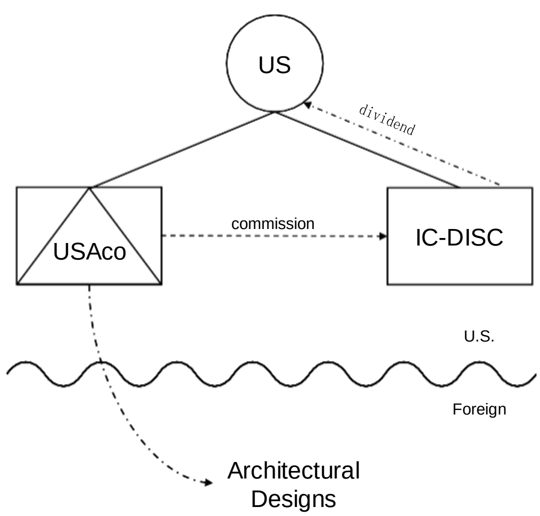
2. Services related to export sales include, but are not limited to, warranty services, maintenance services, repair services, installation services, and even some transportation services.

Example 2: USAco, an S corporation that manufactures and exports widgets, also sells maintenance service contracts for widgets to those same foreign customers. The gross receipts from those maintenance service contracts constitute qualified export receipts.



3. The receipts for engineering or architectural services for construction projects must be with respect to projects located outside of the United States.

Example 3: Uncle Sam wholly-owns USAco, an S corporation that is an architectural firm. USAco's specialty is designing drive-in wedding chapels that are built in Europe. The receipts from the designs constitute qualified export receipts.

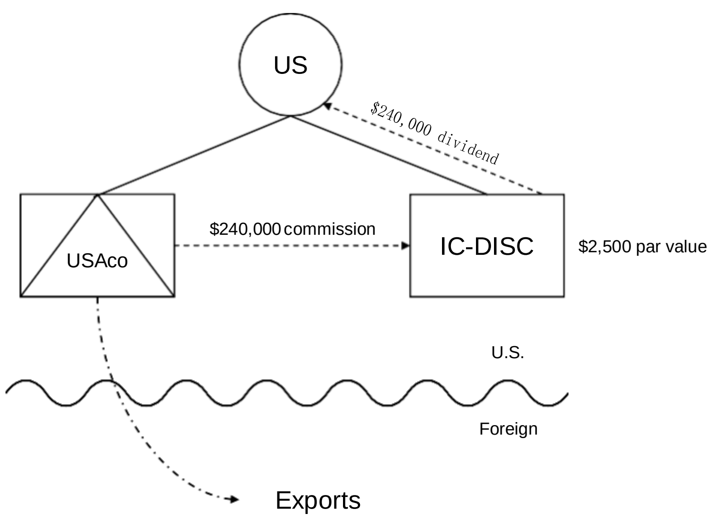


C. The qualified export assets test states that 95% of the assets of the IC-DISC must be qualified export assets.[12]

1. Qualified export assets include accounts receivable, temporary investments, export property, and loans to producers.[13]

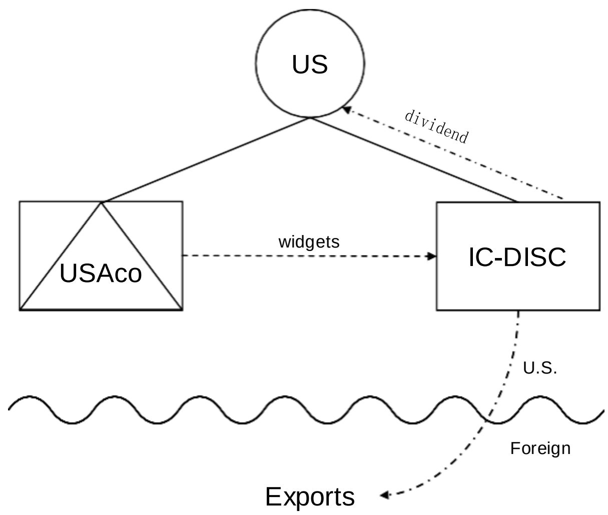
2. Temporary investments must be reasonably necessary to meet the requirements of the IC-DISC and include working capital. For a simply-structured, commission-based IC-DISC, the qualified export assets would typically include the $2,500 of cash paid in as par value for the stock as working capital.

Example 4. Uncle Sam wholly-owns USAco, an S corporation that manufactures widgets. Uncle Sam capitalizes an IC-DISC with $2,500 of cash and the IC-DISC receives a commission during the year of $240,000 that is put in a checking account before being distributed on the last day of the year as a dividend. Because the $2,500 cash remaining constitutes working capital to meet the needs of potential creditors, the $2,500 is a temporary investment and 100% of the IC-DISC's assets constitute qualified export assets. Consequently, the IC-DISC passes the qualified export assets test.



3. Although buy-sell IC-DISCs are not as common as commission-based IC-DISCs, the export property as inventory of a buy-sell IC-DISC (and accounts receivable) constitutes a qualified export asset.

Example 5: Uncle Sam wholly-owns USAco, an S corporation that manufactures widgets. Due to burgeoning export sales, Uncle Sam forms an IC-DISC, which acts as a buy-sell IC-DISC—buying widgets from USAco and selling them to foreign customers. Assuming that the widgets constitute export property, any widgets remaining in inventory at year end constitute qualified export assets and 100% of the IC-DISC's assets constitute qualified export assets. Consequently, the IC-DISC passes the qualified export assets test.



4. Producer loans (and any interest generated) constitute a qualified export asset.

III. QUALIFICATION AS EXPORT PROPERTY

A. General Background.

1. Because most of the qualified export receipt categories focus on export property, satisfying the definition of export property is critical.

2. There are three requirements for an IC-DISC to receive income from a sale of export property:[14]

   (a) the property must be manufactured, produced, grown or extracted in the United States by a person other than the IC-DISC;

(b) the export property must be held primarily for sale, lease or rental for direct use, consumption, or disposition outside the United States; and

(c) the export property must have a maximum of 50% foreign content.

3. Although exporters often think of newly manufactured property as export property, the property can be used equipment or even scrap.

B. The Manufacturing Requirement.

1. The export property must be manufactured in the United States. However, the IC-DISC may not manufacture the export property.

2. Property is manufactured within the United States if either (a) conversion costs incurred in the United States constitute 20% of the cost of goods sold, (b) there is a substantial transformation in the United States, or (c) the operations in the United States are generally considered to constitute manufacturing.[15]

3. The conversion costs include direct labor and factory burden, including packaging and assembly.

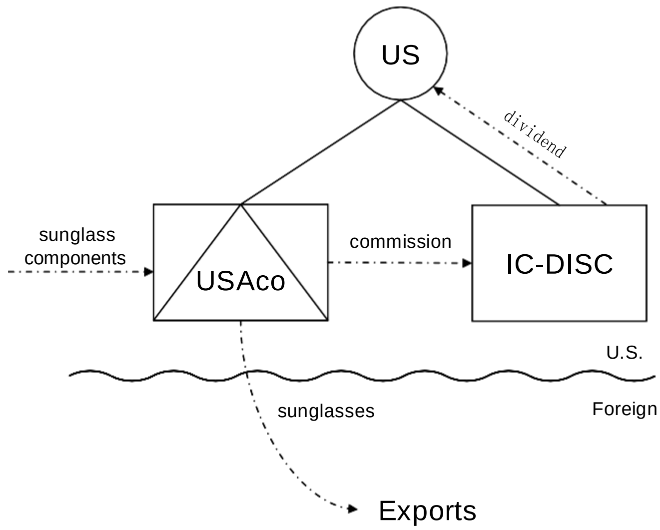
4. A substantial transformation would include, for example, the conversion of wood pulp to paper or the canning of fish.

5. The case law is somewhat vague regarding what is generally considered to constitute manufacturing.

(a) In *General Electric v. Commissioner*,[16] the issue was whether assembling jet engines onto planes constituted manufacturing.

(b) The Second Circuit Court of Appeals stated that the taxpayer did not conduct manufacturing, finding that: (i) the airplane industry recognizes aircraft and engines as legally distinct and separate products; and (ii) affixing a completed product to another does not constitute manufacturing.

Example 6: USAco separately purchases the frames, wings, tinted lenses, and little screws that can be combined to make sunglasses. USAco pays minimum wages to 11th grade dropouts who put together approximately 20 sunglasses each hour. Assuming that these conversion costs are less than 20% of the costs of goods sold and there is a not a substantial transformation of the sunglass components in the sunglasses, manufacturing is satisfied <u>only if</u> this process is generally considered to constitute manufacturing.



C. <u>The Destination Requirement</u>.

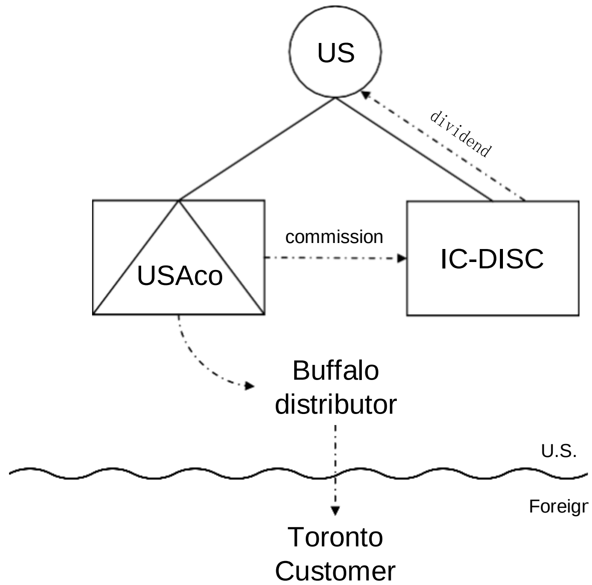
1. The export property must satisfy a destination test, which requires being held for sale, lease or rental in the ordinary course of business for direct use, disposition or consumption outside the United States.[17]

   (a) Property satisfies the destination test if it is delivered to a freight forwarder for ultimate shipment abroad.[18]

   (b) Property also satisfies the destination test if it is sold to a customer in the United States, provided the property does not undergo further manufacturing by the purchaser prior to export, and the property is shipped to a foreign destination within one year.[19]

2. Under the destination test, what may seemingly be domestic sales could qualify as export sales.

   <u>Example 7</u>: USAco sells widgets to a widget distributor in Buffalo, New York. One of the Buffalo distributor's biggest customers is a Toronto-based company. If properly documented, the widgets re-sold by Buffalo distributor to a Toronto-based company satisfy the destination test.



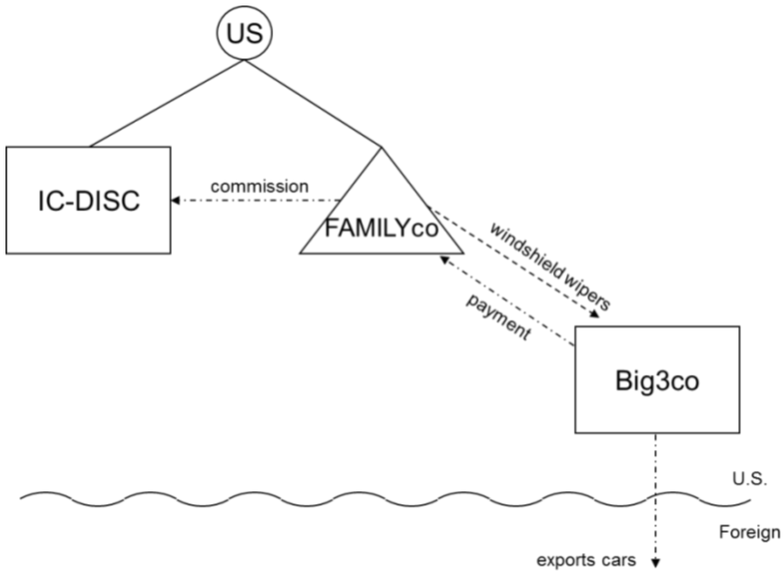
(a) The purchasers of an exporter's product will have to provide the exporter with information showing that the product was exported and, if the domestic purchasers cooperate, the IC-DISC can benefit from these sales.

(b) The U.S. purchaser will have to provide the IC-DISC with documentation of ultimate shipment outside the United States, which may include, *inter alia*, a copy of the export bill of lading, the shipper's export declaration or other information that satisfies the IRS.

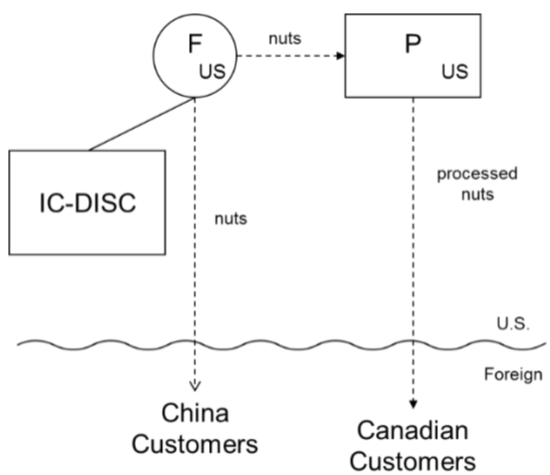
3. At the same time, seemingly export sales could be domestic sales.

4. The export of property by a customer does not satisfy the destination test if the customer itself conducts manufacturing. As with the manufacturing requirement, whether further manufacturing is conducted by the customer is often a question of fact.

Example 8: FAMILYco, a closely-held LLC, manufactures windshield wipers in the United States with U.S. materials. FAMILYco, through its IC-DISC, sells its windshield wipers to Big3co, a Detroit auto manufacturer, which affixes the windshield wipers to its new automobiles that are exported to Canada. The IC-DISC can benefit from the sale of its windshield wipers to Big3co only if affixing windshield wipers to automobiles is not further manufacturing.



Example 9: Farmer grows nuts, some of which he exports directly to customers in China. Farmer sells the other nuts to a Processor that shells the nuts before Processor sells them to Canadian customers. Although Farmer has sold qualified export property to China, the Processor has conducted further manufacturing on the nuts sold to Canadian customers.



5. Sales to a foreign subsidiary can satisfy the destination test. However, only the sale by the exporter (and not by its foreign subsidiary) qualifies.

D. The Maximum of 50% Foreign Content Requirement.

No more than 50% of the fair market value of export property may be attributable to the fair market value of articles imported into the United States. The fair market value of the foreign content is determined by the dutiable value of any foreign components.[20]

IV. DETERMINING THE IC-DISC BENEFIT

A. The commission of an IC-DISC from sales of export property is in an amount constituting as much as the greater of:

1. 4% of the qualified export receipts,[21]

2. 50% of the combined taxable income,[22] or

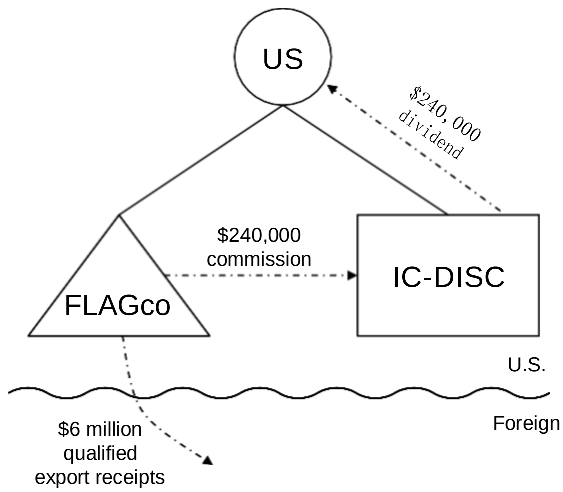
3. the arm's length amount determined under the transfer pricing principles of section 482.[23]

B. Very few taxpayers determine the IC-DISC's income using the transfer pricing principles of section 482 because IC-DISCs generally have little economic activity and, consequently, lower income under those principles than under the other two methods.

C. These methods to determine the IC-DISC's income apply regardless of whether the IC-DISC is a "commission" IC-DISC or a "buy-sell" IC-DISC.[24] Any of these transfer pricing methods for the IC-DISC combined with the 20% rate of tax on dividends from domestic corporations to U.S. individual shareholders create tremendous tax savings from this export benefit.

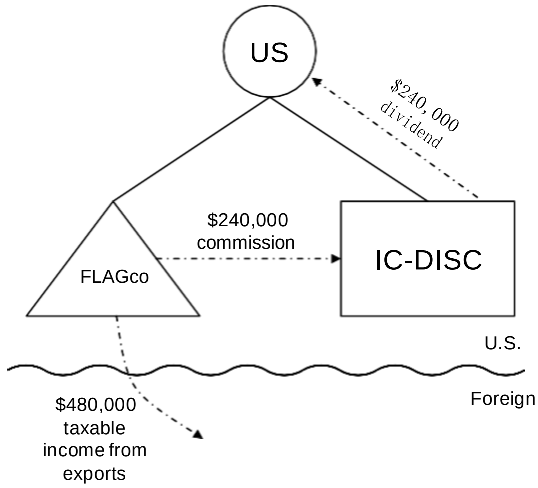
D. The qualified export receipts method allocates 4% of the qualified export receipts from the export sales to the IC-DISC.

Example 10: Betsy Ross, a U.S. citizen owns FLAGco, a single-member LLC that is disregarded for U.S. tax purposes. FLAGco has qualifying export sales of $6 million of flags through its IC-DISC as its only gross receipts. Using 4% of the qualified export receipts method, FLAGco will deduct a commission paid of $240,000 of gross receipts, resulting in a U.S. tax reduction of $96,000 (40% of $240,000). If FLAGco's IC-DISC distributed the cash representing this income as a dividend to Betsy Ross, Betsy Ross would pay U.S. tax of $48,000 ($240,000 at a 20% capital gains rate on the qualified dividend). As a result, the impact of the 4% of qualified gross receipts method combined with the 20% tax rate is a tax savings of $48,000 ($90,000 less $48,000). The tax savings would be even greater if FLAGco were a C corporation because, but for the IC-DISC, the earnings representing the commission would still be in corporate solution.



E. The combined taxable income method allocates 50% of the taxable income from the export sales to the IC-DISC.

Example 11: Betsy Ross owns FLAGco, a single-member LLC that is disregarded for U.S. tax purposes. FLAGco's only taxable income is $480,000 from the export of flags through its IC-DISC ($6 million of exports, $5 million of cost of goods sold and $520,000 of operating expenses). Using the 50% of combined taxable income method, FLAGco pays and deducts $240,000 as a commission to its IC-DISC, which results in tax on only the $240,000 of remaining taxable income, which would be $96,000 (40% of $240,000). If the IC-DISC distributes the $240,000 of cash representing the commission as a dividend to Betsy Ross, that $240,000 would be subject to tax of $48,000 (the 20% capital gains rate on the qualified dividend of $240,000). The individual tax of $48,000 and FLAGco's tax on its remaining $240,000 of $96,000 totals $144,000, which is $48,000 less than the $192,000 if FLAGco had operated without the IC-DISC. The tax savings would be even greater if FLAGco were a C corporation because, but for the IC-DISC, the earnings representing the commission would still be in corporate solution.



V. FOREIGN-DERIVED INTANGIBLE INCOME ("FDII")

A. FDII tries to incentivize C corporations to keep their intangibles in the United States by decreasing the rate on some high returns from 21% to 13.125%.

1. The FDII deduction regime ignores the definition of intangibles[25] and treats any gross income in excess of a 10% return on the quarterly average of depreciable assets as attributable to intangibles.

2. Code section 250(a)(1)(A), which is very definition laden, reaches the 13.15% tax rate for a C corporation by allowing a deduction of 37.5% FDII.

3. FDII is more practically defined as[26]:

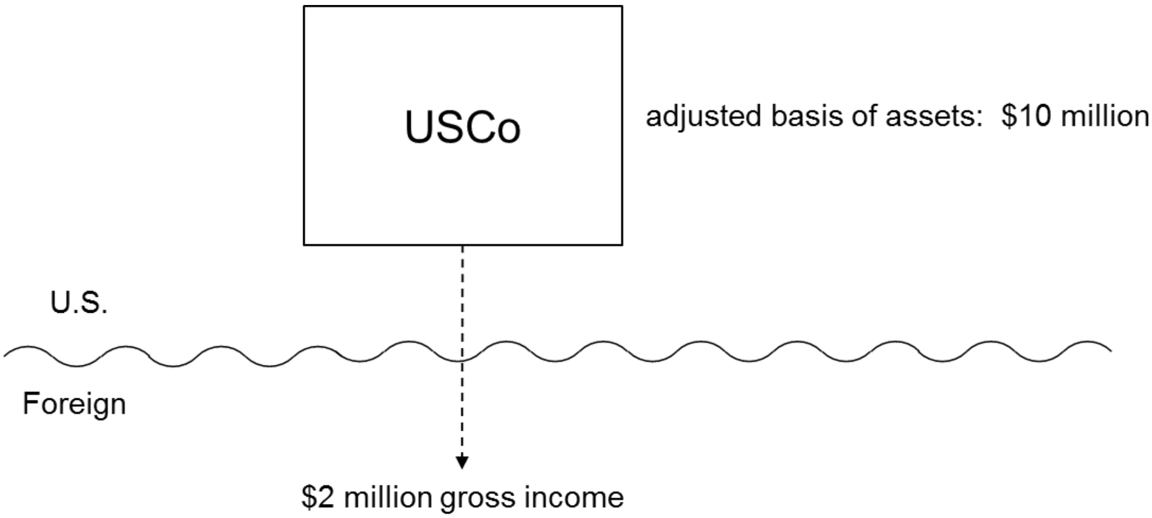
$$(\text{gross income} - 10\% \text{ adjusted basis of assets}) \times \frac{\text{foreign sales or services}}{\text{gross income}}$$

B. Terminology.

1. The gross income excludes any GILTI or Subpart F income.

2. The definitions of foreign sales income and foreign services income ae broader than their definitions under the IC-DISC rules. For example, the foreign sales are not limited to U.S.-manufactured products and the foreign services do not have to be related to or subsidiary to the foreign sales.[27]

Example 12: USCo, a U.S. C corporation has depreciable assets with a quarterly average of $10 million. USCo has gross income of $2 million from foreign sales.



The FDII deduction will be as follows:

$$37.5\% \text{ of } (\$2 \text{ million} - 10\% \text{ of } \$10 \text{ million}) \times \frac{\$2 \text{ million}}{\$2 \text{ million}} = \$37{,}500$$

Deducting $37,500 from $2 million of foreign sales income leaves $1,625,000 that incurs tax of $341,250. In effect, this $341,250 is a blended rate of 13.125% on the $1 million of income beyond the routine 10% return ($131,250) and 21% on the $1 million representing the routine 10% return.

C. Tax Savings.

1. A C corporation can obtain tremendous tax savings by combining the deduction for FDII with an IC-DISC.

2. The amount representing the commission will be a qualified dividend while the non-commission income will incur tax at only 13.125%.

3. If the exporter is a pass-through entity, with an individual owner paying tax at a top individual rate of 37%,[28] the individual should consider having the S corporation contribute the export operations to a C corporation because, as a distributor, most (if not all) of the income will be FDII.

VI. MAXIMIZING THE IC-DISC'S INCOME

A. An exporter can use any of the methods described in the previous section to achieve the greatest IC-DISC income possible.

1. As a simple rule of thumb, the combined taxable income method results in the largest IC-DISC income when exports have a net pre-tax margin of 8% or greater (producing a benefit of approximately $100,000 for every $1 million of combined taxable income).

2. On the other hand, the qualified export receipts method provides the largest IC-DISC income when the net pre-tax margin is less than 8% (producing a benefit of approximately $8,000 for every $1 million of qualified export receipts).

3. The IC-DISC rules permit the use of different methods to different sales based on product lines, recognized industry or trade usage, and even by transaction.[29]

4. In practice, most of the decisions will be between the qualified export receipts and combined taxable income methods.

5. If the net pre-tax margin on exports is lower than worldwide net pre-tax margins, which often occurs due to the extra shipping and administrative expenses of foreign sales, the marginal costing of combined taxable income may result in the largest commission.

6. The exporter can maximize the IC-DISC's income by ignoring loss sales.[30]

B. Grouping.

1. Grouping refers to the exporter's maximizing the IC-DISC's commission by separating the high-margin sales from the low-margin sales.

Example 12: VinCo, an S corporation, exports domestically produced beer and wine. The annual gross receipts and combined taxable income from these export sales are as follows:

	Gross receipts	*Combined taxable income*	*Net pre-tax margin*
Beer	$ 5,000,000	$1,000,000	20%
Wine	$ 5,000,000	$ 200,000	4%
Total export sales	$10,000,000	$1,200,000	12%

Through product grouping, VinCo can use the 50% of combined taxable income method for sales of beer, which allocates $500,000 [50% of $1,000,000] to the IC-DISC. At the same time, VinCo can use the 4% of qualified export receipts method for sales of wine, which excludes $200,000 [4% of $5,000,000]. The total amount of the IC-DISC's income is $700,000.

2. Exporters have considerable flexibility in grouping.

(a) An exporter's product or product line groupings will be accepted if the groupings conform to recognized trade or industry usage or the two-digit major groups (or inferior classifications) of Standard Industrial Classification codes.[31]

(b) In addition, within the same taxable year, an exporter can use grouping for one product line and the transaction-by-transaction method for another product line.[32]

C. Marginal Costing.

1. A second technique for increasing the IC-DISC's income is marginal costing.[33] Under the general rule, combined taxable income equals the excess of the qualified export receipts over the total direct and indirect costs related to exports.[34]

(a) If the exporter elects marginal costing, however, only marginal costs (e.g., direct costs) are taken into account in computing combined taxable income.

(b) Therefore, marginal costing allows a taxpayer to increase combined taxable income by excluding the fixed costs related to export sales.

(c) Marginal costs include only the direct material and direct labor costs.

(d) All other costs, such as selling, general, administrative, and even interest expenses are ignored for purposes of computing combined taxable income.[35]

(e) A requirement for the use of marginal costing states that the amount of combined taxable income under marginal costing must be greater than that under a full costing approach.[36]

2. An overall profit percentage limitation restricts the combined taxable income of an exporter to an amount equal to qualified export receipts multiplied by the ratio of full costing combined taxable income from all sales (domestic and foreign) to total receipts from all sales (domestic and foreign).[37]

D. <u>Expense Allocations</u>.

1. A third technique for increasing the IC-DISC's income is expense allocations.

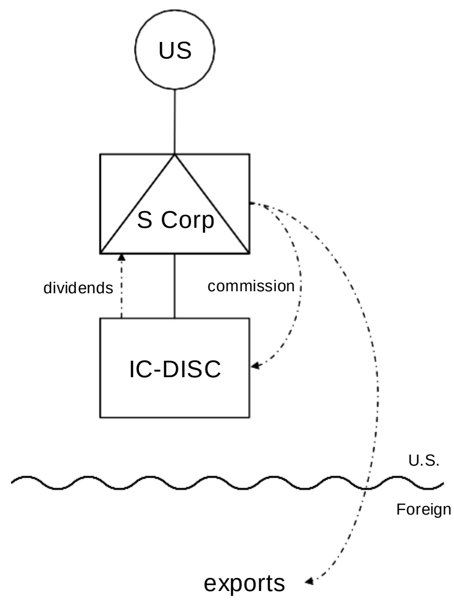
2. As discussed above, combined taxable income equals the excess of qualified export receipts over the total costs of the exporter, which includes deductions that are definitely related to export sales (e.g., cost of goods sold) and a ratable portion of any deductions that are not definitely related to any specific class of gross income (e.g., interest expense and selling, general, and administrative expenses).[38]

3. A taxpayer can increase combined taxable income and, in turn, the amount of its IC-DISC's income, by developing defensible apportionment bases that allocate fewer deductions against qualified export receipts.[39]

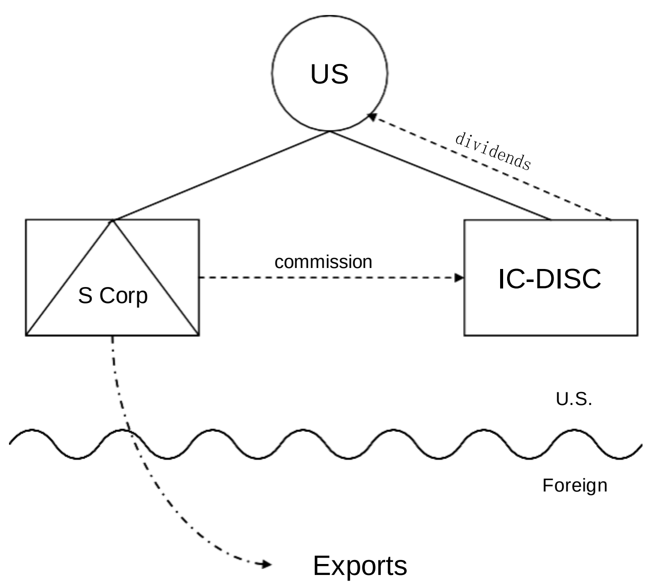
VII. STRUCTURING THE IC-DISC

A. An IC-DISC may either be a subsidiary of a flow-through entity or a brother-sister entity of a flow-through entity.

1. IC-DISC as a subsidiary of an S corporation or another flow-through entity.

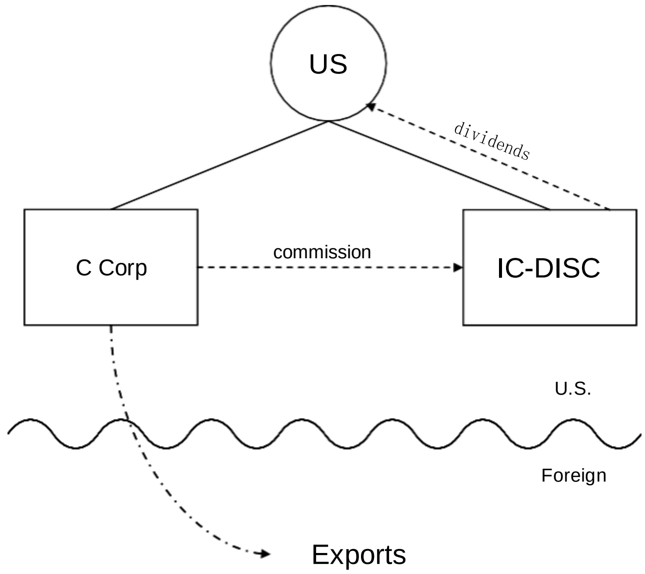


2. IC-DISC as a brother-sister entity of an S corporation or another flow-through entity.



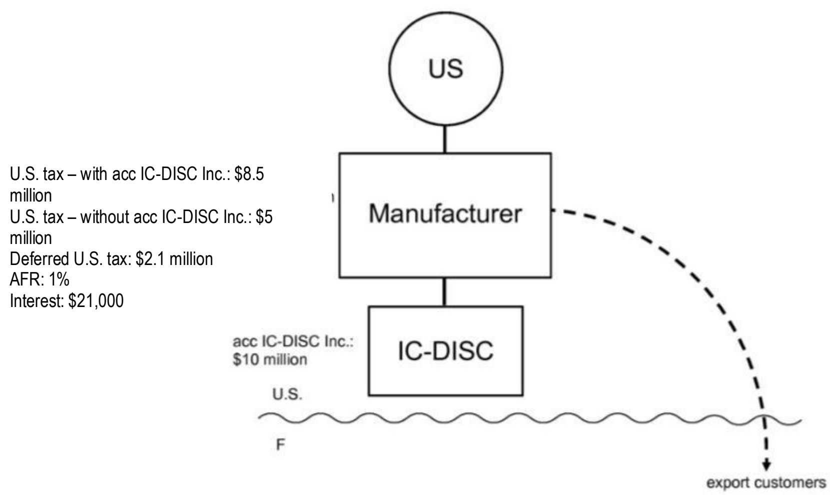
B. An IC-DISC should only be a brother-sister entity of a C corporation.

1. IC-DISC as a brother-sister entity of a C corporation.

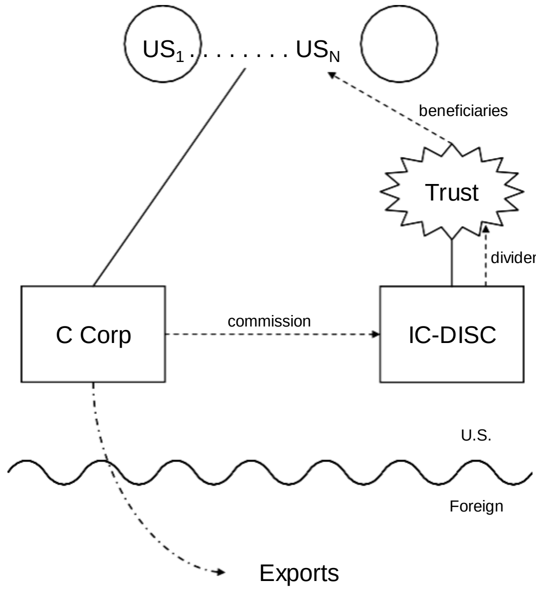


2. An IC-DISC should not be the subsidiary of a C corporation because the C corporation is not entitled to a dividends received deduction when receiving the dividend from the IC-DISC.[40]

3. An IC-DISC as a subsidiary of a C corporation only works for deferral.



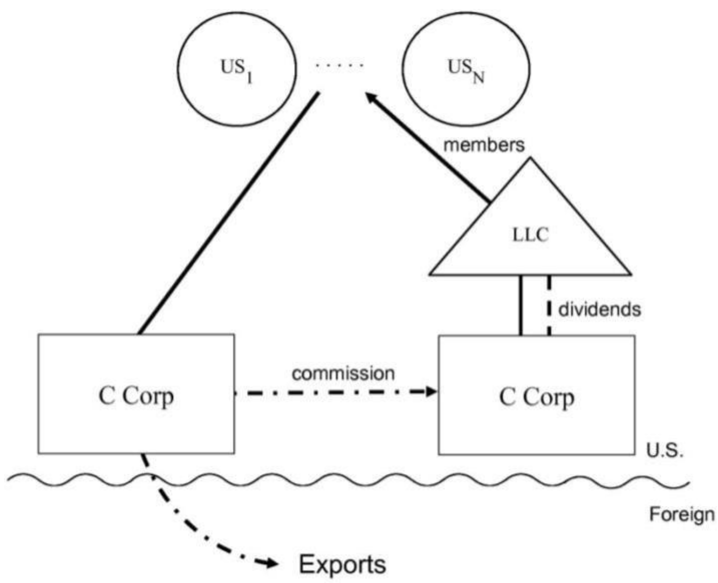
4. If shares of a C corporation are commonly sold, a trust could own the shares of the IC-DISC.



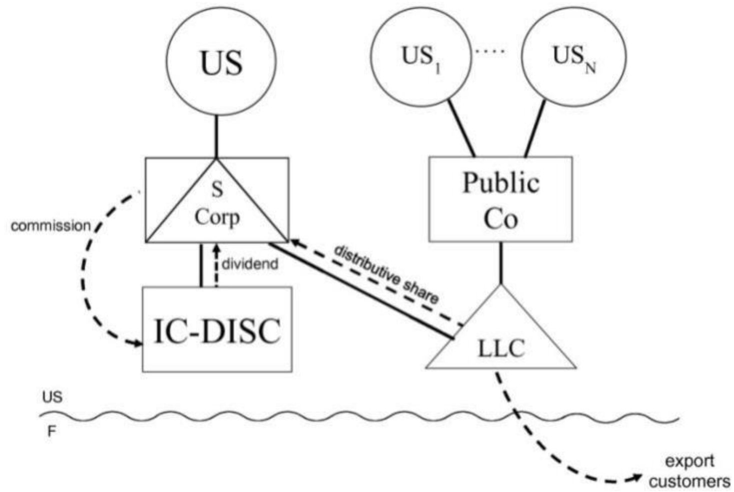
(a) The beneficiaries of the trust would be the owners of the C corporation's shares.

(b) This structure would avoid changing the ownership percentage of the IC-DISC shares every time ownership of the C corporation's shares change.

5. LLC ownership also works but is not as easy to draft.

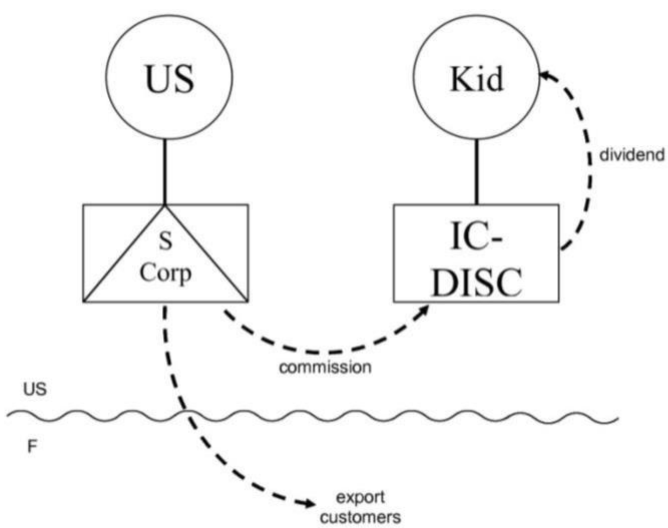


6. An S corporation (or another flow-through entity, such as an LLC), can use an IC-DISC when entering a joint venture with a public company.

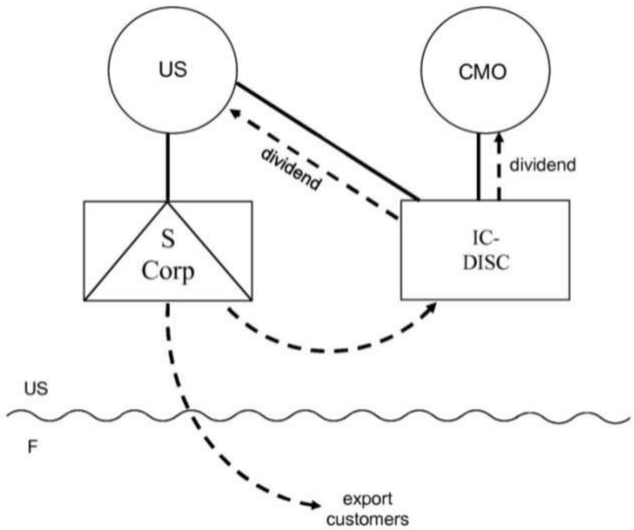


C. Provision of IC-DISC shares to someone who is not currently an owner of the exporter.

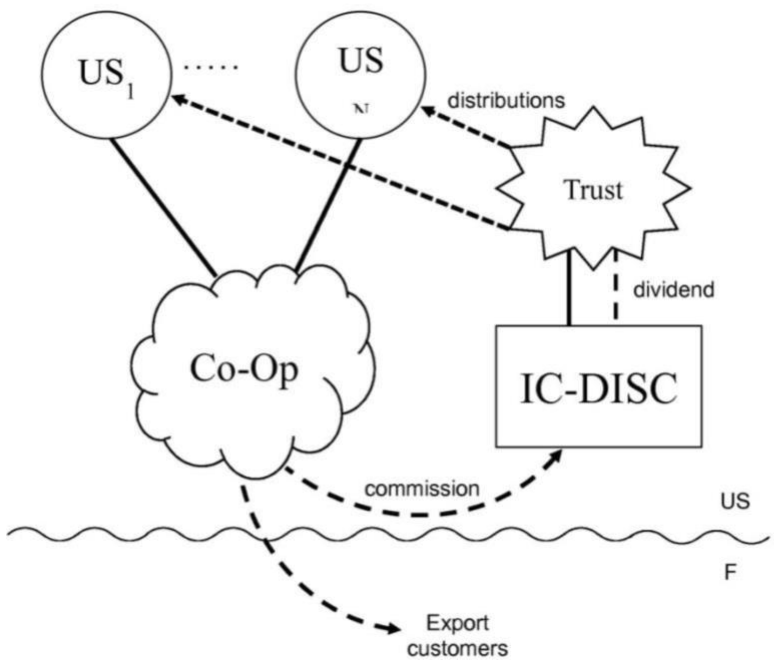
1. Does providing IC-DISC shares to a family member result in gift tax implications?



2. IC-DISC shares could be provided to an employee who is not an owner of the exporter.

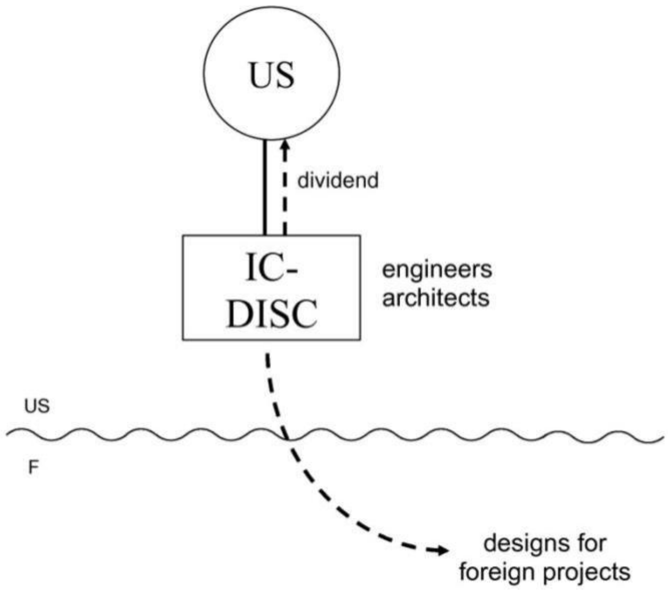


D. IC-DISCs can turn patronage dividends (taxed at ordinary rates) into qualified dividends.

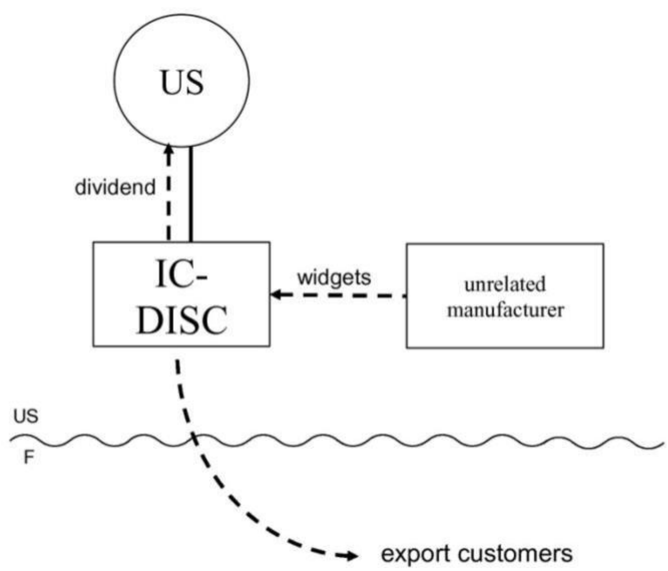


E. Use of only an IC-DISC without another entity.

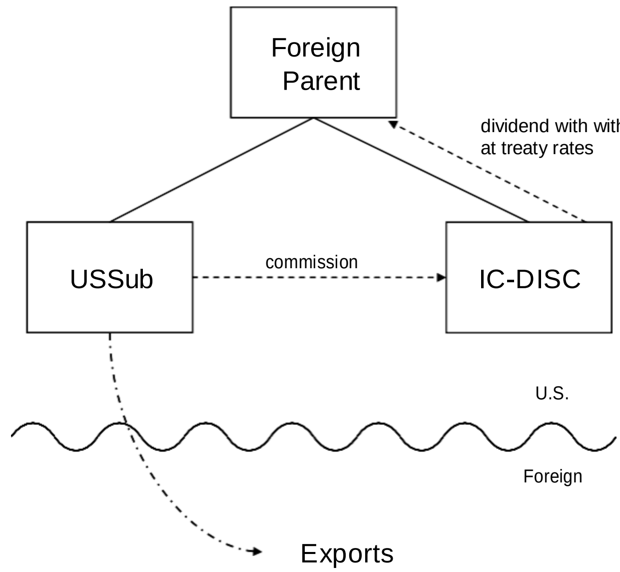
1. Architects and engineers providing designs for foreign projects can all be in one IC-DISC.



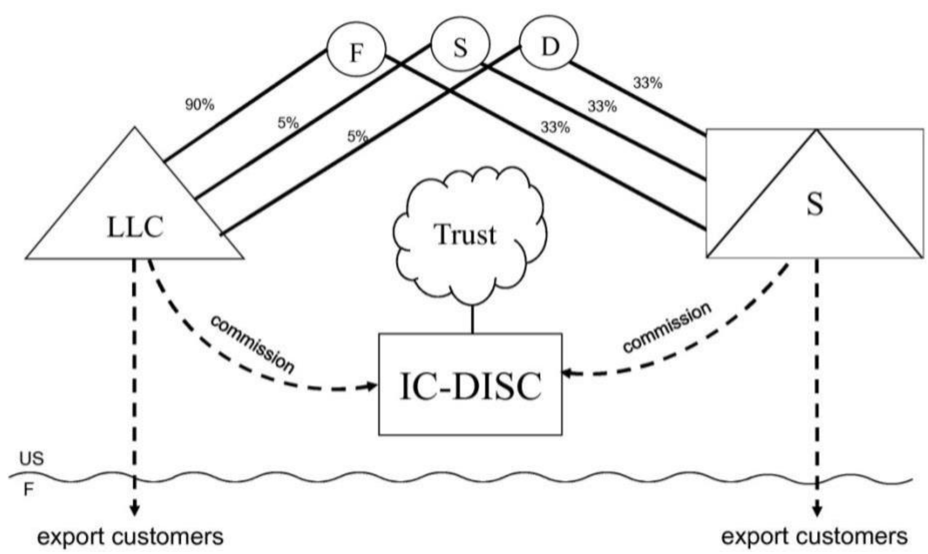
2. Because an IC-DISC cannot manufacture product, a pure distributor that merely exports can capture the entire benefit of an IC-DISC.



F. A foreign parent in a country with a recently ratified treaty with the United States can take advantage of reduced treaty rates.

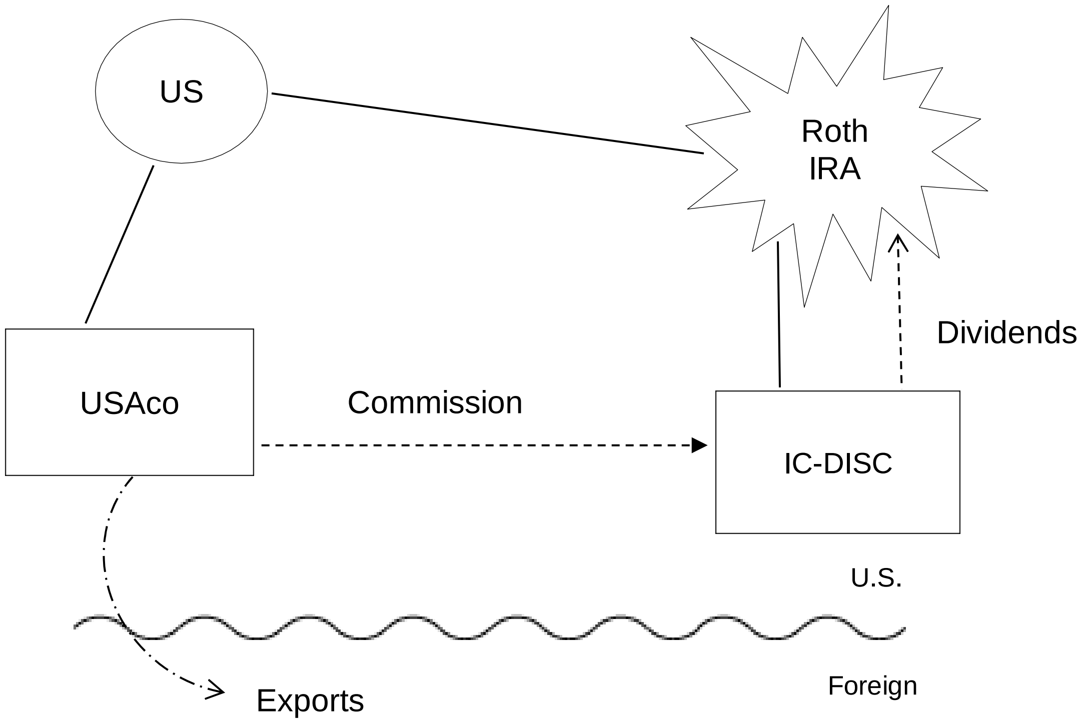


G. An IC-DISC can be used with a trust to capture the benefits of two related exporting entities that have varying ownership interests.



H. Ownership by a Roth IRA

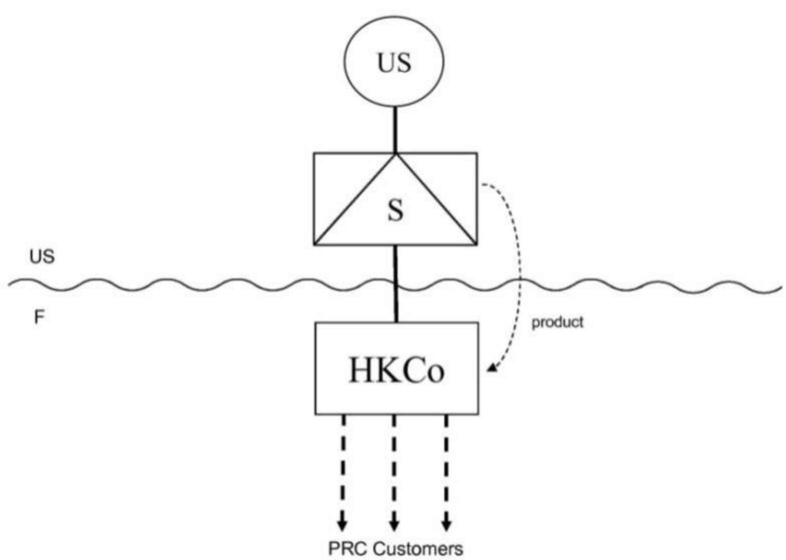
1. IC-DISC can be owned by either a Roth IRA on a C corporation that the Roth IRA owns.



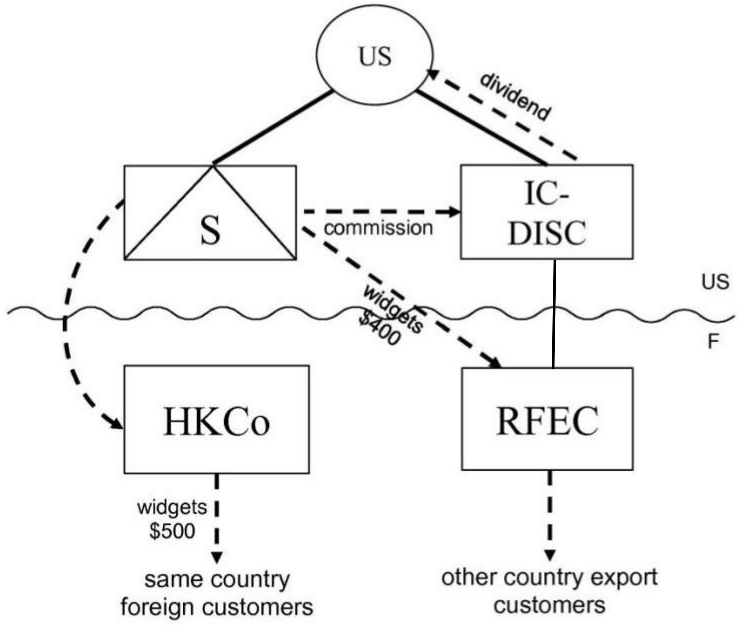
2. Although the Tax Court ruled against this structure,[41] two Circuit Court of Appeals have approved.[42]

I. IC-DISC to avoid Subpart F or GILTI.

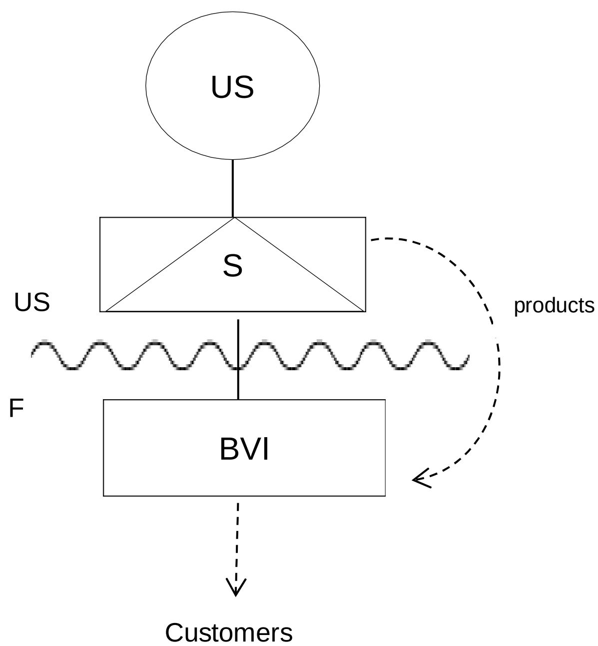
1. Foreign based company sales income occurs when product manufactured outside the CFC's country of incorporation and sold for use outside the CFC's country of incorporation as a related-party component.

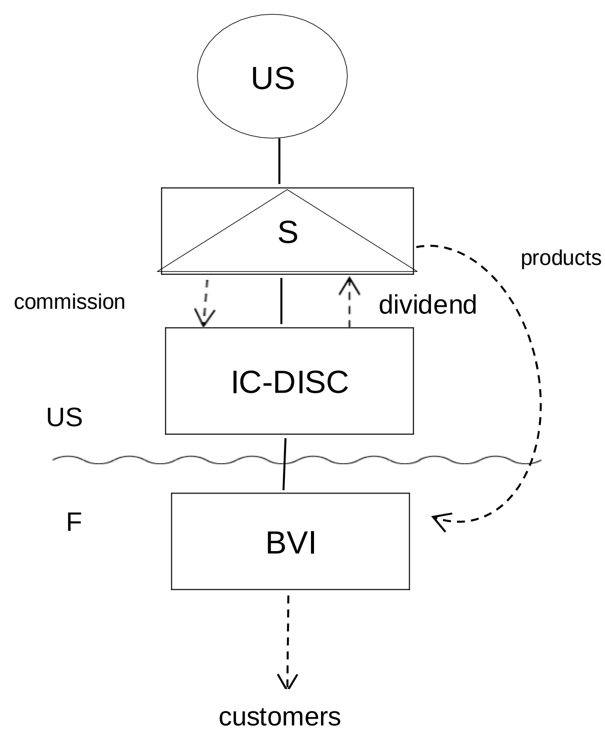


2. We can convert ordinary income inclusions from Subpart F into qualified dividend income via a Related Foreign Export Corporation.



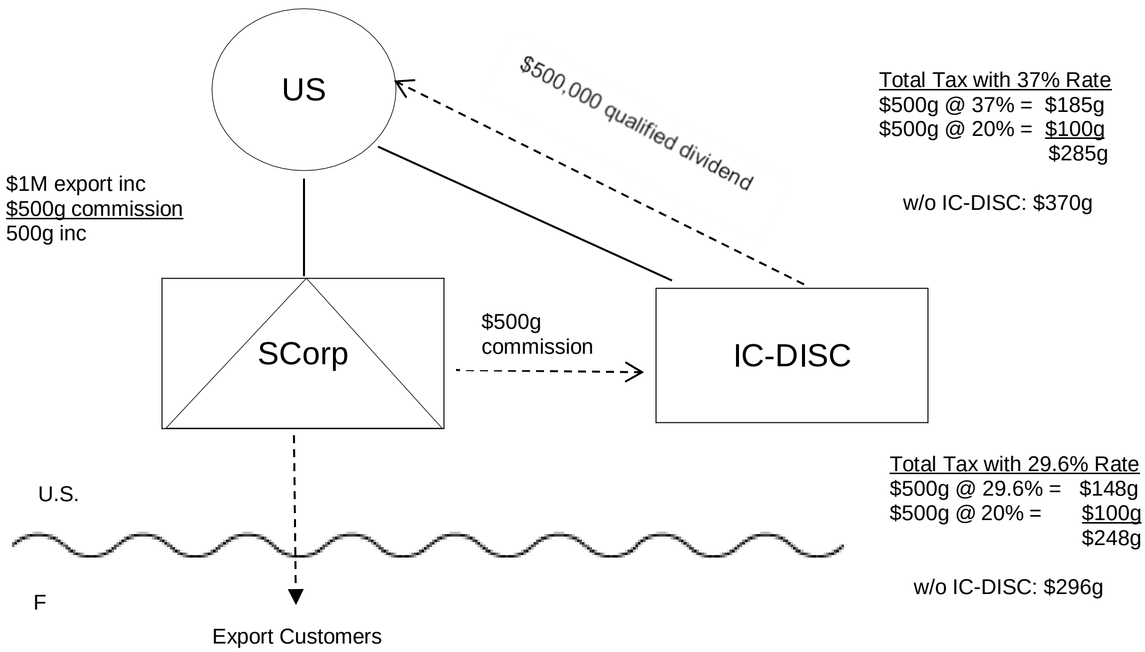
3. We can convert ordinary income inclusions from GILTI into qualified dividend income via a Related Foreign Export Corporation.



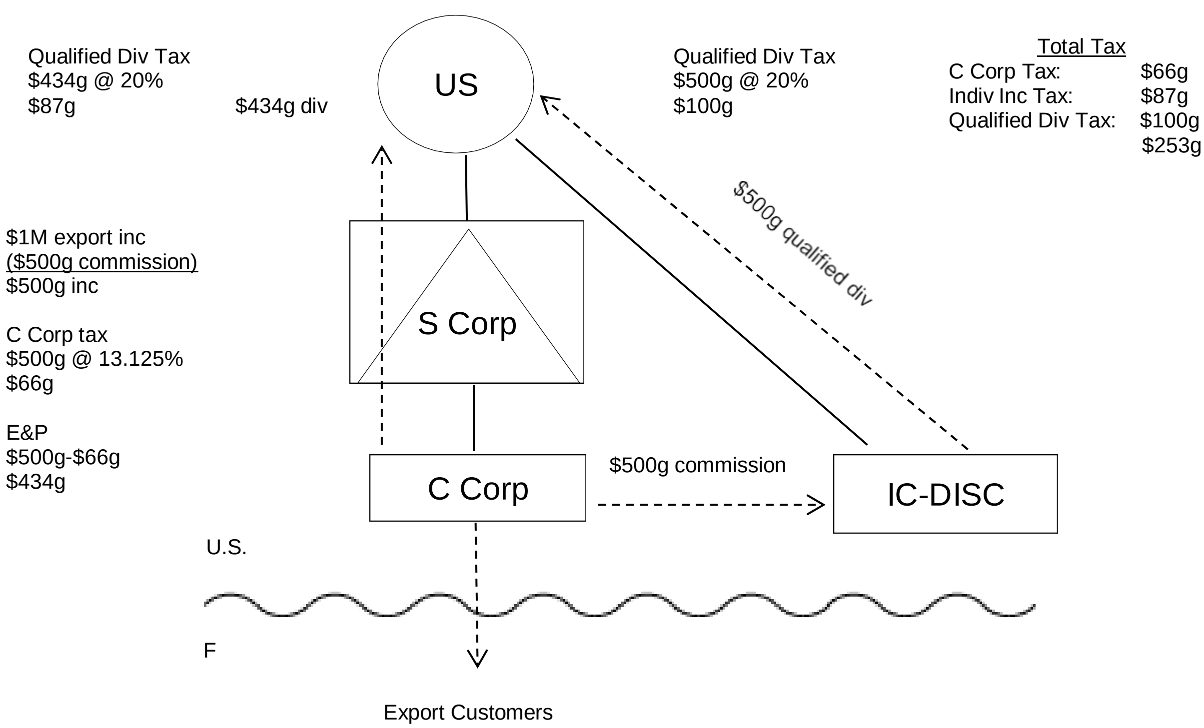


J. IC-DISC and the 2017 Act.

1. Does section 199A apply?



2. Super-charging an IC-DISC with FDII.



VIII. IMPLEMENTATION CONSIDERATIONS FOR THE IC-DISC

A. Execution is critical to ensure that the IC-DISC and the export sales qualify for this benefit.

B. Implementation considerations include the following:

1. Incorporate the IC-DISC before the export sales begin and make a $3,000 capital contribution;

2. Analyze the export sales, which includes sales to Canada;

3. Draft the commission agreement between the IC-DISC and the exporter;

4. Prepare and file the Form 4876-A that elects IC-DISC status for the corporation;

5. Prepare a manual that contains guidelines for the client's operating procedures, which includes a checklist/calendar to determine when the client should complete various activities, such as when the client should determine that the IC-DISC has satisfied the gross receipts test and the export assets test.

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[1] Code. Sec. 992(a)(1)(C).

[2] Code Sec. 992(a)(1)(C).

[3] Reg. § 1.992-2.

[4] Code Sec. 991.

[5] The 37% individual tax rate less the 20% qualified dividend rate is seventeen percentage points.

[6] After a corporate tax rate of 21%, the qualified dividend rate of 20% results in an effective rate of 37%, which is 17 percentage points higher than the 20% dividend rate.

[7] Code Sec. 995(a) and (b).

[8] Code Sec. 995(b)(1)(E). It is not possible to circumvent the $10 million limitation by creating multiple IC-DISCs. Code Sec. 995(b)(4)(B).

[9] Code Sec. 995(f)(2). A U.S. shareholder must continue to pay interest on deferred IC-DISC income until that income is distributed or deemed distributed by the IC-DISC. The interest rate is the current market rate for 52-week Treasury bills. Code Sec. 995(f)(4).

[10] Code Sec. 1411.

[11] Code Secs. 992(a)(1) and 993(d) and (f).

[12] Code Secs. 992(a)(1)(E) and 993(b).

[13] Code Sec. 993(b)(4).

[14] Code Sec. 993(c).

[15] Reg. § 1.993-3(c).

[16] 245 F.3d 149 (2d Cir. 2001); *rev'g* 70 TCM 39 (1995).

[17] Code Sec. 993(c)(1)(B).

[18] Reg. § 1.993-3(d)(2)(i)(a).

[19] Reg. § 1.993-3(d)(2)(i)(b).

[20] Reg. § 1.993-3(e)(4)(i).

[21] Code Sec. 994(a)(1).

[22] Code Sec. 994(a)(2).

[23] Code Sec. 994(a)(3).

[24] The IC-DISC may also add 10% of its export promotion expenses to the commission, but the export promotion expenses are typically negligible.

[25] Code Sec. 936(a)(3)(b).

[26] Code Sec. 250(b)(1) through (3).

[27] Code Sec. 250(b)(5).

[28] This scenario assumes that the new deduction under Code Sec. 199 does not apply.

[29] Reg. § 1.994-1(c)(7).

[30] Reg. § 1.994-1(e)(1).

[31] Reg. § 1.994-1(c)(7)(ii).

[32] Reg. § 1.994-1(c)(7)(iii).

[33] Code Sec. 994(b)(2) and Reg. § 1.994-2(c).

[34] Reg. § 1.994-1(c)(3).

[35] Reg. § 1.994-2(b)(2).

[36] Reg. § 1.994-2(b)(1). When computing marginal costing combined taxable income, taxpayers use the same transaction grouping procedures available when computing full costing combined taxable income.

[37] Reg. § 1.994-2(b)(3).

[38] Reg. § 1.994-1(c)(6)(iii).

[39] For an example in the context of research and development expenditures, see *St. Jude Medical, Inc. v. Comm'r*, 34 F.3d 1394 (8th Cir. 1994).

[40] Code Sec. 243(a). The dividends are not coming from an entity subject to corporate tax.

[41] *Summa Holdings, Inc. v. Commissioner*, T.C. Memo. 2015-119.

[42] *Summa Holdings, Inc. v. Commissioner*, 848 F.3d (6th Cir. 2017); *Benenson v. Commissioner*, 887 F.3d 511 (1st Cir. 2018).

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Mr. Misey has spoken on international taxation at continuing education programs in many states and foreign countries. He has published numerous articles and has authored the treatises *U.S. Taxation of International Transactions*, *ETI Repeal Under The American Jobs Creation Act of 2004* and *Federal Taxation: Practice and Procedure*.

Mr. Misey received his Juris Doctor and Master of Business Administration degrees from Vanderbilt University and his Master of Laws in Taxation, with high distinction, from Georgetown University, where he was the graduate student editor of *The Tax Lawyer*. A member of the bar in California, Kentucky, Wisconsin and the District of Columbia, he can be reached via phone at either 312-207-5466 or 414-298-8135 or via e-mail at rmisey@reinhartlaw.com.

A Primer on the International / Corporate Tax Updates under the TCJA and Other Selected Developments

Texas Bar Association – International Tax Seminar

November 8, 2018

By William Skinner

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Emphasis:
International Tax
Tax Planning
Tax Controversy

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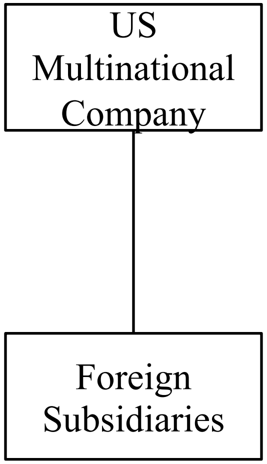
He attended the University of California at Berkeley, and Stanford Law School. Prior to joining Fenwick & West, Will clerked for the Hon. Carlos T. Bea, at the US Court of Appeals for the Ninth Circuit.

New International Corporate Developments – the Agenda

- Outbound Provisions of the Act – Other than 965 and GILTI
- Inbound Provisions of the Act
- Regulatory Developments

Outbound Corporate Tax Developments (other than Section 965 and GILTI)

Overview



- The TCJA revolutionized the taxation of US Corporations with offshore operations.

International Tax Reform Impact's on US Multinational Corporations in a Nutshell

	Old Rules (pre-2018)	New Rules (Post-TCJA)
Taxation of a US Corporation's CFCs	Deferred from US tax until repatriated unless subject to subpart F Full US tax (35%) when earnings repatriated	Transition tax on all deferred foreign earnings under pre-2018 law US minimum tax on most CFC income of 10.5% (i.e., so-called tax on "GILTI") Any income not taxed as GILTI can be repatriated tax-free under Section 245A
Taxation of Foreign Sales Made Directly by a US Corporation (i.e. exports)	Taxed at normal corporate rates (35%)	Incentive tax rate of 13.125% for Foreign Derived Intangible Income (FDII), instead of 21%
Treatment of Foreign Branches	Taxed at normal corporate rates (35%), losses available	Same – but lower rate (21%) and new "branch basket" for foreign tax credits
Foreign Tax credits	Multiyear pooling for indirect credits 2 Primary Baskets	Repeal pooling and move to single year credit under Section 960 4 Primary Baskets and Lower Rates of Tax 80% haircut and no FTC carryover in the GILTI basket
Other		BEAT Enhanced transfer pricing rules / 367 Anti-hybrid rules

Foreign-Derived Intangible Income
(“FDII”)

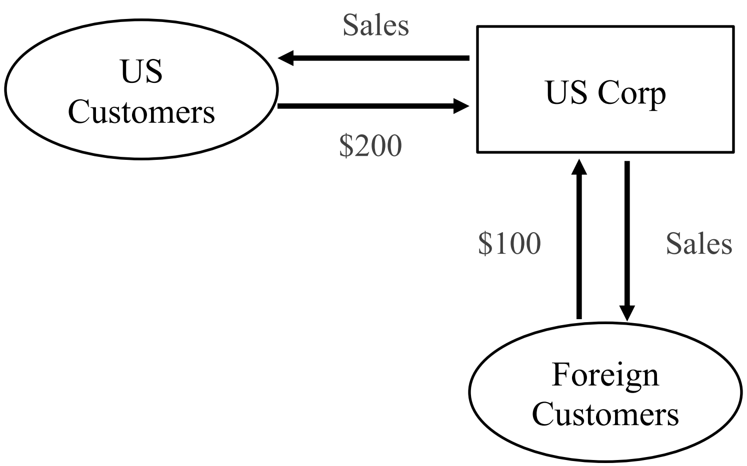
GILTI and FDII – the Stick & Carrot

- GILTI and FDII were enacted together to impose a global minimum tax on CFC earnings of a US taxpayer, while also reducing the US corporate tax on export sales made directly out of the US.

- The intent is to make a US corporation indifferent between earning foreign sales income directly in the US vs. in a foreign IP company (e.g., in Ireland).

- The applicable rates (10.5% for GILTI and 13.125% for FDII) partially phase out beginning in 2025 (13.125% for GILTI and 16.4% for FDII).

FDII Benefits for Foreign Sales



- FDII potentially provides a reduced rate of tax of 13.125% on US Corp's taxable income with respect to its foreign customers.
- ***Note*** – both product sales and services income may qualify for FDII.

Elements of the FDII Deduction

- Taxpayer must be a subchapter C corporation (i.e., FDII deduction under Section 250 is only available for C Corporations).
- Taxpayer must have "deduction eligible income"
- Taxpayer must establish that this income is "foreign derived income"
- Only the "intangible income" of "foreign derived deduction eligible income" is entitled to FDII benefits
- <u>Taxable income limitation</u> – to the extent the taxpayer has an NOL from other sources, this is allocated proportionately to reduce the FDII deduction and GILTI deduction.

Deduction Eligible Income

- Deduction eligible income is defined as income of the taxpayer, except for the following types of income:
  - Subpart F income
  - GILTI
  - ***Financial services income within the meaning of Section 904(d)(2)(D) of the Code***
  - Dividends received from CFCs
  - Domestic oil & gas extraction income
  - ***Foreign branch income***

Foreign Derived Income

- The taxpayer must establish under regulations to be provided by the IRS that the income is derived from a foreign sale (i.e., an export) of the property or services.
- Tangible property sales are deemed to be foreign derived if (1) sold to a person that is not a US person and (2) established to the IRS's satisfaction to be sold for a foreign use.
- For services, the taxpayer must establish that the service is provided to any person, or with respect to property, not "located within the United States."
- **Income from the lease or license of property is treated as derived from a sale of property.**

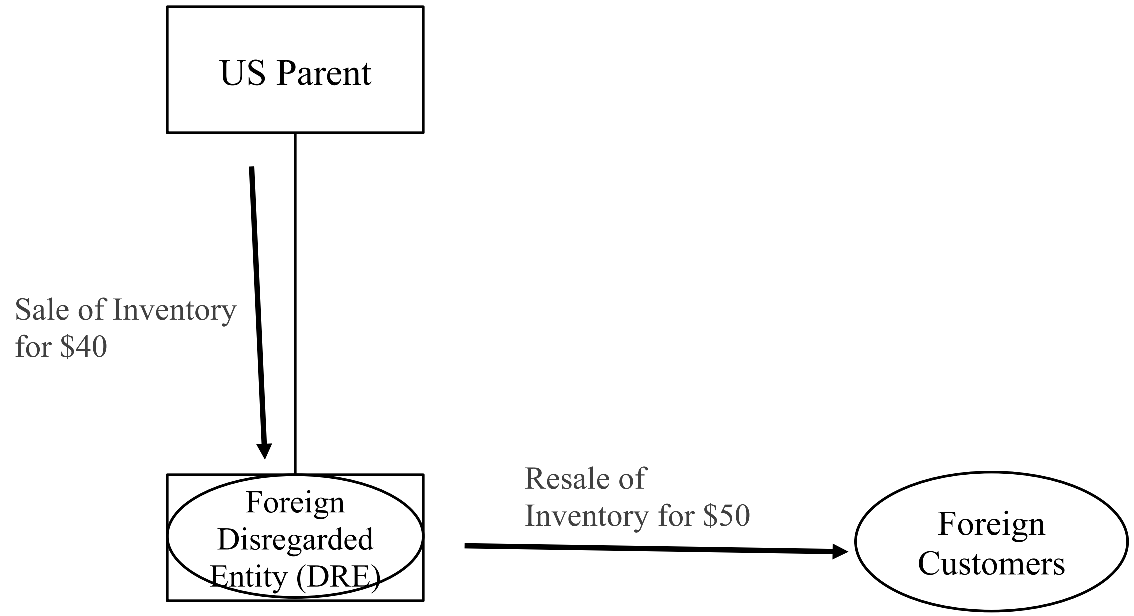
Foreign Derived Income – Related Parties & Intermediaries

- For sales to related parties (e.g., foreign affiliate), the FDII rules allow the taxpayer to look through to the foreign affiliate's sale to determine foreign use
  - Property must ultimately be sold for use, or used, outside of the United States
  - For services, related party must not perform "substantially similar services" for any US person
- Unrelated domestic intermediaries (e.g., a reseller) are not subject to look-through even if they resell the goods or services abroad – the reseller is the one who is entitled to FDII benefits.

Foreign Derived Intangible Income

- Once the taxpayer has established the amount of its deduction eligible income that is foreign derived, FDII rules limit the deduction to the portion of this income that is deemed to be "intangible income."
- Intangible income is defined as the amount of taxable income minus 10% of the domestic corporation's Qualified Business Asset Investment (QBAI). This follows the same rules as GILTI computation for CFCs, including the use of Section 168 straight-line depreciation rules.
- *Paradoxically, the new rules incentivize US companies to locate plant and equipment (i.e., QBAI) in CFCs, rather than in the United States.*

FDII and Foreign Branch Income



- What is US parent’s income eligible for FDII deduction?
- How much of its gross income is attributable to the “branch basket”?

Foreign Tax Credit Changes

Foreign Tax Credits in the New Regime

- The Tax Cuts and Jobs Act placed renewed emphasis on foreign tax credit planning for several reasons:
  - Reduction of US tax rates overall, and special reduced rates of tax for GILTI / FDII, make excess credit position more likely
  - Segregation of a US taxpayer's income into greater number of baskets
  - Single year credit calculation under Section 960 and GILTI
  - Changes to source and expense allocation rules

- Major open questions remain pending upcoming regulatory guidance

The New Section 904(d) Baskets

Old Law (2006-2017):

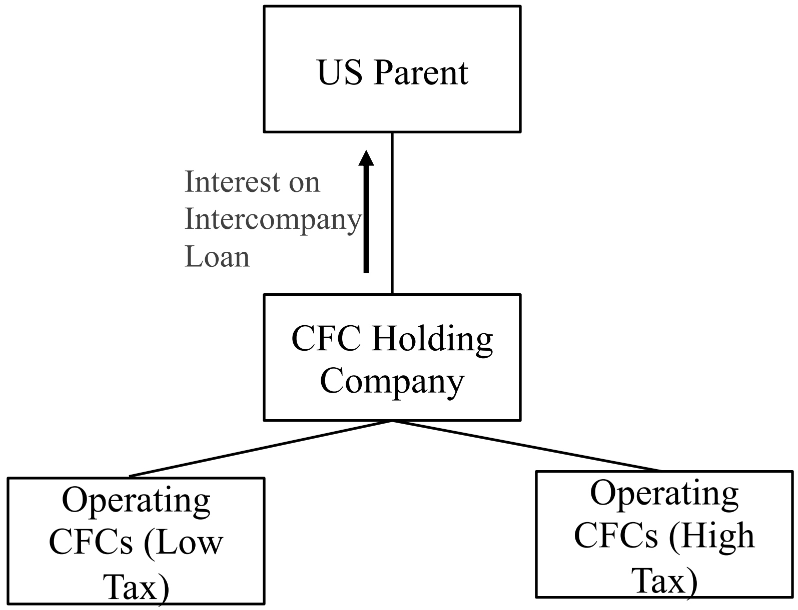
- General Basket
- Passive Basket

New Law (2018 and Beyond):

- General Basket
- Passive Basket
- Branch Basket
- GILTI

- Will transition rules address how tax credit carryovers arising in different baskets may be carried to periods before or after the Act?

Example of the Impact of the New Sec. 904(d) Baskets

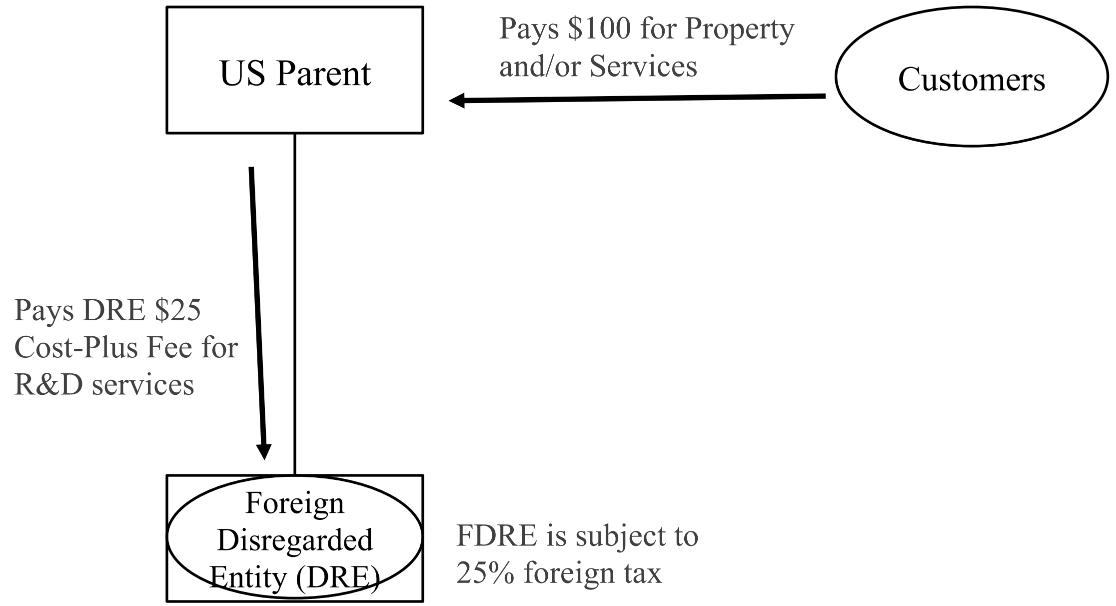


- Under old law, Section 904(d) interest payments were general basket income able to be credited against operating income.
- Will look-through income continue to be in the general basket even if the interest expense reduces GILTI?

The Branch Basket

- Sec. 904(d)(2)(J) creates a new separate category of income for business profits attributable to a foreign branch. Attribution of profits to the foreign branch category are subject to regulations.
- Several questions arise for regulations in attributing profits to the branch basket:
    - Books and records vs. ECI concept
    - Treatment of disregarded transactions between the branch and the home office
    - Sale of a branch
    - Withholding taxes on a distribution from the branch to the home office

FDII and Foreign Branch Income

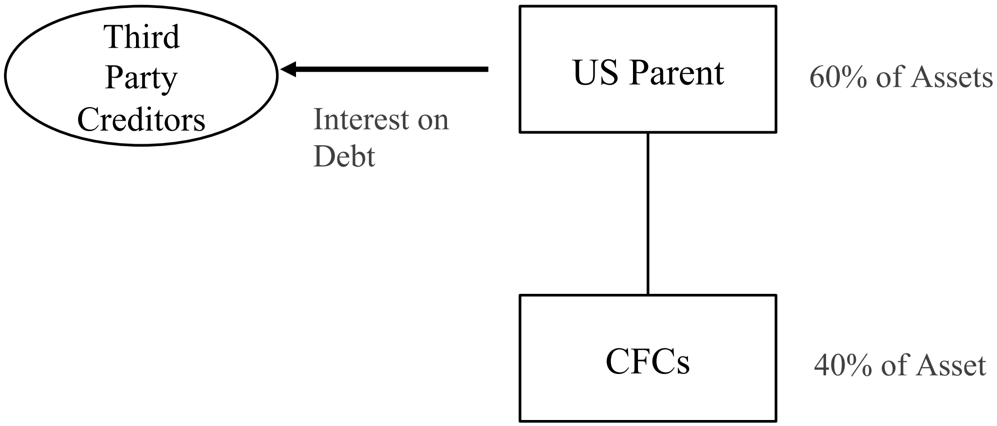


- In potentially crediting the taxes imposed on the foreign disregarded entity, consider: the Source of US Parent's income between US and Foreign, and the attribution of profits to the foreign branch.

Section 863(b) Repeal

- Longstanding IRS regulations under IRC Section 863(b) provided for split sourcing of income from the manufacture of property in the US and its sale without the US (or vice-versa).
- So-called 50/50 rule as a default method of allocation provided foreign tax credit limitation benefits to US exporters by sourcing half of their income to foreign sources under the title passage rule.
- TCJA Sec. 14304 amended Section 863(b) to provide that income from the production and sale of inventory will be sourced entirely to the place of production.

Sec. 861 Interest Expense Apportionment – Repeal of FMV Method



- For foreign tax credit purposes, US Parent generally allocates and apportions interest expense between US and foreign source income using an asset method.
- Act Sec. 14502 mandated use of the tax book value method in all cases, no longer allowing the FMV method from old law.
- “Worldwide apportionment” to be effective beginning in 2020.

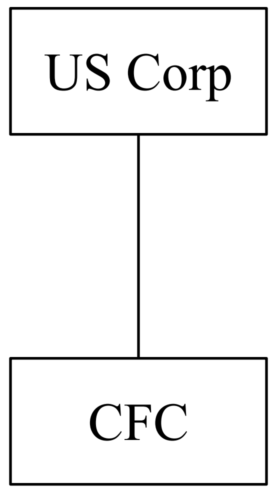
The New Indirect Credit – Section 960

- Section 902's multi-year pooling rules were repealed as part of the move to the new system.
- New Section 960(a) provides an indirect credit for CFC-level taxes "attributable to" inclusions under Subpart.
- Section 960(d) provides an indirect credit for "tested foreign income taxes" attributable to GILTI inclusions, subject to certain limitations:
  - 80% haircut on taxes
  - Tested income taxes creditable in year is limited to "inclusion percentage" of GILTI in the year
  - No Section 904(c) carryover or carryback.

The GILTI Credit - Impact of Expense Allocations

- One issue pending guidance from the IRS is how existing expense allocation rules under IRC Section 861 apply to GILTI.
- If a shareholder is required to allocate significant expenses to GILTI (e.g., stewardship expense, interest, R&D), then some of the indirect credit on GILTI may be limited by the foreign tax credit limitation of Section 904.
- As a result a shareholder may end up paying US tax on GILTI, even if its CFCs' effective foreign tax rate far exceeds 12.5%.

Example of Expense Allocations & GILTI



US Corp has $10 of expenses allocated to GILTI under Sec. 861

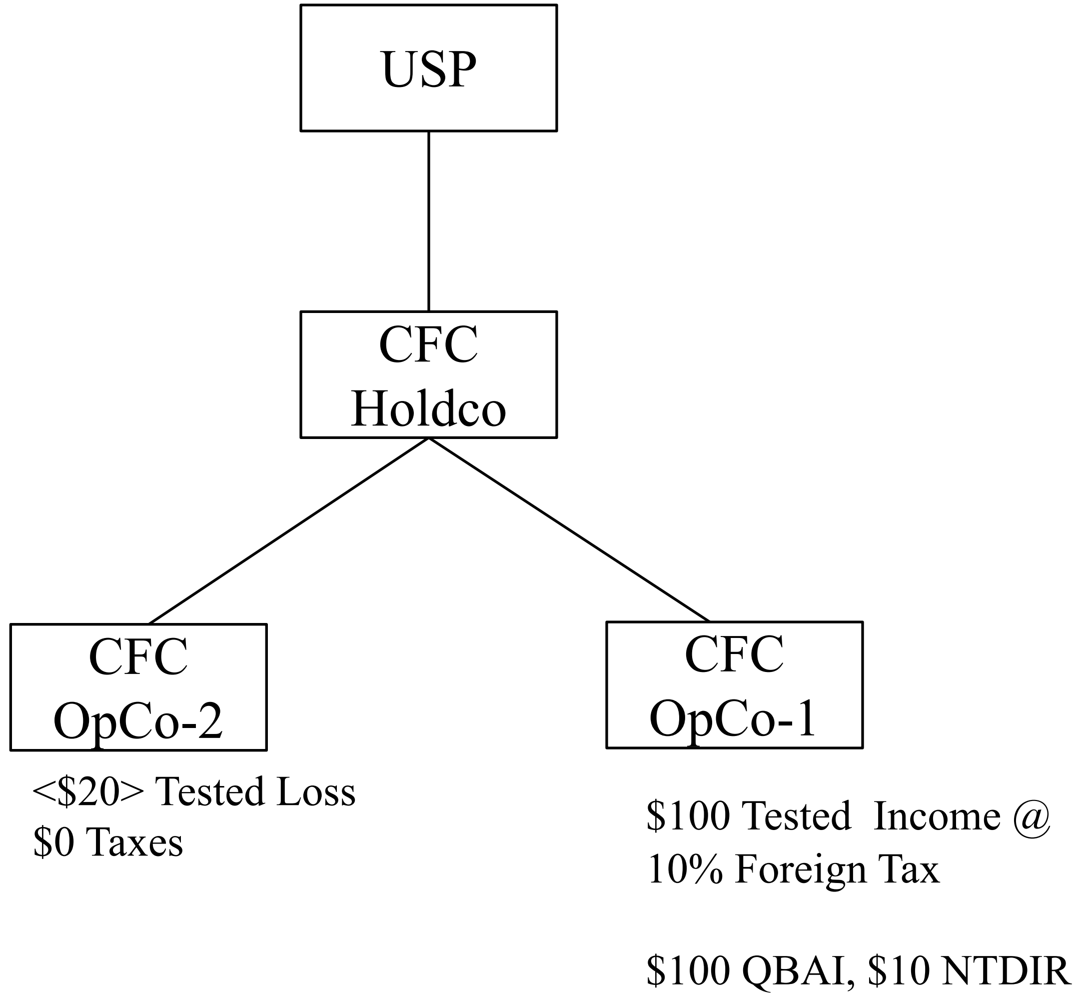
Assume CFC earns $100 GILTI and pays $20 foreign tax

CFC has no QBAI

Example with Expense Allocations

Tested Income before Tax	$100
Foreign Tax	($20)
Tested Income After tax	$80
GILTI Inclusion (before Sec. 78 gross-up)	$80.0
Haircut to FTCs under 80% Rule	($4.0)
FTCs	$16.00
Grossed-up GILTI Inclusion*	$100.0
Section 250 Deduction	($50.0)
Net GILTI Inclusion	$50.0
Pre-Credit US Tax on GILTI	$10.50
Section 904 Calculation	
Taxable Income in the GILTI Basket (net of 50% DRD)	$50.00
Expense Allocations	($10.00)
Net Sec. 904 Income in GILTI Basket	$40.00
Section 904 Limitation	$8.40
Residual US Tax After FTC	***$2.10***
Excess GILTI FTCs (no carryforward)	$7.60
**Assumes GILTI gross up is in the GILTI basket*	

Example with Tested Losses – Impact on GILTI Credit



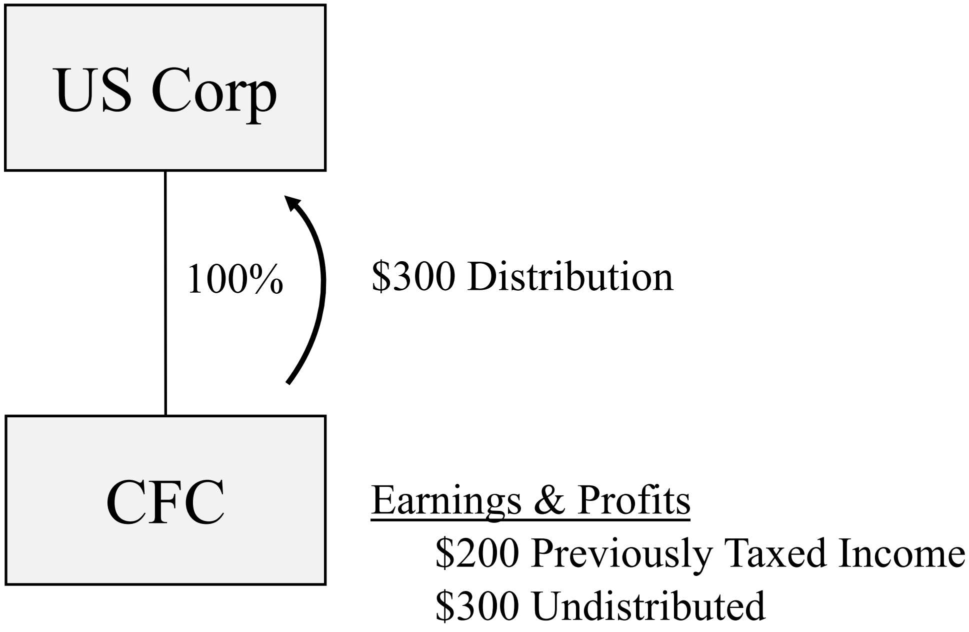
Computation of Foreign Tax Credit with Tested Loss

CFC-1's Items:		CFC-2's Items:	
Net Tested Income before Tax	$100	Net Tested Income before Tax	($20)
Foreign Tax @10%	($10)	Foreign Tax	$0
After tax income	$90	After tax income	($20)
QBAI	$100		
Reduce GILTI for 10% NTDIR	**($10)**		
Allocation of CFC-2 Tested Loss	**($20)**		
GILTI Inclusion (before Sec. 78 gross-up)	$60.0		
Total CFC-1 FTCs	$10.0		
Shareholder's Inclusion Percentage	**67%**		
FTCs before 80% Haircut	$6.67		
Haircut to FTCs under 80% Rule	($1)		
Allowable FTCs	$5.33		
Grossed-up GILTI Inclusion*	$66.7		
US Pre-Credit Tax at 10.5%	$7.00		
Residual US Tax After Credit	***$1.67***		

Participation Exemption – Sec. 245A

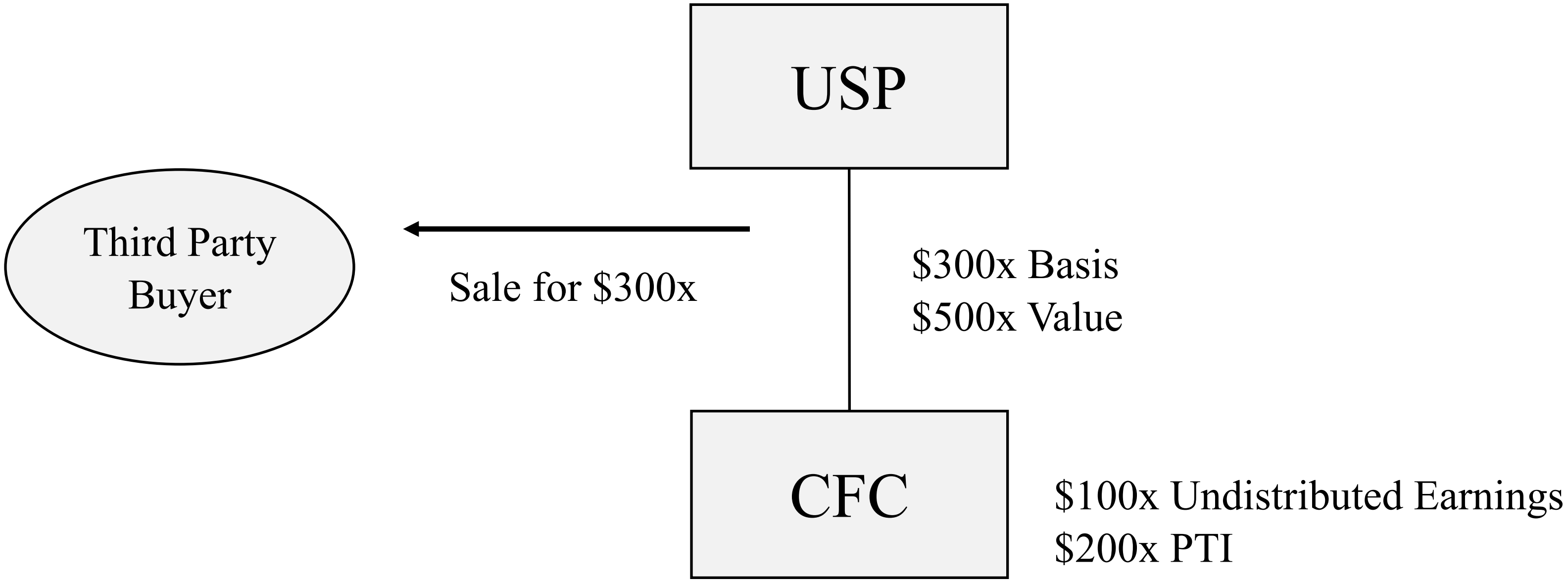
- As part of the new rules, Congress also provided US corporations with a 100% dividends received deduction (DRD) for dividends received from 10% or greater owned foreign subsidiaries.
- Section 245A requires the US company meet a 1 year holding period within the 2 years surrounding the dividend. Section 1059 also requires a two-year holding period for certain "extraordinary distributions."
- Section 245A also applies to Section 1248 deemed dividends on sales of CFC stock.

Basic Example of Section 245A



- The first $200 of the distribution is tax-free out of Previously Taxed Income under Section 959. The balance of $100 is potentially eligible for a DRD under Section 245A.

Example of a Section 1248 Deemed Dividend



- Under IRC Section 1248, $100x of USP's gain on the sale is re-characterized as a dividend to the extent of USP's share of CFC's Section 1248 E&P.
- USP may claim a Section 245A DRD of $100x to the same extent as would be the case for an actual dividend.

Inbound Changes Made by the TCJA

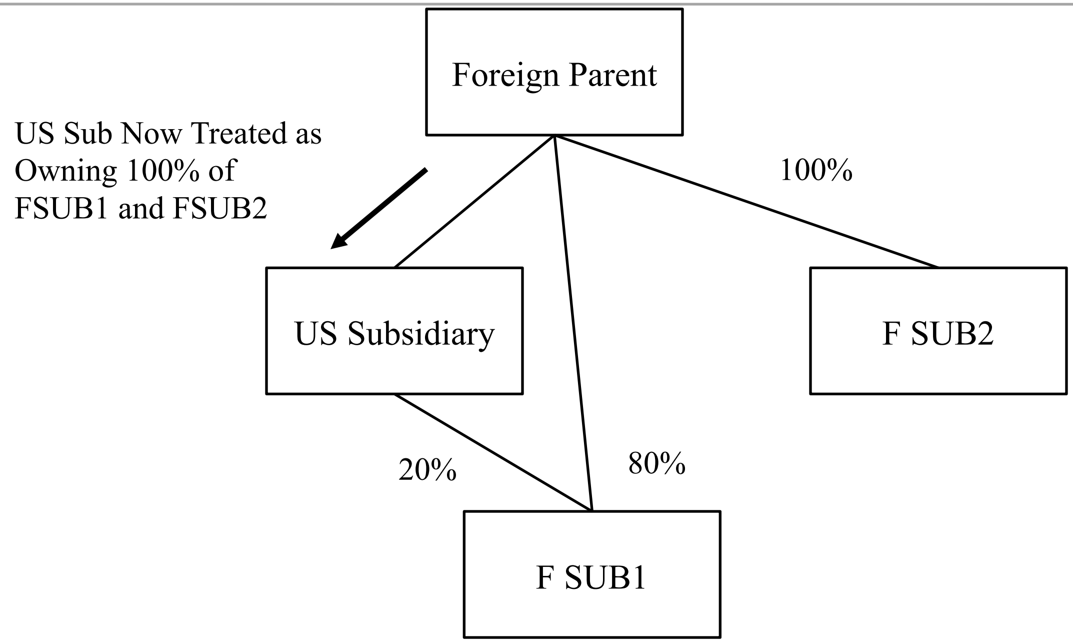
Inbound Changes Made by TCJA - Overview

- The Base Erosion and Anti-Abuse Tax (BEAT)
- Anti-hybrid rules of Section 267A
- Changes in Constructive Ownership Rules for CFC Status

Section 958(b)(4) Repeal

- For determining CFC status, Section 958(b) generally incorporates the rules of Section 318 with certain modifications.
- Section 318 includes family attribution rules, “up” attribution rules from entities to their owners, and “down” attribution rules from owners to commonly owned entities.
- Section 958(b)(4) formerly limited “down” attribution from a foreign owner to a controlled entity. This was repealed.

Repeal of Section 958(b)(4)



- Section 318(a)(3) deems US Subsidiary to own all of F Sub 1 and F Sub 2, making both entities CFCs under Section 957 of the Code.
- US Sub has a 20% inclusion with respect to F Sub 1 (including GILTI).
- Consider ancillary effects of classifying F Sub 1 and F Sub 2 as CFCs.
- In Notice 2018-26, the IRS provided selected relief from certain effects of CFC status (e.g., Form 5471 filings) where US Sub is not actually a 10% US shareholder of the CFC.

Section 267A Anti-Hybrid Rules

- Section 267A now disallows deductions for US tax purposes for certain "disqualified related party amounts" paid or accrued to or by a hybrid entity or pursuant to a hybrid transaction.
- Disqualified related party amounts are amounts where the payment is not included in income of the related party under its tax laws, or where the related party is allowed a deduction with respect to such amounts.
- Amounts where the income is included by a US shareholder in subpart F income are not subject to the anti-hybrid rule.

Base Erosion and Anti-Abuse Tax (the "BEAT")

Overview of the BEAT (Sec. 59A)

- Intended to serve as a corporate alternative minimum tax computed without regard to the deductions from certain related party payments.
- BEAT tax rate for relevant taxable years:
  - 5% in taxable years beginning in calendar year 2018
  - 10% in taxable years beginning in 2019-2025
  - 12.5% in taxable years beginning after 2025
- Through 2025, BEAT permits R&E credits and 80% of certain general business credits to be used against the BEAT.

BEAT – Threshold for Application

- BEAT only applies to an "applicable taxpayer," defined as:
  - A corporation
  - With average annual gross receipts ***of at least $500 million over the 3 taxable years*** ending with the preceding taxable year
  - That has a "base erosion percentage" of at least 3% in the current taxable year.
- Gross receipts of related parties that are common employers under Section 52 are aggregated. Related parties are also aggregated for purposes of determining the base erosion percentage.
- Foreign corporations are subject to BEAT only with respect to ECI.

BEAT Calculation

- The BEAT liability is equal to
  - 10% (or 5% for 2018) of the taxpayer's modified taxable income, over
  - The taxpayer's regular tax liability, reduced, but not below zero, by credits against tax in excess of (1) the R&D credit under Section 41 and (2) 80% of applicable general business credits.
- Modified taxable income equals regular taxable income ***without regard to*** (1) ***base erosion tax benefits*** and (2) the base erosion percentage of any NOL allowed under Section 172 for the taxable year.

Definition of "Base Erosion Payments"

- A key concept in application of BEAT is the "base erosion payment." Base erosion payments generally mean—
  - Deductions that are currently allowable to the taxpayer with respect to payments made to a foreign related party
  - Deductions for amortization or depreciation allowable to the taxpayer from a purchase of property from a foreign related party
  - Certain reinsurance premiums (**RARE**)
  - In the case of certain inverted companies, payments that result in a reduction of gross receipts (**RARE**).

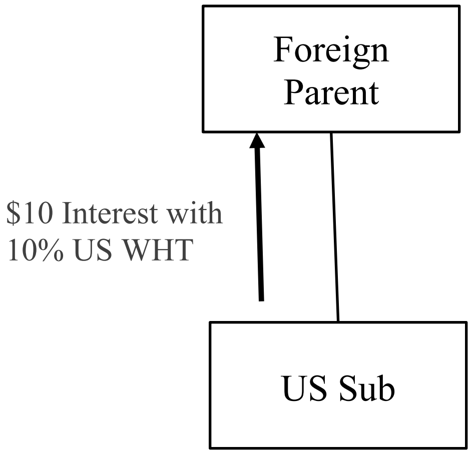
“Base Erosion Tax Benefits”

- Where the taxpayer makes base erosion payments, BEAT is calculated without regard to the taxpayer’s base erosion tax benefits.

- If a 30% US withholding tax under Sections 1441 or 1442 is applied to the payment, the payment is not considered to result in a base erosion tax benefit.

- Where a partial withholding tax applies under a treaty, the payment is considered a base erosion payment to the extent of the Withholding Tax under the principles of old Section 163(j).

Example of the BEAT Calculation



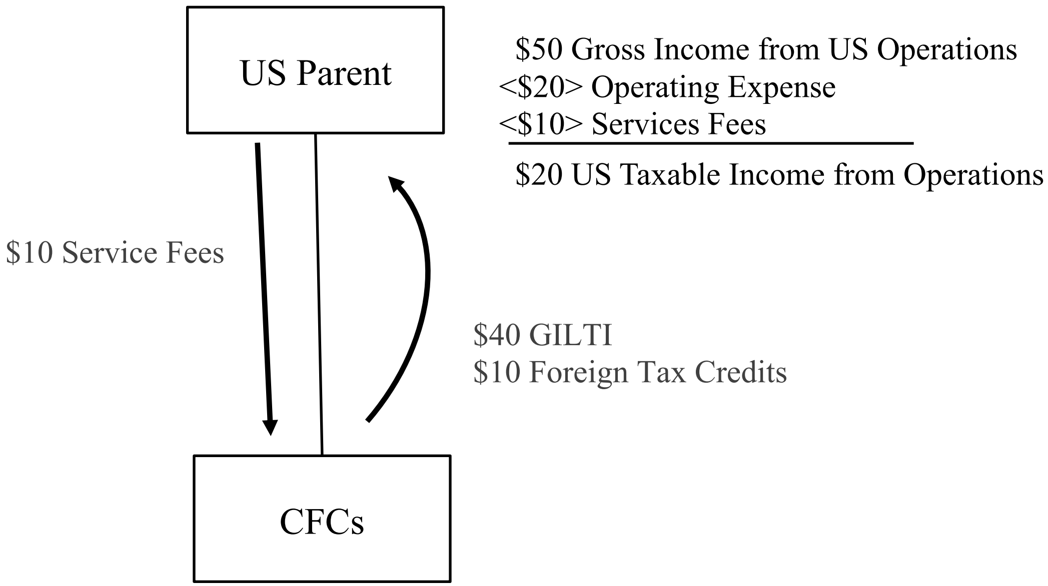
<$50 Gross Income
<$20> Operating Expenses
<$10> Interest

$20 Regular Taxable Income

Calculation of BEAT Tax Liability in Example

BEAT Tax Calculation		
(A) Regular Taxable Income		$20
Regular US Federal Tax @21%		$4.2
Base Erosion Tax Benefits		
	FP Interest	$10
	Less Portion subject to US WHT	($3)
(B)	Total	$6.67
US Sub's Modified Taxable Income (A) + (B)		$26.67
Potential BEAT @10%		$2.67
Reduction for Regular Tax Liability		($3)
Total BEAT		$0

Example of the BEAT Calculation – Impact of Credits



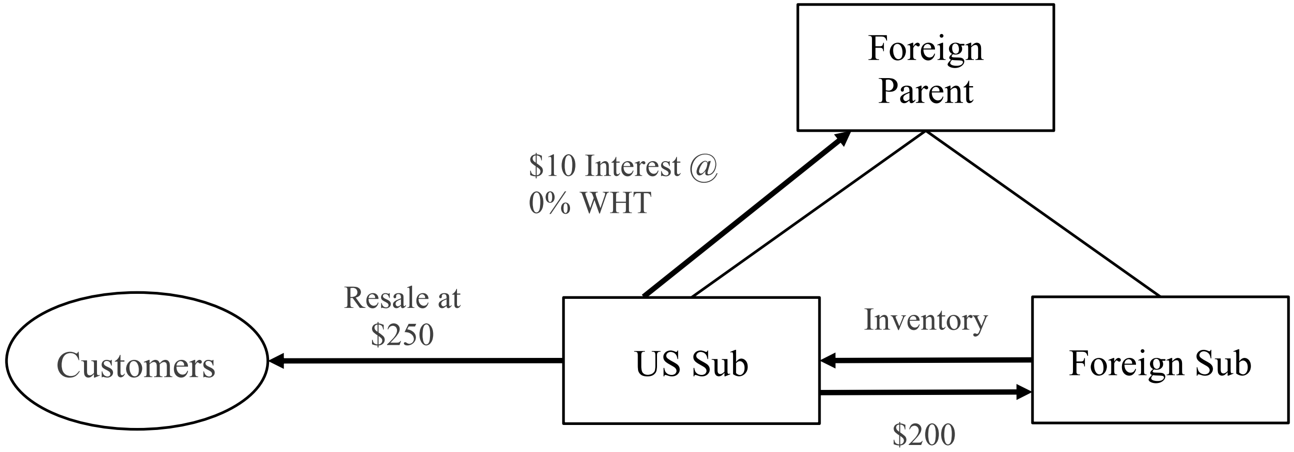
Calculation of BEAT Liability with Foreign Tax Credits

US Taxable Income from Operations		$20
US "GILTI" Inclusion from CFCs, net of Sec. 250 deduction		$25
(A) Regular Taxable Income		$45
Pre-Credit Regular Tax at 21%		$9.5
Less Foreign Tax Credit on GILTI (21% * $25)		**($5.3)**
Net Regular Tax Liability		$4.2
Base Erosion Tax Benefits		
	Service Fees Paid to CFCs	$10
	Less Portion subject to US WHT	($0)
(B)	Total	$10
US Sub's Modified Taxable Income (A) + (B)		$55.00
Potential BEAT @10%		$5.50
Reduce for Regular Tax Liability ***after Credit for Foreign Taxes***		($4.20)
Total BEAT		**$1.30**

BEAT – Impact of NOL Carryovers

- For BEAT purposes, NOLs are deemed to give rise to base erosion tax benefits to the extent of "the base erosion percentage of any net operating loss deduction allowed under Section 172 for any taxable income."
- If other NOLs carryovers would be available after reversing out the NOL deduction, are they freed up to be used against BEAT liability (i.e., an AMT concept)?
- In the case of NOL carryovers from pre-BEAT years, how is the "base erosion percentage" determined – source year vs. absorption year?

Example of the BEAT Calculation – Impact of NOLs



$50 Gross Income
<$20> Operating Expense
<$10> Interest
<$20> Carryover of Pre-2018 NOLs

$0 Taxable Income

Example of a BEAT Calculation with NOLs –

US Taxable Income from Operations			$20
NOL Carryover Deduction			($20)
(A) Regular Taxable Income			$0
Pre-Credit Regular Tax at 21%			$0.0
Base Erosion Tax Benefits			
	FP Interest		$10
	Base Erosion Percentage of NOLs		$0.0
(B)	Total		$10.00
US Sub's Modified Taxable Income (A) + (B)			$10.00
Less Additional NOL for BEAT			$0.00
Final Modified TI			$10.00
BEAT @10%			***$1.00***

Example of Alternative BEAT Calculation with NOLs–

US Taxable Income from Operations			$20
NOL Carryover Deduction			($20)
(A) Regular Taxable Income			$0
Pre-Credit Regular Tax at 21%			$0.0
Base Erosion Tax Benefits			
	FP Interest		$10
	Base Erosion Percentage of NOLs (33% of $20)		$6.7
(B)	Total		$16.67
US Sub's Modified Taxable Income (A) + (B)			$16.67
Modified Taxable Income			$16.67
BEAT @10%			***$1.67***

Other Issues with BEAT

- Services cost exception in the statute for amount of services that represents the services cost method without a markup component.
    - Is the BEAT applied to the markup or the entire service fee in the case of eligible services?
- Treatment of COGS vs. below-the-line deductions
- Identity of the true payer of expense or true earner of revenue

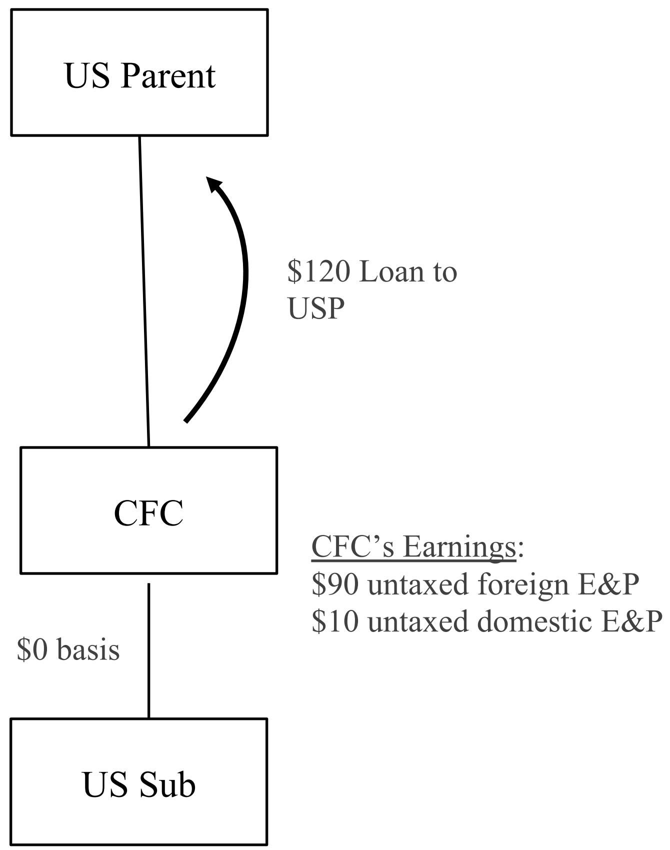
Selected Regulatory Developments

Section 956 Proposed Regulations (released 10/31/2018)

- As noted above, Section 245A provides a 100% deduction for dividends received by a domestic corporation from a CFC's untaxed earnings.
- Under the Proposed Regulations, to the extent a US corporate shareholder would enjoy a Section 245A deduction on an actual dividend from a CFC, the Section 956 amount is reduced.
- Section 956 would continue to apply unchanged to US individuals, pass-trough's and other shareholders that are not eligible for Section 245A.

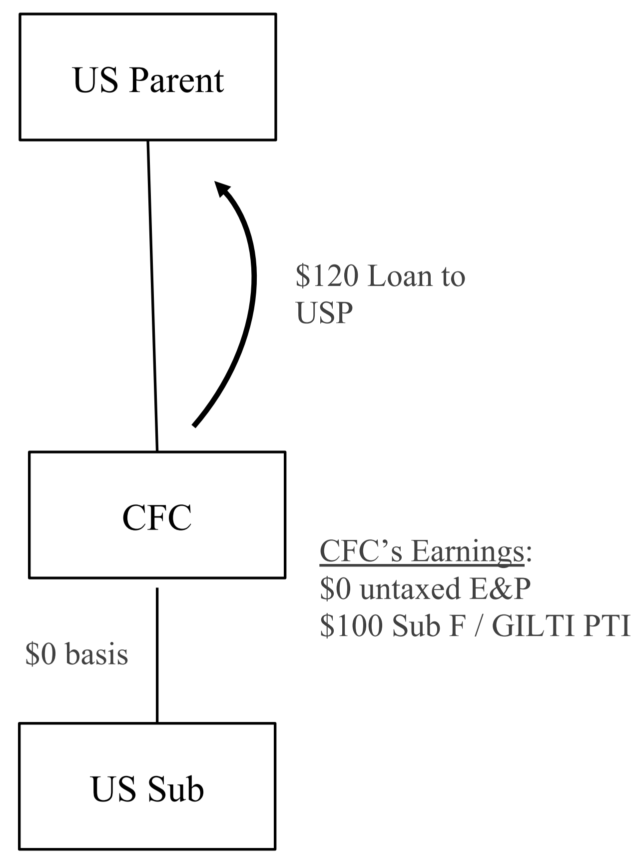
Section 956 Proposed Regulations – Example 1

- CFC's loan to US Parent is a Section 956 investment, triggering a deemed dividend to the extent of CFC's untaxed E&P ($100).
- Under Proposed Regs, the dividend from foreign E&P ($90) would be eligible for Section 245A.
- The 956 amount is reduced to $10.



Section 956 Proposed Regulations – Example 2

- CFC's loan to US Parent is a Section 956 investment, triggering a deemed dividend to the extent of CFC's untaxed E&P ($100).
- Since all of CFC's E&P is PTI, there would be no taxable inclusion to US Parent under Section 959(a)(2).
- There is still an inclusion of $100 sheltered by PTI.



Foreign Currency Proposed Regulations (Released December 2017)

- Shortly before enactment of the TCJA, IRS and Treasury released taxpayer-favorable regulations dealing with a range of foreign exchange transaction issues:
  - Liberalization of the treatment of CFC-level hedging transactions as not giving rise to "whipsaw" situations
  - Expansion of hedge timing rules at the CFC level
  - Optional mark-to-market election under Prop. Reg. 1.988-7
- Proposed Regulations generally may be early adopted by taxpayers.

Any Questions?

UBS

Expatriation

What you'll pay when there's nothing left to say

Stephen Liss
Senior Wealth Strategist

November 8, 2018

Table of contents

Section 1

Background

UBS

Being an American is Great!

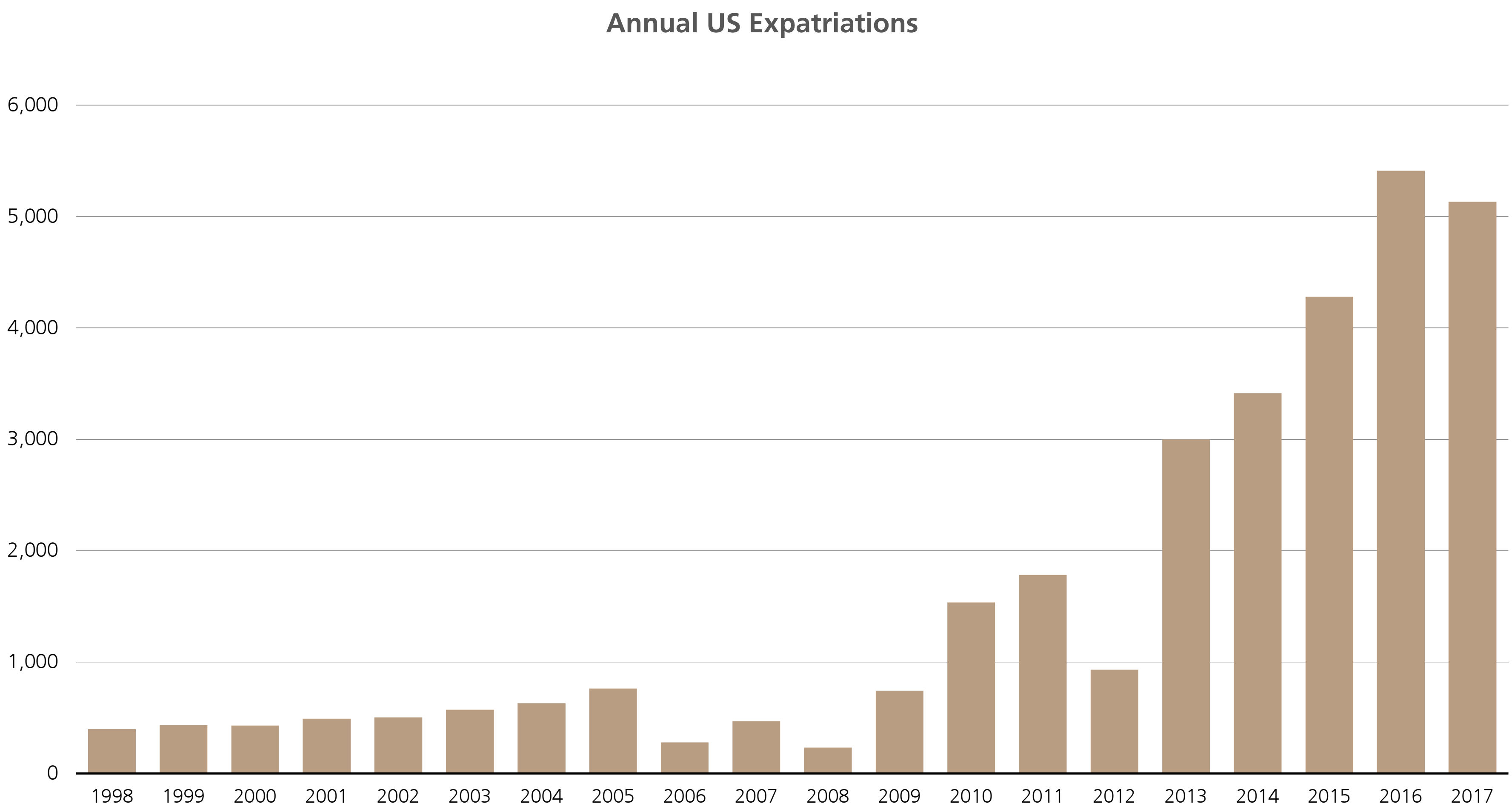
- US passport provides extensive visa-free travel
- Ability to sponsor family members for green cards
- Vote in federal elections
- Access to US jobs market
- US consulate will assist with:
  - Passport issues
  - Detention by foreign governments
  - Cross-border legal issues
  - More
- According to DHS, between 2015 and 2017 over 2.4 million people became naturalized US citizens

Living Abroad?

US Citizenship Can Be an Expensive Luxury

- Regardless of residence, citizens are subject to income tax on world-wide income
- Regardless of residence, citizens are subject to estate tax on world-wide assets
- Extensive information reporting (FBAR, Form 8938, Form 3520, etc.)
- Excluded from numerous offshore investments by policy or tax rules
- FATCA reporting
- Increasing number of financial institutions will not do business with US taxpayers

Number of Annual US Expatriates



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Section 2

Who Is An Expatriate?

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For Tax Purposes, Who is an Expatriate?

- You are a US citizen and surrender your citizenship
- You are a long-term resident who ceases to be a lawful permanent resident ("LPR")
  - A LPR is essentially a green card holder
  - A long-term resident is someone who was a LPR in 8 of the last 15 years

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For Tax Purposes, Who is an Expatriate?

You Are A Lawful Permanent Resident If:

- You have a green card
- Green card has not been revoked
- Green card was not determined to be abandoned
- Not claiming treaty benefits

Yes

You Are A Long-Term Resident If:

- Lawful Permanent Resident for 8 of the last 15 years

Yes

You Are An Expatriate If You:

- Cease to be a Lawful Permanent Resident

No = Not An Expatriate

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Section 3

Covered Expatriates

Not All Expatriates Are "Covered Expatriates"

A Covered Expatriate ("CE") is an expatriate who fails one of the following tests:

1. Income Tax Test
   – Average annual net income tax in excess of $165,000 for the five preceding taxable years ending before the expatriation date (inflation adjusted)

2. Net Worth Test
   – A net worth as of the expatriation date of $2 million or more (no inflation adjustment)

3. The "Poor But Ignorant" Test
   – Fail to file IRS Form 8854 certifying you were tax-compliant for the five taxable years preceding expatriation (including income tax, employment tax, gift tax and all information returns). See *Topsnik v. Commissioner.*

Exceptions to Covered Expatriate Status

- Dual Citizen at Birth
  - Taxpayer was a dual citizen at birth
  - Continues to be a citizen of, and taxed as a resident in, that other country as of the expatriation date
  - Has been income tax resident in the US (based on the substantial presence test) for no more than 10 of the past 15 years
- Minors
  - Not a CE if you relinquish US citizenship before reaching age 18½ and you have been income tax resident in the US (based on the substantial presence test) for 10 taxable years or less

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What Are the Potential US Tax Consequences of Expatriating?

Mark-To-Market	**"Wait and See" Items**	**Inheritance Tax**
• A CE is deemed to have sold his worldwide assets the day <u>before</u> his expatriation date, triggering a capital gains tax	• Future distributions from certain trusts and certain deferred compensation arrangements to a CE are subject to a 30% tax	• A covered gift or bequest to a US Person by a CE is subject to a 40% tax

Going Forward, How is a CE Taxed?

- Distributions from eligible deferred compensation is subject to 30% withholding
- Distributions from non-grantor trusts may be subject to 30% withholding
- Estate and gift tax is only imposed on US situs assets
- Section 2801 inheritance tax is imposed on any covered gift or bequest

Section 4

The Mark-To-Market Exit Tax

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Expatriation and the Mark-To-Market Exit Tax

- All "property" of a CE is treated as sold on the day before the expatriation date for its fair market value, thereby triggering any built-in gain
- Valuation – The fair market value of each interest is determined using federal estate tax valuation principles
  - Requires a formal appraisal of worldwide assets
- Both gains and losses are taken into account
- The amount of gain deemed recognized is reduced by $713,000
  - Inflation adjusted each year
  - Allocated across all gain proportionally
  - Does not exclude gain recognized under Section 684
- Exceptions – A different regime applies to:
  - Deferred compensation items
  - Specified tax-deferred accounts
  - Interests in "non-grantor" trusts

Ernie the Expatriate

- A 50% interest in the penthouse at 123 Sesame Street
  - Apartment has a $2 million fair market value
- $2 million UBS account
- Collection of vintage ducks

Asset	Basis	Value	Gain	Exemption	Net Gain
Apartment	$500,000	$750,000	$250,000	$118,833	$131,167
Brokerage Account	$1,500,000	$2,000,000	$500,000	$237,667	$262,333
Ducks	$2,000,000	$2,750,000	$750,000	$356,500	$393,500
			$1,500,000	$713,000	$787,000

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Section 5

Non-Grantor Trusts and 877A

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Section 877A and Non-Grantor Trusts

- 877A takes a "wait and see" approach to "non-grantor trusts"
- In this context a non-grantor trust means any trust not treated as owned by the CE under the grantor trust rules
- The "taxable portion" of a distribution from a non-grantor trust to a CE is subject to a 30% withholding tax
  - The taxable portion of a distribution is that portion that would be includible in gross income if the CE were still a US tax resident
- The trustee is required to withhold the tax and is liable for failing to do so
- A CE may, instead, elect to be treated as receiving the value of his interest on the day before the expatriation date
  - This is only an option if the CE's interest has an ascertainable value

What is a "Non-Grantor Trust" Under 877A?

- For purposes of 877A, only a trust that is “grantor” to the CE is a grantor trust; all others are 877A non-grantor trusts
  – This determination is made immediately before the expatriation date
- Example – Ernie the Expatriate is the beneficiary of an insurance trust created by his mother. While the trust is a grantor trust for US income tax purposes, this is an 877A non-grantor trust.
- Example – Ernie created an insurance trust for the benefit of his buddy Bert. Prior to Ernie’s expatriation, this was a grantor trust for US income tax purposes and will also be an 877A grantor trust.
  – Note when Ernie becomes a CE the trust will likely become a non-grantor trust for US income tax purposes and could also become a foreign trust (potentially triggering tax under Section 684)

Section 6

Deferred Compensation and Tax-Deferred Accounts

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Summary

Deferred Compensation and Specified Tax-Deferred Accounts

Asset Class	Applicable Tax	Tax Base and Timing
Eligible Deferred Compensation	30%	Taxable Payment upon Distribution
Ineligible Deferred Compensation	Ordinary Income	Present Value of Accrued Benefit the Day before Expatriation Date
Services-Related Ineligible Deferred Compensation	Ordinary Income	Current Balance Day before Expatriation Date
Specified Tax-Deferred Accounts	Ordinary Income	Current Balance Day before Expatriation Date

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The Special Rules of Deferred Compensation

- Eligible Deferred Compensation
  - The payor is a US person (or elects to be treated as a US person) AND the CE notifies the payor of his status as a CE and waives any rights under a treaty to reduce withholding on the deferred compensation
- Ineligible Deferred Compensation
  - Anything that is not Eligible Deferred Compensation
- Services-Related Ineligible Deferred Compensation
  - Property or rights to property connected with the performance of services that were not previously taxed under Section 83
  - Statutory and non-statutory stock options, stock and other property, stock-settled stock appreciation rights and units
- Specified Tax-Deferred Accounts
  - Include IRAs, Individual Retirement Annuities, 529 accounts, 529A accounts, Coverdell Education Savings Accounts, health savings accounts and an Archer MSA

Section 7

Inheritance Tax

2801 Inheritance Tax: Where are we now?

- Proposed regulations were issued September 10, 2015
- When the regulations are finalized new Form 708 will be published
- All covered gifts and bequests made since June 17, 2008 will need to be reported and any tax paid once Form 708 is available
  - The IRS has promised "a reasonable period of time" to report these historic gifts and bequests

UBS

The Inheritance Tax Regime

- If a US citizen, a US-domiciled individual, or a US resident trust receives a "covered gift or bequest," the recipient owes a tax
- A covered gift or bequest is any property acquired by gift or bequest, directly or indirectly, from an individual who is a CE:
  - At the time of acquisition, with respect to a gift
  - Immediately before death, with respect to a bequest
- Distributions from foreign trusts can also be covered gifts or bequests if the trust was funded by a CE
- It is presumed all gifts are made by CEs
- It is assumed all distributions from foreign trusts are subject to 2801

Exceptions

- There is no 2503(e) exception for medical and educational expenses
- Fair market value transactions
- Annual exclusion gifts
  - No present interest requirement
  - Each recipient has one annual exclusion
- Transfers to a citizen spouse or a charity
  - Foreign trusts that distribute assets to a spouse or charity do not qualify for spousal or charitable exceptions
- QDOT exception applies
- Section 2523(i)(2) annual exclusion is permitted

Exceptions (cont'd)

- Transfers otherwise subject to gift or estate tax
  - Gift and estate tax definitions of US situs assets are very different
  - Statute requires timely reporting
  - Proposed regulations add a timely payment requirement
  - It is possible to owe both gift/estate tax and 2801 tax
  - Tax expatriation does not change domicile

Examples of Covered Gift or Bequest

- Big Bird gives $5 million to his friend, Snuffie. The next week Big Bird surrenders his US citizenship and becomes a covered expatriate.
- Snuffie cannot stand living without Big Bird, so he too expatriates. He left in a hurry, so after expatriating he gifts everything in his cave to Oscar.
- Little Bird also misses Big Bird, so he too expatriates. After becoming a CE, Little Bird sends a $15,000 check each month to Grover.

Calculating the Inheritance Tax

- Rate is the highest marginal estate or gift tax rate (currently 40%)
- Tax base is the fair market value of the property received
  - Traditional willing buyer/willing seller methodology is used and Chapter 14 special valuation rules apply
- Valuation date is date of receipt (not necessarily date of death)
- No generation-skipping tax (GST tax) equivalent
- Credit for foreign gift or estate tax paid with respect to the covered gift or bequest
  - Can be complicated in practice due to differences in timing, tax base, etc.

How are Trusts Treated under Section 2801

- A US trust is a resident, so gifts or bequests to US trusts trigger 2801
- A gift or bequest to a foreign trust does not trigger 2801
  - A foreign trust can elect to be treated as a US trust for 2801 purposes
- 2801 applies to a distribution from a foreign trust to a US person if the foreign trust received a gift or bequest from a CE
  - A trust that was only partially funded by a CE will have a "section 2801 ratio," and distributions will be partially subject to the 2801 tax
  - It is assumed a distribution from a foreign trust is subject to 2801 if the foreign trustee cannot calculate the section 2801 ratio
- There are no qualified severance rules for foreign trusts

Trusts under Section 2801 (cont'd)

- Note, the throwback rules of 665 can also apply to a distribution from a foreign trust
- Electing Foreign Trust
  - A foreign trust may elect to be treated as a domestic trust for 2801 purposes
  - Triggers 2801 tax on any covered gift or bequest received in the year of election
  - Triggers 2801 tax on the portion of a foreign trust previously funded through a covered gift or bequest (purging election)
  - Section 2801 ratio of the trust will be zero going forward
  - The commissioner may dispute the calculated 2801 tax
- Trust Migration - A foreign trust that becomes a US trust must file Form 708 as though it was an electing foreign trust making a purging election

Example: Trusts and Section 2801

- Ernie the expatriate dies and leaves all his wealth to a foreign trust for the benefit of his friend Oscar
  - No inheritance tax on Ernie's death since the trust is not a US person
  - If the trust makes a distribution to Oscar, he will owe inheritance tax on the amount received
  - To avoid the throwback rules of 665, the trust could migrate and become a US trust. That would trigger 2801 tax on the entirety of the trust assets.

Section 8

Planning Considerations

Planning Considerations

The Definition of a Covered Expatriate

- Recall that a taxpayer is only a CE if they fail the Income Tax Test or the Net Worth Test or fail to properly file Form 8854
- Income Tax Test
  - This test is based on an average of the past five years' income tax liability, so attorneys often consider ways to reduce this average

Amend prior returns
Expatriate before a large tax event
Wait for large tax events to age out
Defer current income to drop the average
Invest in low or no tax asset classes
Convert grantor trusts to non-grantor trusts to drop the average

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Planning Considerations (cont'd)

The Definition of a Covered Expatriate

- Net Worth Test
  - Recall the net worth of a taxpayer is calculated by valuing the property of the taxpayer using established estate tax valuation principles. Attorneys often consider ways to decrease the net worth of a person prior to their expatriation date.

Gift assets as permitted by the US gift tax regime
Divide ownership of assets
Modify trusts to eliminate beneficial interests
Employ valuation discounts

Planning Considerations (cont'd)

Retain or Obtain US Citizenship

- Sometimes it's better to keep your US citizenship, or even transition from a green card to US citizenship
- Tax treaties are designed to eliminate double taxation. As discussed, a LPR often cannot use treaties without becoming a covered expatriate.
- Retaining or obtaining citizenship minimizes professional fees up front, but often produces a more complicated annual tax return
- US citizens remain subject to US estate tax, but don't have to address Section 2801 issues
  - Note that US citizenship may mean the taxpayer is subject to both US and foreign estate tax; few estate tax treaties

Planning Considerations (cont'd)

Mitigating 877A

- For someone who is a CE, the 877A mark-to-market exit tax will apply
- The amount of gain triggered depends on the fair market value of the taxpayer's assets, so attorneys often consider ways to reduce this gain
  - Give away highly appreciated assets
  - Divide ownership of assets
  - Wait for short-term gain to age into long-term gain
  - Convert 877A grantor trusts to 877A non-grantor trusts
  - Avoid converting US trusts to foreign, which would trigger 684
  - Employ valuation discounts
- Since the 877A gain is only a "deemed" sale, it may also be prudent to actually sell assets and trigger real gain. This eliminates valuation issues and the new country of residence will most likely only credit the historic basis anyway.

Planning Considerations (cont'd)

Mitigating 2801

- If a CE remains US domiciled:
  - A CE may still be considered US domiciled if he does not reside somewhere else with an intention to remain permanently
  - A CE is entitled to the $11.18 million exemption so long as he is US domiciled
  - Section 2801 does not apply to transfers that are subject to estate or gift tax so long as a return is filed and any tax paid
- There are other considerations for a CE whose spouse has a green card:
  - Gifts or bequests to the spouse are “covered gifts or bequests” but do not qualify for a marital deduction unless through a QDOT (bequest only)
  - The spouse will likely be subject to US estate tax at death, creating the potential for two transfer taxes on those assets

Questions?

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Expatriation: What You'll Pay When There's Nothing Left to Say

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TABLE OF CONTENTS

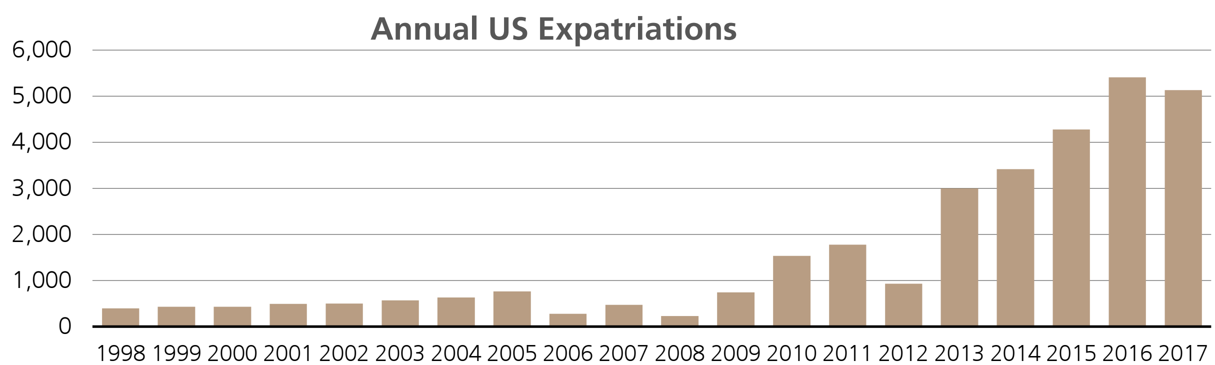
I. SOME BACKGROUND ON EXPATRIATION

a. By the Numbers:

i. In every day parlance, an "expatriate" is an American living outside the United States. For tax purposes, however, it has a very different meaning. An expatriate for tax purposes is someone who has given up US citizenship or, as detailed more fully in the following sections, given up a green card.

ii. As the chart below shows, according to the US Treasury Department, from 1998 to 2005 the number of expatriates steadily rose from 398 to 762. It fluctuated rather dramatically the next four years, with only 278 expatriations in 2006, 470 in 2007, 231 in 2008 and 742 in 2009. Since 2010, there has been a relatively high number of expatriations, ranging from 932 in 2012 (due to an unusual fourth quarter when only 45 individuals expatriated) to a record of 5,411 in 2016. In the first two quarters of 2018, 2,189 individuals expatriated.[1]

iii. While the number of people expatriating seems to have increased materially, according to the 2010 census there were over 308,000,000 people living in the United States. That means 5,000 expatriates represents less than 0.002% of the US population.



[1] Treasury is required to publish the names of each individual who expatriates on a quarterly basis pursuant to IRC § 6039G. The number of expatriates in this paragraph is based on those quarterly publications as contained in the Federal Register, as is the chart below. While this list is intended to include the names of both expatriating citizens and long-term residents, Treasury only has accurate information with regard to citizens. That is, the State Department is able to provide accurate data on expatriating citizens, but the data on long-term residents is not comprehensive.

iii. Partially in response to the increasing number of expatriations and the corresponding strain on consular officer time and resources, in August of 2014 the State Department increased its fee for processing a renunciation of citizenship from $450 to $2,350.[2]

b. Why People Leave: It's always dangerous to speculate as to why people make such a significant life decision, but the following are some of the reasons often cited.

   i. Tax Compliance Costs: It can be complicated and expensive for Americans to live abroad and remain US tax-compliant. Americans generally rely on some combination of a double tax treaty, credits for foreign taxes, and the foreign earned income exclusion to avoid paying income tax to both their country of residence and the US. It is a complicated system that few individuals are able to navigate without the assistance of sophisticated, and expensive, professionals.

   ii. Information Reporting Burdens: The information that must be disclosed to the IRS each year continues to expand. Some taxpayers have privacy concerns, but all must deal with the cost in time and money required to file forms that often result in no tax liability, such as Foreign Bank Account Reporting (FBAR), Form 8938, annual reporting of PFICs, Form 5471, Form 3520; the list goes on.

   iii. The US Voluntary Disclosure Program: The modern program was launched in 2009, with a revised program launched in 2011, another in 2012, and the most recent iteration having been announced in June 2014. The IRS has aggressively promoted these programs, making Americans living abroad increasingly aware that they are not fully US-compliant, and perhaps making them feel increasingly attacked. The OVDP officially ended September 28, 2018, with that announcement producing yet another wave of media attention on the tax obligations of Americans living abroad.

   iv. Investment Restrictions: Americans who live outside the US do not live their lives in dollars, but all US taxes are accounted for and paid in dollars. Currency gains and losses are complicated and can have dramatic impacts on the economics of every investment. Normal investments in that individual's local country can be Passive Foreign Investment Companies, and therefore tax-inefficient. Many investments will simply not be available because the foreign fund does not want to accept US investors.

   v. FATCA: The Foreign Account Tax Compliance Act (FATCA) has led an increasing number of foreign financial institutions to stop taking new US clients and even to close accounts of US clients that have been open for years. Again, publicity

[2] See Department of State Public Notice 8850, 79 Fed. Reg. 51,247.

associated with FATCA has sensitized many to the US tax obligations they had previously ignored.

vi. Estate Tax: Many foreign countries do not have an estate tax, so expatriating may be a way to eliminate a significant liability. There are also very few estate tax treaties, so for Americans living in countries with an estate tax, it can be complicated to avoid double taxation. Developing an estate tax plan that accounts for both the US and foreign tax systems presents unique challenges that many would prefer to simply avoid.

c. Factors Impacting The Economics Of Expatriation[3]

Expatriating does not necessarily result in a net tax savings, especially after accounting for the estate tax. Many western countries have income tax rates that are higher than the US, and the generous $11.18[4] million estate tax exemption (increased by inflation for those who die after 2018) means the US regime is often more benign than that of other nations. In determining whether expatriation makes sense economically, a number of factors need to be considered, particularly the following:

i. Destination Country: The mark-to-market regime of § 877A[5] detailed below can result in a significant loss of capital. Moving to a country with tax rates similar to, or higher than, those in the US can make it impossible to economically recover.

ii. Age: If you move to a lower tax jurisdiction, doing so earlier in life gives you more opportunity to benefit from those lower tax rates.

iii. Asset Composition: If your assets have little to no appreciation when you expatriate (like a lottery winner or someone who recently inherited assets), the mark-to-market regime will have a minimal impact. If all of your wealth consists of ineligible deferred compensation, on the other hand, the exit tax will be maximized.[6]

iv. Residency of Beneficiaries: If your heirs are US persons, the § 2801 inheritance tax regime comes into play. With a flat maximum rate tax regime and the loss of $11.18 to $22.36 million of exemption, leaving the US can be expensive. If your heirs are also offshore, however, expatriating may allow you to avoid the US estate tax, maximizing the benefit of your planning.

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[3] A thorough discussion of the economics of expatriation can be found in: "Is the Toll Charge for the U.S. Exit Tax Worth The Price Tag for Getting on the Road Out of the United States?", by Leigh-Alexandra Basha, Victoria Burk and Abigail E. O'Connor, Daily Tax Report, 116-DTR-J-1, June 17, 2013.

[4] Please note the estate tax exemption will be cut in half on January 1, 2026 unless Congress acts to extend the increased exemption which was contained in the Tax Cuts and Jobs Act.

[5] All references herein to statutes and regulations are to the Internal Revenue Code of 1986, as amended, and associated Treasury regulations unless specifically stated otherwise.

[6] Both the "mark-to-market" regime and the tax treatment of ineligible deferred compensation are detailed in Section IV below.

II. WHO IS SUBJECT TO THE EXPATRIATION REGIME?

a. Only citizens and lawful permanent residents ("green card" holders) are potentially subject to the expatriation tax regime.[7] Merely being an income tax resident, no matter how long that resident status continues, does not bring a taxpayer within the expatriation regime, nor is it sufficient to be US-domiciled.

b. Note that a US Person is subject to income and capital gains tax on a worldwide basis[8] and a US Person includes a US Citizen or Resident.[9] A non-citizen is a US Resident if:[10]

   i. Such individual is a lawful permanent resident of the United States at any time during the calendar year (the so called "green card test");

   ii. Such individual meets the substantial presence test of § 7701(b)(3); or

   iii. Such individual elects to be taxed as a US resident per § 7701(b)(4).

c. For estate and gift tax purposes, an individual is a US resident if that person is domiciled in the United States.[11] A resident is subject to estate or gift tax on relevant transfers regardless of where the transferred asset is situated.[12]

III. WHO IS A COVERED EXPATRIATE?

a. Covered Expatriate: The expatriation tax regime only applies to covered expatriates (CEs), so determining whether an individual is, or will be, a CE is critical.

   i. In General: A CE is an expatriate (as defined in the next section):[13]

      1. Whose average annual net income tax for the five taxable years ending before the expatriation date is greater than $165,000 (inflation adjusted)[14] or with a net worth as of the expatriation date of $2 million or more (no inflation adjustment); or

      2. Who fails to certify under penalty of perjury that he[15] has met his requirements under the Internal Revenue Code (including income tax, employment tax, gift tax and information returns) for the five taxable years preceding expatriation or fails to submit evidence of compliance as required by the Secretary of the Treasury. This certification is made on IRS Form 8854, Initial and Annual Expatriation Statement. As a result, even a taxpayer who falls below the tax liability and net worth thresholds can be categorized as a CE if he fails to file a Form 8854.

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[7] IRC § 877A(g)(2) and Prop. Treas. Reg. § 28.2801-2(b).
[8] Treas. Reg. § 1.1-1(b).
[9] IRC § 7701(a)(30)(A).
[10] IRC § 7701(b)(1)(A).
[11] Treas. Reg. § 20.0-1(b)(1) and Treas.Reg. §25.2501-1(b).
[12] IRC § 2031 and Treas.Reg. §25.2501-1(a)(1).
[13] IRC § 877A(g)(1)(A) and referencing IRC § 877(a)(2).
[14] The inflation-adjusted figure was $157,000 in 2014, $160,000 in 2015, $161,000 in 2016 and $162,000 in 2017. See Rev. Proc. 2017-58.
[15] Note that this outline largely refers to "individuals," "taxpayers" and "persons." Where for ease of reading a gender reference is used, those gender references will be masculine.

a. In the case of *Topsnik v. Commissioner*,[16] the Tax court found the taxpayer was a covered expatriate because he had failed to file Form 8854. In that case the taxpayer had not been in tax compliance for the preceding five years, and therefore could not make the required certification under penalties of perjury. Having found that the taxpayer had failed to make the required certification, the court did not even consider the income tax or net worth tests.

b. It is unclear whether a late-filed Form 8854 would avoid CE status where the form was required merely to certify historic tax compliance.

ii. <u>The Net Income Tax Test</u>[17]

1. Whether the taxpayer's net income tax for the five taxable years preceding expatriation exceeds $165,000 is determined using the methodology of § 38(c)(1).[18]

2. "An individual who files a joint income tax return must take into account the net income tax that is reflected on the joint income tax return for purposes of the tax liability test."[19] In other words, an expatriating spouse must reflect 100% of the tax shown on a jointly filed return. The expatriating spouse cannot report half of that amount, nor may he/she calculate income tax based solely on the income he/she earned.

iii. <u>The Net Worth Test</u>[20]

1. For purposes of determining whether an individual's net worth is $2 million or more, an individual is considered to own any interest in property that would be taxable as a gift under Chapter 12 if the individual were a citizen who transferred that interest immediately prior to expatriation. This determination is made without regard to §§ 2503(b)-(g) (includes annual exclusion gifts and payments for educational and medical expenses), § 2513 (gift splitting), § 2522 (charitable gifts), § 2523 (spousal exemption) and § 2524 (limiting deductions to transfers that are themselves subject to gift tax).

[16] 146 T.C. No.1 (1/20/2016).
[17] Section 2(B) of Notice 2009-85, referencing Section III of Notice 97-19.
[18] "For purposes of the preceding sentence, the term 'net income tax' means the sum of the regular tax liability and the tax imposed by section 55 [the AMT tax], reduced by the credits allowable under subparts A and B of this part…" IRC § 38(c)(1).
[19] Section 2(B) of Notice 2009-85, referencing Section III of Notice 97-19.
[20] *Id.*

a. *PLANNING CONSIDERATION:* A taxpayer may be able to make transfers prior to the expatriation date to reduce his estate below the $2 million threshold. As a US domiciliary, in 2018 a taxpayer can transfer up to $11.18 million without triggering any gift tax.

b. *PLANNING CONSIDERATION:* A US citizen is always subject to the US gift tax, but a green card holder is only subject to gift tax if domiciled in the US. If a green card holder physically leaves the US and takes up residence in a foreign country with the intention to remain there permanently, that taxpayer may no longer be US-domiciled and therefore no longer subject to US gift tax.[21] If that were the case, an unlimited amount of wealth could be given prior to the expatriation date so long as the donated assets were not US situs property for US gift tax purposes.[22]

2. The valuation principles under § 2512 apply in calculating the net worth of an individual.[23]

    a. *PLANNING CONSIDERATION:* As a result, discounts for lack of control, marketability, fractionalization, etc. would be accounted for in calculating net worth. This valuation methodology can impact whether the net worth of an expatriate falls below the $2 million threshold.

3. For purposes of the Net Worth Test, interests in trusts are also allocated and valued.[24] Whether the trust is a grantor or non-grantor trust is not relevant for these purposes.

    a. All trust property is first allocated among beneficiaries based on the relevant facts and circumstances. That would include, among other factors, the terms of the trust, any letter of wishes and any historical pattern of distributions. For example, if all the income from a trust must be paid to beneficiary A and the remainder passes to beneficiary B, A would be allocated an income interest in the trust principal and B would be allocated a remainder interest in the trust principal.

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[21] *See e.g. Khan v. Commissioner*, T.C. Memo 1998-22, in which the IRS argued a decedent was not US-domiciled despite holding a green card.

[22] Treas. Reg. § 25.2511-1(b).

[23] Section 2(B) of Notice 2009-85, referencing Section III of Notice 97-19.

[24] *Id.*

b. If interests in trust property cannot be allocated based on all the facts and circumstances, trust property will be allocated "to the beneficiaries of the trust under the principles of intestate succession (determined by reference to the settlor's intestacy) as contained in the Uniform Probate Code, as amended."[25]

c. With all property allocated among the beneficiaries, the interests will be valued under the principles of § 2512.

d. *PLANNING CONSIDERATION:* A taxpayer who does not intend to benefit from a trust in the future could try to eliminate any beneficial interest that would otherwise be included in this calculation. This could be accomplished by disclaimer (subject, of course, to gift tax considerations and state law requirements), decanting the trust or perhaps impacting the "facts and circumstances." For example, the trustee could indicate an intention to never make a distribution to the beneficiary, assuming the preparation of such a letter was permitted from a fiduciary perspective.

b. Expatriate: Only an "expatriate" can be a CE. For these purposes an expatriate is any US citizen who relinquishes his citizenship and any long-term resident of the United States who ceases to be a lawful permanent resident of the United States.[26]

   i. Expatriation Date: The expatriation date of an individual is (i) the date the individual renounces US citizenship or (ii) the date a long-term resident ceases to be a lawful permanent resident.[27]

   ii. Citizenship[28]

      1. A US citizen is treated as relinquishing that citizenship on the earliest of:

         a. The date the individual renounces US nationality before a diplomatic or consular officer of the US pursuant to paragraph 5 of § 349(a) of the Immigration and Nationality Act (8 USC 1481(a)(5)), provided the renunciation is subsequently approved by the issuance of a certificate of loss of nationality by the Department of State;

         b. The date the individual furnishes to the US Department of State a signed statement of voluntary relinquishment of US nationality confirming the performance of an act of expatriation specified in paragraph 1, 2, 3 or 4 of § 349(a) of the Immigration and

[25] *Id.*
[26] IRC § 877A(g)(2).
[27] IRC § 877A(g)(3).
[28] IRC § 877A(g)(4).

Nationality Act (8 USC 1481 (a)(1)-(4)), provided the renunciation is subsequently approved by the issuance of a certificate of loss of nationality by the Department of State;

c. The date the US Department of State issues to the individual a certificate of loss of nationality; or

d. The date a court of the United States cancels a naturalized citizen's certificate of naturalization.

iii. Long-Term Residents

1. A lawful permanent resident of the United States is an individual who has been accorded the privilege of residing permanently in the United States (green card holder) and such status has not been revoked and has not been administratively or judicially determined to have been abandoned.[29]

2. A long-term resident is an individual who is a lawful permanent resident in at least 8 of the 15 taxable years ending with the year during which the expatriation occurs.[30]

3. Violation of an immigration law does not necessarily result in revocation of a green card or constitute an administrative or judicial determination that a green card was abandoned.[31] It is therefore possible for a green card to stop being effective as an immigration document (for example, by continuously traveling outside the US for more than a year without obtaining a reentry permit using Form I-131 or a returning resident visa (SB-1)), but for the green card holder to retain his tax status as a lawful permanent resident (and therefore a US person subject to worldwide taxation).

4. A green card is formally abandoned when it is surrendered and Form I-407 is filed with USCIS.[32]

5. Treaties:

   a. An individual will cease to be a lawful permanent resident, and will therefore be deemed to expatriate, if (i) such individual is treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country, (ii) does not

[29] IRC § 7701(b)(6).
[30] IRC §§ 877A(g)(5) and 877(e)(2).
[31] The tax court recently held that lawful permanent resident status "for Federal income tax purposes turns on Federal income tax law and is only indirectly determined by immigration law." *See Topsnik v. Commissioner*, 143 T.C. 12 (9/23/14). As a result, the court held against the taxpayer who claimed he had "informally" abandoned his status as a resident alien.
[32] See *Topsnik*, 146 T.C. 1 (1/20/16), where the Tax court found that the expatriation date for a green card holder was "when he filed with the INS a Form I-407 and surrendered his green card."

waive the benefits of such treaty applicable to residents of the foreign country and (iii) notifies the Secretary of the commencement of such treatment.[33]

b. The taxpayer would notify the Secretary he is claiming treaty benefits using IRS Form 8833, which states on the form itself "Note. If the taxpayer is a dual-resident taxpayer and a long-term resident, by electing to be treated as a resident of a foreign country for purposes of claiming benefits under an applicable income tax treaty, the taxpayer will be deemed to have expatriated pursuant to § 877A."

c. *PLANNING CONSIDERATION*: Because of the notice requirement, it's not entirely clear if this change of status occurs only when Form 8833 is filed, or if it is effective for the entire taxable year. If we focus on the notice requirement, until Form 8833 is filed all of the elements required for a change of status under IRC § 7701(b)(6) have not been satisfied. On the other hand, the instructions to the form state, "If you are an individual who is a dual-resident taxpayer and you choose to claim treaty benefits as a resident of a foreign country, you are treated as a nonresident alien in figuring your U.S. income tax liability for the part of the tax year you are considered a dual-resident taxpayer." In other words, if you qualified as a resident of a foreign country for the entire tax year based on the domestic income tax rules of that country AND you claim treaty benefits, you will be treated as a resident of that country for the entire tax year.

d. *PLANNING CONSIDERATION:* Determining the correct expatriation date for a CE is always important because it is the valuation date for the mark-to-market regime of §877A. It may also be important to avoid classification as a long-term resident. If a green card holder leaves the US after having held a green card in 7 of the last 15 years or less, and is thereafter taxed as a resident of a foreign country under an income tax treaty, that individual can avoid becoming a "long-term resident" for purposes of § 877A. That is, in any year when the treaty allows him to be taxed as a resident of the foreign country, the individual will not be a lawful permanent resident, so the count is frozen at 7 of 15 years (or whatever the

[33] IRC § 7701(b)(6).

case may be) and he never crosses over to long-term resident status. As a result, he can never be subject to the § 877A expatriation regime. This approach, however, may not be effective if the taxpayer's status as a lawful permanent resident continues until notice is actually given to the Secretary by filing Form 8833.

c. Exceptions

i. Dual Citizenship at Birth:[34] An individual is not a CE if:

1. he became a US citizen and a citizen of another country at birth;
2. he continues to be a citizen of, and resident in, that second country as of the expatriation date; and
3. he has been an income tax resident in the US (based on the substantial presence test rules of § 7701(b)(1)(A)(ii)) for no more than 10 of the 15 year period ending with the taxable year of the expatriation.

ii. Minors[35] An individual is not a CE if the individual relinquishes US citizenship before reaching age 18½ and has been an income tax resident in the US (based on the substantial presence test rules) for 10 taxable years or fewer prior to relinquishing citizenship.

1. *PLANNING CONSIDERATION*: In many instances missing the 18½ age for expatriation is not significant, because people so young rarely have the income or net worth required to be considered a CE. If such a person was the beneficiary of significant trusts, however, he may fail the Net Worth Test.

iii. Certification Not Waived: The language under § 877A(g)(1)(B) says an individual is not treated as failing the Net Income Tax test or the Net Worth test under § 877(a)(2)(A) and (B) respectively if they satisfy the Dual Citizenship exception or if they expatriate before age 18 ½. The requirement to file Form 8854, Initial and Annual Expatriation Statement, however, is not waived. An individual who fails to make the required filing will still be considered a CE even if they meet the Dual Citizenship exception or expatriate before age 18½. As the *Topsnik v. Commissioner* case demonstrates, failing to satisfy the filing requirement of § 877(a)(2)(C) is sufficient to render a taxpayer a CE.

iv. Re-establishment of Citizenship or Residence: For purposes of §§ 877A(d)(1) and 877A(f), an individual is not treated as a CE while he is subject to tax as a citizen or resident of the US.[36] That is, if a person is a CE and then becomes an income tax resident of the US again, he will not be subject to the § 877A rules on the taxation

[34] IRC § 877A(g)(1)(B)(i).
[35] IRC § 877A(g)(1)(B)(ii).
[36] IRC § 877A(g)(1)(C).

of distributions from eligible deferred compensation plans or non-grantor trusts during that period of residence. He will be taxed as is any other resident taxpayer. If he becomes a citizen or long-term resident again, however, he would be subject to § 877A again if he expatriated a second time and again meets the definition of a CE.

1. _PLANNING CONSIDERATION_: Previously, it appeared that if a CE became a US income tax resident, he would no longer be subject to § 2801 while an income tax resident. That continues to be the plain meaning of § 877A(g)(1)(C), which is adopted by reference in § 2801(f), but the proposed regulations (as detailed below) indicate the CE must be US-domiciled to cease being subject to § 2801.

v. Proposed Relief for Certain Accidental Dual Citizens

1. As part of its 2016 Budget Proposal, the Obama administration proposed that an individual would not be subject to tax as a US citizen and would not be a covered expatriate subject to the mark-to-market exit tax under § 877A if the individual:
    a. became at birth a citizen of the United States and a citizen of another country;
    b. at all times, up to and including the individual's expatriation date, has been a citizen of a country other than the United States;
    c. has not been a resident of the United States (as defined in §7701(b)) since attaining age 18½;
    d. has never held a US passport or has held a US passport for the sole purpose of departing from the United States in compliance with 22 CFR § 53.1;
    e. relinquishes his or her US citizenship within two years after the later of January 1, 2016, or the date on which the individual learns that he or she is a US citizen; and
    f. certifies under penalties of perjury his or her compliance with all US Federal tax obligations that would have applied during the five years preceding the year of expatriation if the individual has been a nonresident alien during that period.[37]

[37] Department of the Treasury General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals, page 282.

2. Note that this was only a proposal and as of October 2018, it has not become law. No similar proposal was contained in the Trump Administration's Fiscal Year 2018 Budget Proposal.[38]

[38] https://www.whitehouse.gov/sites/whitehouse.gov/files/omb/budget/fy2018/2018_blueprint.pdf

IV. INCOME TAX CONSEQUENCES

a. Mark-to-Market

i. All property of a CE is treated as sold on the day before the expatriation date for its fair market value.[39] Both gain and loss are taken into account, but the wash sale rule under § 1091 does not apply to losses triggered by the deemed sale.[40] Provisions of the code that avoid the recognition of certain gains, such as § 121 exempting up to $500,000 of gain from the sale of a residence, are not applicable.[41]

1. *PLANNING CONSIDERATION:* While non-recognition provisions cannot be used to avoid gain on the § 877A deemed sale, if a taxpayer engages in a transaction prior to expatriating he would still benefit from any applicable non-recognition provisions. For example, if a taxpayer actually sold his home to a third party prior to expatriating, he would be entitled to the § 121 exemption.

ii. The amount of gain included in gross income as a result of this deemed sale is reduced by $713,000.[42] For example, if a CE had $1 million of stock with a $87,000 basis he would be deemed to have $913,000 of capital gain under the § 877A mark-to-market exit tax. As a result of excluding $713,000 of gain, only $200,000 would be included in gross income for the year of expatriation.

1. The exclusion is allocated among all built-in gain property in proportion to the amount of gain.
2. If all gain is sheltered by the exemption and the taxpayer has a loss on certain assets, he must report the loss on his final Form 1040.[43]
3. *PLANNING CONSIDERATION*: Taxpayers should consider disposing of their long-term capital gain property prior to expatriation so as to use their $713,000 exclusion to shelter gains taxed at higher rates, such as short-term capital gains and gains from the disposition of collectibles.

iii. EXCEPTIONS: The mark-to-market regime does not apply to three specific groups of assets: (i) deferred compensation items; (ii) specified tax deferred accounts; and (iii) interests in non-grantor trusts.[44] Those items have special rules, detailed below.

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[39] IRC § 877A(a)(1).
[40] IRC § 877A(a)(2).
[41] *Id.*
[42] IRC § 877A(a)(3) provides for an inflation adjusted exclusion of $600,000. The inflation adjusted figure for 2015 was $690,000, $693,000 in 2016 and $699,000 in 2017. *See* Rev. Proc. 2017-58. Each individual is entitled to only one lifetime exclusion amount, so if an individual becomes a citizen or long-term resident and expatriates a second time, he may have little to no exclusion available. Section 3(B) of Notice 2009-85.
[43] Section 3(B) of Notice 2009-85.
[44] IRC § 877A(c).

iv. What is Taxed Under the Mark-to-Market Regime?

1. Estate Taxable Estate: While the code states that all "property" of a covered expatriate is treated as sold, the code does not provide a definition of property.[45] Notice 2009-85 addressed this issue, "[A CE] is considered to own any interest in property that would be taxable as part of his or her gross estate for federal estate tax purposes…as if he or she had died on the day before the expatriation date as a citizen or resident of the United States."[46]

   a. The Secretary is authorized[47] to issue regulations necessary or appropriate to carry out the purposes of §877A. In *Topsnik v. Commissioner*[48] the Tax court noted that Notice 2009-85 is not the equivalent of regulations. While the Notice may persuade the court, it is not binding. That said, the court did indeed find the Notice persuasive and approved the use of estate tax concepts to both determine what is "property" for §877A purposes and to value that property.

2. Beneficial Interest in Trusts: A CE is also deemed to own his beneficial interest in a trust that would not constitute part of his estate.[49] Since non-grantor trusts are treated differently (as detailed below), this inclusion only applies to a grantor trust in which (1) the CE is treated as the owner of the trust and (2) the CE has a beneficial interest.[50] The most common example of this would be a revocable trust, but other common estate planning vehicles like grantor retained annuity trusts (GRATs) and qualified personal residence trusts (QPRTs) would also be captured. The value of such an interest is calculated using the same methodology as for calculating a CE's net worth (as detailed above).

   a. *PLANNING CONSIDERATION:* Although the assets of a grantor trust in which the CE does not have a beneficial interest may not be impacted by § 877A, any appreciation on those trust assets may still be subject to capital gains tax as a result of expatriation due to § 684 as detailed more fully in Section IV(g)(vii) below.

[45] IRC § 877A(a)(1).
[46] Section 3(A) of Notice 2009-85.
[47] IRC § 877A(i).
[48] 146 T.C. 1 (1/20/16).
[49] Section 3(A) of Notice 2009-85, *citing* Section III of Notice 97-19.
[50] See Sections IV(f)(iv) and (g) infra regarding the definition of grantor and non-grantor trusts for § 877A purposes and the treatment of grantor trusts for § 877A purposes.

v. How Is Property Valued Under the Mark-to-Market Regime?

1. General Rule: The fair market value of each interest as of the day before the expatriation date is determined in accordance with the valuation principles applicable for purposes of the Federal Estate tax, as contained in § 2031.[51]

   a. *PLANNING CONSIDERATION*: Discounts for lack of control, marketability, fractionalization, etc. would be accounted for in calculating the value of property that was deemed sold, with the potential to materially decrease the gain (or even create losses) under the mark-to-market regime.

   b. The alternate valuation date (§ 2032) and special rules for valuation of farms and certain real property (§ 2032A) do not apply.

   c. The charitable deduction (§ 2055), marital deduction (§§ 2056 and 2056A) and special rules for family-owned business interests (§ 2057) do not apply.

2. Non-grantor Trusts: The value of a beneficial interest in a non-grantor trust that is not part of the taxpayer's gross estate will be valued under the gift tax principles of § 2512.[52]

3. Insurance: An interest in a life insurance policy is valued in accordance with the applicable gift tax regulations under Treas. Reg. § 25.2512-6, as if the CE had made a gift of the policy the day before the expatriation date.

b. Election to Defer

i. A CE may irrevocably elect to defer the "additional tax attributable" to gain on property under the mark-to-market regime until the property is actually disposed of.[53] Disposal includes sale, non-recognition transactions, gifts or other means.[54] This election is made on an asset by asset basis and reported on Form 8854.[55]

1. Gain on property ultimately disposed of in a non-recognition transaction is deferred until such date as the Secretary of the Treasury prescribes in regulations that have yet to be issued.[56]

2. Deferral is only permitted if the taxpayer irrevocably waives any right under a treaty that would preclude the assessment or collection of tax under § 877A.[57] Such waiver would be made on IRS Form 8854.

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[51] Section 3(A) of Notice 2009-85. Note this is slightly different from the rules used to determine whether a potential CE has a net worth in excess of $2 million. In that case, gift tax principles apply, while here it is estate tax principles.
[52] *Id.*
[53] IRC § 877A(b)(1) and (6).
[54] Section 3(E) of Notice 2009-85.
[55] *Id.*
[56] IRC § 877A(b)(1).
[57] IRC § 877A(b)(5).

ii. The "additional tax attributable" to any property is proportionate to the total amount of gain recognized under the mark-to-market regime.[58] For example, if total gain under the mark-to-market regime is $10,000 and the gain from the deemed sale of a personal residence is $3,000, then the taxpayer could elect to defer 30% of the gain to the year when the residence is actually sold.

iii. Due Date: Payment of the deferred tax, plus interest,[59] must be made by the due date for the tax return in the year of: (i) disposition of the asset;[60] (ii) the expatriate's death; or (iii) the time the security provided fails to meet the requirements and such failure is not corrected within 30 days after the IRS mails notice to the last known address of the CE and his US agent.[61]

1. Security: Adequate security is required to elect deferral of gain. Security could be in the form of a bond or another form as prescribed by the Secretary of the Treasury.[62] The IRS has issued a template tax deferral agreement, which is to be used when making the election.[63]
    a. Under the template, Treasury has discretion as to which form of collateral will be acceptable.
    b. The agreement will only be effective for an agreed upon number of years, at which time the taxpayer and Treasury may agree to extend the tax deferral agreement, provided that the security continues to be adequate.
    c. Treasury has sole discretion to determine if security is inadequate at any point, and could require the taxpayer to provide adequate security within 30 days or risk an end to the deferral period.
2. Interest: The interest on underpayment of tax is assessed during the deferral period.[64]

c. Deferred Compensation

i. Recall that deferred compensation is not subject to the § 877A mark-to-market regime. As detailed below, the taxation of "eligible deferred compensation" is deferred until actually received, while "ineligible deferred compensation" is reported on the final US tax return of the expatriate.

ii. Deferred Compensation includes:[65]

1. any interest in a plan or arrangement described in § 219(g)(5);

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[58] IRC § 877A(b)(2).
[59] IRC § 877A(b)(7).
[60] IRC § 877A(b)(1).
[61] IRC § 877A(b)(3) and Section 3(E) of Notice 2009-85.
[62] IRC § 877A(b)(4).
[63] *See* Appendix A of Notice 2009-85.
[64] IRC § 877A(b)(7), *citing* §6601; *see also* Section 3(E) of Notice 2009-85 for additional guidance.
[65] IRC § 877A(d)(4).

a. A plan described in § 401(a) that includes a trust exempt from tax under § 501(a);
b. An annuity plan described in § 403(a);
c. A § 457 plan;
d. An annuity contract under § 403(b);
e. A simplified employee pension under § 408(k);
f. Any simple retirement account under § 408(p); and
g. A trust described in § 501(c)(18).[66]

2. any interest in a foreign pension plan or similar retirement arrangement or program;
3. any item of deferred compensation; and
    a. This is a catch-all category that includes any legally binding right as of the expatriation date to compensation that has not been actually or constructively received on or before the expatriation date, but is payable to or on behalf of the CE on or after the expatriation date.
    b. This is intended to include nonqualified deferred compensation under § 404(a)(5), cash settled stock appreciation rights, phantom stock arrangements, cash settled restricted stock units, an unfunded and unsecured promise to pay money or other compensation in the future and an interest in a trust described in § 402(b)(1) or (4).[67]
4. any property, or right to property, that the individual is entitled to receive in connection with the performance of services to the extent not previously taken into account under § 83 or in accordance with § 83.
    a. This would include statutory and non-statutory stock options, stock and other property, stock-settled stock appreciation rights and stock settled restricted stock units.[68]
    b. Property will generally be considered to have been taken into account under § 83 if it has vested or a valid § 83(b) election is made and the additional requirements detailed in Section 5(b)(1) of Notice 2009-85 are satisfied.

[66] Section 5(B)(1) of Notice 2009-85.
[67] Section 5(B)(4) of Notice 2009-85.
[68] Section 5(B)(1) of Notice 2009-85.

iii. Eligible Deferred Compensation: The treatment of deferred compensation under § 877A depends on whether it is "eligible deferred compensation" or "ineligible deferred compensation" (both are discussed in the next section). Eligible deferred compensation includes a deferred compensation item with respect to which the payor is a US person or elects to be treated as a US person for these purposes AND the CE notifies the payor of his status as a CE and makes an irrevocable waiver of any right to reduced withholding on such item under any treaty.[69]

1. Withholding on Eligible Deferred Compensation: At the time an eligible deferred compensation item would be includible in the gross income of a CE (if the expatriate continued to be subject to tax as a US resident), the payor must withhold 30% of such payment.[70] Because the taxpayer waived the right to claim treaty benefits with respect to eligible deferred compensation, the 30 percent withholding cannot be reduced or eliminated by treaty.[71]

2. The taxpayer must inform the payor of his status as a CE by filing Form W-8CE (Notice of Expatriation and Waiver of Treaty Benefits) on the earlier of (1) 30 days after the expatriation date or (2) the day prior to the first distribution on or after the expatriation date.[72]

    a. *PLANNING CONSIDERATION*: For long-term residents, electing to be taxed as a resident of a treaty country by filing Form 8833 is the act of expatriation. As discussed above, the expatriation date in that instance may be retroactive to the first day of the taxable year for which the election is made. In such a scenario it appears Form W-8CE must be provided by the 30th day of the tax year. From a practical perspective that may be impossible, in which case it appears none of the CE's deferred compensation will be eligible deferred compensation.

    b. *PLANNING CONSIDERATION:* Note that eligible deferred compensation can be converted to ineligible deferred compensation by failing to provide Form W-8CE. Depending on: (i) how the new country of residence will tax this income; (ii) how rapidly the deferred compensation is expected to appreciate; and (iii) how clean a break with the US tax system the CE desires (along with other factors unique to each situation), it could be

[69] IRC § 877A(d)(3).
[70] IRC § 877A(d)(1).
[71] Section 5(C) of Notice 2009-85.
[72] Section 5(F) of Notice 2009-85.

advantageous to make this choice, even though it results in increased US tax liability in the year of expatriation.

iv. Other Deferred Compensation Items (a.k.a. "Ineligible Deferred Compensation"):

1. In the case of any deferred compensation item that is not an eligible deferred compensation item, an amount equal to the present value of the CE's accrued benefit is treated as being received by the individual on the day before the expatriation as a distribution under the plan.[73] As a result, such ineligible deferred compensation will generally be subject to ordinary income tax.

   a. The taxpayer must provide the payor of the deferred compensation with a Form W-8CE. The payor then has 60 days to advise the CE of the present value of the accrued benefit in the deferred compensation.[74]

      i. Currently there is no guidance on withholding for ineligible deferred compensation. Rather, the CE must report the ineligible deferred compensation items on his Form 1040 for the year ending on the day prior to the expatriation date. Similarly, the FICA and FUTA taxation of ineligible deferred compensation is currently determined without regard to § 877A.[75]

   b. Valuation Methodology:

      i. Except for ineligible deferred compensation items described in Sections 5 B(1)(a) or 5 B(1)(d) of Notice 2009-85 (which are also described in § 877A(d)(4)(A) and (D)), the present value of the CE's accrued benefit is determined by applying the principles of Prop. Treas. Reg. § 1.409A-4.[76]

      ii. The present value of a defined contribution plan described in Section 5 B(1)(a) of Notice 2009-85 is the account balance, while the present value of a defined benefit plan described in Section 5(B)(1)(a) of Notice 2009-85 is determined using the method set forth in Section 4.02 of Rev. Proc. 2004-37.[77] A plan described in Section

[73] IRC § 877A(d)(2)(A)(i).
[74] Section 5(D) of Notice 2009-85.
[75] Section 5(F) of Notice 2009-85.
[76] Section 5(D) of Notice 2009-85
[77] *Id.*

5(B)(1)(a) of Notice 2009-85 is a plan or arrangement described in § 219(g)(5) (see Section IV(c)(ii)(1) above).

iii. Any ineligible deferred compensation item described in Section 5(B)(1)(d) of Notice 2009-85 (see Section IV(c)(i)(4) above) is treated as becoming transferable and not subject to a substantial risk of forfeiture on the day before the expatriation date. Thus, such income is taxable at its current value and is not subject to the present value calculation generally applicable to ineligible deferred compensation.[78]

1. This generally includes "statutory and non-statutory stock options…stock and other property; stock-settled stock appreciation rights; and stock-settled restricted stock units."[79]

2. Ineligible deferred compensation items are not subject to additional tax as early distributions, and "appropriate adjustments" will be made to subsequent distributions to reflect this tax event.[80] This includes any additional tax imposed under §§ 72(t), 220(e)(4), 223(f)(4), 409A(a)(1)(B), 529(c)(6), 529A(c)(3) or 530(d)(4).[81]

3. Appropriate Adjustments: Appropriate adjustments must be made to items of ineligible deferred compensation to reflect any income recognized under these provisions.[82] Where appropriate, such income will be treated as an investment in the contract under § 72. Where Prop. Treas. Reg. § 1.409A-4 would apply in calculating the present value of the accrued benefit, adjustments will be made pursuant to principles similar to Prop. Treas. Reg. § 1.409A-4. Where § 72 and Prop. Treas. Reg. § 1.409A-4 do not apply, taxpayers may use any reasonable method to determine the amount of such adjustment so long as such method is "consistently applied to all such ineligible deferred compensation items with respect to the covered expatriate…"[83]

d. Services Performed Outside the United States

i. The rules governing taxation of eligible and ineligible deferred compensation items do not apply to any deferred compensation attributable to services performed

[78] *Id.*
[79] Section 5(B)(1)(d) of Notice 2009-85.
[80] IRC § 877A(d)(2)(B) and (C).
[81] *See* IRC § 877A(g)(6) and Section 5(D) of Notice 2009-85.
[82] IRC § 877A(d)(2)(C).
[83] Section 5(D) of Notice 2009-85.

outside the United States while the CE was not a citizen or resident of the United States.[84]

ii. To determine the portion of a deferred compensation item excluded from these rules, taxpayers are allowed to use any reasonable method that is consistent with existing guidance (such as Treas. Reg. § 1.861-4(b)(2), Rev. Rul. 79-388 and Rev. Proc. 2004-37) and is based on a reasonable, good faith interpretation of § 877A(d)(5).[85]

iii. *PLANNING CONSIDERATION*: Section G, Example 14 of Notice 2009-85 is particularly interesting. In that example, D had 1,000 shares of restricted common stock that had been awarded in connection with services. Those shares were awarded one year before the expatriation date and would be forfeited if D left the company in the next four years, for a total deferral of five years. Normally those shares would be treated as vesting with no ongoing risk of forfeiture the day before expatriation, triggering current taxation on the fair value of all 1,000 shares (Example 13). However, if D notifies the corporation of her status as a CE and irrevocably waives any right to claim treaty benefits, the gain is deferred until the shares actually vest four years later. At that time D reasonably determines 80% of the value of the restricted shares is attributable to services performed outside the US while D was not a citizen or resident (since she worked outside the US as a CE for four of the five years), so in year 5, D only has to recognize as gross income 20% of the year 5 value of the shares. A 30% withholding tax will apply to that value.

e. Specified Tax-Deferred Accounts

i. Specified tax-deferred accounts include Individual Retirement Accounts (§ 408(a)), Individual Retirement Annuities (§ 408(b)), 529 accounts, Coverdell Education Savings Accounts (§ 530), health savings accounts (§ 223) and an Archer MSA (§ 2201).[86]

ii. For tax years beginning after December 31, 2014, a qualified ABLE program, as defined in § 529A, is also a specified tax-deferred account.[87]

iii. A specified tax-deferred account does not include a simplified employee pension under § 408(k) or a simple retirement account under § 408(p).[88] Those types of accounts are treated as deferred compensation items.[89]

iv. A CE is treated as receiving a distribution of his entire interest in all specified tax-deferred accounts the day before the expatriation date, but no early distribution

[84] IRC § 877A(d)(5).
[85] Section 5(E) of Notice 2009-85.
[86] IRC § 877A(e)(2).
[87] IRC § 877A(e)(2) as modified by Section 102(e)(2)(A) of the ABLE Act of 2014, HR5771, 12/19/14.
[88] *Id.*
[89] Section 6 of Notice 2009-85.

tax[90] applies and appropriate adjustments should be made to subsequent distributions from the account to reflect this treatment.[91]

f. Non-grantor trusts

i. General Rule: Unless an election is made (as discussed below), instead of the standard mark-to-market regime, § 877A essentially takes a wait-and-see approach to taxing non-grantor trusts. Tax is imposed when distributions are made to a CE, at which time the trustee of a non-grantor trust must withhold 30% of the "taxable portion" of a distribution to a CE.[92]

1. The trustee, as the person required to deduct and withhold the tax, is liable for such tax.[93]

2. The CE must notify the trustee of his status as a CE by submitting Form W-8CE on the earlier of: (1) 30 days after the expatriation date; and (2) the day prior to the first distribution after the expatriation date.[94] In general, a CE is deemed to have waived the right to claim the benefit of any treaty and thereby reduce or eliminate this withholding.[95]

a. *PLANNING CONSIDERATION*: Again, as noted in the discussion of eligible deferred compensation above, a long-term resident who elects to be taxed as a resident of a treaty country may be deemed to have expatriated on the first day of the taxable year. If that is the case, without careful planning it may not be possible for such a taxpayer to provide timely notice to a trustee.

ii. Taxable Portion: The taxable portion of a distribution is that portion of a distribution that would have been includible in gross income had the CE not expatriated and had instead continued to be subject to tax as a US resident.[96]

1. If the fair market value of distributed property exceeds its income tax basis, gain is recognized to the trust as if such property were sold to the expatriate at its fair market value.[97] As a result, either the trust will need to pay tax on that gain or the gain will be incorporated in calculating the taxable portion of the distribution. Recall that capital gain is generally not

[90] Per Section 6 of Notice 2009-85, an early distribution tax includes §§ 72(t), 220(e)(4), 223(f)(4), 409A(a)(1)(B), 529(c)(6) or 530(d)(4). An early distribution tax also includes any increase in tax imposed under § 529A(c)(3). IRC § 877A(g)(6) as modified by Section 102(e)(2)(B) of the ABLE Act of 2014, HR5771, 12/19/14.
[91] IRC § 877A(e)(1).
[92] IRC § 877A(f)(1)(A).
[93] Section 7(C) of Notice 2009-85.
[94] *Id.*
[95] IRC § 877A(f)(4)(B).
[96] IRC § 877A(f)(2).
[97] IRC § 877A(f)(1)(b).

included in calculating distributable net income for domestic trusts and is included in calculating distributable net income for foreign trusts.[98]

iii. Option to Accelerate Income: The CE may, however, elect not to utilize the "wait-and-see" approach, and to instead accelerate income recognition. If this election is made on Form 8854, the CE is treated as having received the value of his interest in the trust on the day before the expatriation date.[99] As a result of this election, "no subsequent distribution from the trust to the covered expatriate will be subject to 30 percent withholding…"[100]

1. The value of the CEs interest is determined through an IRS private letter ruling following the procedures of Rev. Proc. 2009-4 and its progeny (currently Rev. Proc. 2018-4).[101] This election is not available if the IRS ultimately determines that the CE's interest in the trust does not have an ascertainable value.[102]
2. If a CE elects to be treated as having received the value of his interest in the trust on the day before the expatriation date, the CE will preserve his right to claim a treaty benefit with respect to a future distribution.[103]

iv. Is the Trust a Non-grantor Trust?

1. For estate planners, the way § 877A defines "non-grantor trust" is a little confusing. Section 877A(f)(3) states, "For purposes of this subsection, the term 'non-grantor trust' means the portion of any trust that the individual is not considered the owner of under subpart E of part I of subchapter J. The determination under the preceding sentence shall be made immediately before the expatriation date." So, for purposes of § 877A, a trust is only a grantor trust if the CE is considered the owner of the trust under Subchapter J. All other trusts are non-grantor trusts for § 877A purposes.
2. A trust that is taxed as a grantor trust under Subchapter J with someone other than the CE as the grantor is a "non-grantor" trust for purposes of § 877A. A distribution from such a trust does not have a taxable portion, however, because distributions from grantor trusts are not taxable to US resident beneficiaries. As a result, a distribution from such a "non-grantor" trust would not be subject to 30% withholding.
3. If a non-grantor trust, tested immediately before the expatriation date, becomes a grantor trust with respect to the CE after the expatriation date,

[98] IRC §643(a)(3) and (6).
[99] Section 7(D) of Notice 2009-85.
[100] *Id.*
[101] *Id.*
[102] *Id.*
[103] *Id.*

it is deemed to be a taxable distribution to the CE under § 877A(f)(1) and therefore subject to a 30% withholding tax.[104]

a. NOTE: It would be a very unusual situation for a non-grantor trust to become a grantor trust with respect to a CE after expatriation. Section 672(f) generally prevents a trust from being a grantor trust with respect to a foreign person. If an exception under § 672(f)(2) applied, the trust would have normally been a grantor trust the day before expatriation. For this situation to arise it is likely the trust was modified in some way after the expatriation date.

v. Beneficiary Status

1. The withholding requirement only applies to a trust if the CE was a beneficiary on the day before the expatriation date.[105]
2. A beneficiary is a person:
   a. Who is entitled or permitted, under the terms of the trust instrument or applicable local law, to receive a direct or indirect distribution of trust income or corpus;
   b. With the power to apply trust income or corpus for his or her own benefit; or
   c. To whom the trust income or corpus could be paid if the trust or the current interests in the trust were then terminated.[106]
3. *PLANNING CONSIDERATION:* It may be possible to exclude a CE as a beneficiary from a trust to avoid the 30% withholding regime and to add them back as a beneficiary at some future date. Before implementing this strategy, one must consider issues like the step-transaction doctrine, implied understanding, etc.
4. *PLANNING CONSIDERATION:* The definitions of "non-grantor trust" and beneficiary for § 877A purposes raises interesting questions about the revocable trusts of a parent. If a parent has a revocable trust that permits distributions to the CE, it appears to be a non-grantor trust (for purposes of § 877A), and the CE appears to be a beneficiary of that trust. A literal reading of the Code suggests that after the parent dies and the trust becomes irrevocable (and non-grantor in the conventional sense), the taxable portion of any distributions from that trust to the CE will be subject to 30% withholding. It is unclear whether this withholding requirement

[104] Section 7(A) of Notice 2009-85.
[105] IRC § 877A(f)(3) and (5).
[106] Section 7(A) of Notice 2009-85.

would only apply to that portion of the trust that was funded on the expatriation date or would also apply to assets transferred to the trust thereafter. It may be prudent for the parents of a CE to establish a testamentary trust or to establish a new revocable trust after the expatriation date.

g. Are All Grantor Trusts Subject to the § 877A Mark-to-Market Exit Tax?

i. The answer to this question is far from clear.

ii. The Joint Committee on Taxation thinks the answer is yes. "In the case of the portion of any trust for which the covered expatriate is treated as the owner under the grantor trust provisions of the Code, as determined immediately before the expatriation date, the assets held by that portion of the trust are subject to the mark-to-market tax."[107]

iii. Section 877A itself is far more ambiguous. The mark-to-market regime applies to all "property" of the CE, but § 877A does not define property. Section 877A(c)(3) specifically exempts interests in non-grantor trusts (as defined in § 877A(f)(3)) from the mark-to-market exit tax, but it would be wrong to make the negative inference that all grantor trusts are subject to the § 877A tax, particularly given that trusts that are grantor under Subchapter J but taxed to someone other than the CE are treated as "non-grantor" trusts under § 877A. That is, to be a grantor trust for purposes of § 877A, the CE must be treated as the grantor of the trust.

iv. Notice 2009-85 does not say that all grantor trusts are subject to the mark-to-market tax. Rather, property is only treated as belonging to the CE, and therefore subject to the mark-to-market tax, if it would be taxable as part of his gross estate for federal estate tax purposes had he died the day prior to the expatriation date.[108] Many grantor trusts, like insurance trusts, are not subject to estate tax. As discussed above, a grantor trust that would not be subject to estate tax could still be subject to the § 877A mark-to-market regime if the CE has a beneficial interest in a trust that would not constitute a part of his estate.[109]

v. The Instructions to Form 8854 are not entirely consistent with Notice 2009-85. Specifically, the instructions for Line 2 of Part IV suggest, but do not require, using the balance sheet from Schedule A of Part V to determine net worth on the date of expatriation. Line 9 of that balance sheet, and the associated instructions, indicate that assets owned by a trust that is deemed owned by the CE under §§ 671-679 are to be included in calculating the mark-to-market exit tax. That is, the instructions

[107] J. Comm. on Tax'n, Technical Explan. of HR 6081, JCX-44-08 at 43 (May 20, 2008).
[108] Section 3(A) of Notice 2009-85.
[109] Section 3(A) of Notice 2009-85, *citing* Section III of Notice 97-19.

appear to be consistent with the legislative history, but inconsistent with Notice 2009-85.

vi. This inconsistent guidance is troubling, but it is worth noting the instructions say a taxpayer "can use the balance sheet in Part V (Schedule A) to arrive at" net worth, so using this balance sheet does not appear to be mandatory.[110] At this time it is reasonable to take the position that if a trust is a grantor trust with the CE as the grantor and that trust would not be subject to estate tax, it is not subject to the mark-to-market regime unless the CE has a beneficial interest in that trust. This position, however, is not free from doubt given how explicit the legislative history is and what the current instructions to Form 8854 provide.

vii. Of course, in many situations a mark-to-market regime would still apply, just not the one under § 877A. As discussed below, in some instances a domestic trust will become a foreign trust as a result of the expatriation of a person who has a substantial power over the trust, which causes the trust to fail the "control test" of § 7701(a)(30)(E). In that instance § 684 could be triggered, resulting in a deemed sale regardless of § 877A.

1. *PLANNING CONSIDERATION:* Before the expatriation date of a CE, thought should be given to: (1) modifying existing grantor trusts to convert them to non-grantor trusts and therefore clearly avoid § 877A and § 684; or (2) concluding that a trust cannot be so modified, determine whether § 684 will apply, and determine what position the CE intends to take with regard to grantor trusts and § 877A. Careful consideration, however, must be given to possible consequences of terminating grantor trust status. For example, income may be recognized if the trust is the obligor on a debt.[111]

h. Miscellaneous:

i. Pre-Immigration Assets: For purposes of the mark-to-market tax of § 877A, property that was held by the individual on the date he first became resident in the US is treated as having a basis equal to the greater of the actual basis and the fair market value of the property on the residency starting date. This eliminates any pre-immigration gain from the mark-to-market tax. A taxpayer may elect out of this treatment, using Form 8854, on an asset-by-asset basis.[112] Some taxpayers will choose to do so given that obtaining a fair market value appraisal of property as of a residency starting date (often many years in the past) may prove prohibitively expensive.

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[110] The American College of Trust and Estate Counsel (ACTEC) sent a letter dated July 9, 2014 to the IRS requesting that the instructions to Form 8854 be modified to conform to Notice 2009-85. As of October, 2018 those instructions have not been modified.

[111] See e.g. *Madorin v. Commissioner*, 84 TC 667 (1985) and Treas. Reg. §1.1001-2(c) Ex.5.

[112] IRC § 877A(h)(2) and § 3(D) of Notice 2009-85.

1. Certain Assets Excluded From Pre-Immigration Basis Step Up[113]
    a. US Real Property Interests (USPRIs) within the meaning of § 897(c).
    b. Property used or held for use in connection with the conduct of a trade or business within the United States unless: (i) prior to becoming a resident of the US the taxpayer was a resident of a country with which the US had an income tax treaty; and (ii) the applicable trade or business was not carried on through a permanent establishment in the US under the income tax treaty between such country and the US, in which case the property is eligible for a pre-immigration basis step up.

ii. Coordination with § 684 Gain Recognition:

1. Under § 684, if a domestic trust becomes a foreign trust and it is not treated as a grantor trust with respect to a US person, there is a deemed sale of all trust assets. A foreign trust is any trust unless (i) a court within the United States is able to exercise primary supervision over the administration of the trust (the "Court Test") and (ii) one or more US persons have the authority to control all substantial decisions of the trust (the "Control Test").[114] If an individual who is the settlor or a beneficiary of a trust expatriates it is not unusual to suddenly fail the Control Test, which makes the trust a foreign trust and triggers tax under § 684.
2. Section 679 generally treats a trust funded by a US person that would otherwise be a foreign trust as a grantor trust. As a result, an expatriation may result in a trust created by someone other than the CE continuing to be taxed as a grantor trust or the conversion of a non-grantor trust into a grantor trust. While this could eliminate the tax under § 684, it raises other potential tax consequences that need to be carefully considered.
3. If expatriation results in the recognition of gain under § 684, § 877A applies after the application of the tax under § 684.[115] Accordingly, the § 877A gain exclusion cannot be used against § 684 gain.
4. It should be noted that under § 684, gain on trust assets are recognized, but losses are not. Given the option, therefore, a taxpayer would generally prefer paying tax under the § 877A regime.

iii. Split Year Reporting: The year of expatriation requires a dual-status return. The CE should file Form 1040NR with a Form 1040 attached as a schedule.[116] Thereafter a

[113] Section 3(D) of Notice 2009-85.
[114] IRC § 7701(a)(30)(E).
[115] IRC § 877A(h)(3).
[116] *See* Section 8(B) of Notice 2009-85, *citing* Treas. Reg. §§ 1.6012-1(b)(2)(ii)(b), § 1.871-13 and Chapter 6 of IRS Publication 519.

CE files Form 1040NR unless the US source income of the CE is fully withheld and the CE has no income effectively connected with a US trade or business, in which case the CE will not be required to file a Form 1040NR.[117]

iv. Basis Under Foreign Tax Regime: While the income tax system of each country is different, a deemed sale under § 877A will often not be treated as an actual disposition for purposes of a foreign tax regime. As a result, the taxpayer may continue to have the historic (low) basis for capital gains purposes under that foreign regime. This situation creates the potential for double taxation (to the US on expatriation and to the new country of residence when the asset is actually disposed of). Similarly, foreign countries may not credit tax paid under a deemed recognition event such as expatriation. As a result, a taxpayer who anticipates becoming a CE may wish to actually dispose of assets to minimize such issues.

[117] Section 8(B) of Notice 2009-85, *citing* Treas.Reg. § 1.6012-1(b) and Treas.Reg. § 1.6012-1(b)(2).

V. ESTATE TAX CONSEQUENCES OF EXPATRIATION

a. A Note Regarding the Proposed Regulations:

i. On September 10, 2015, proposed regulations were issued under § 2801. These regulations were released more than seven years after the effective date of § 2801 (June 17, 2008), and more than six years after Notice 2009-85 provided substantial guidance with regard to § 877A.

ii. This delay reflects the novel issues Treasury and the IRS had to consider in developing effective and practical guidance under § 2801. For example, the tax is imposed on the recipient of certain transfers, unlike the estate and gift taxes that are imposed on the transferor. To be specific, the tax is only imposed on transfers from CEs, yet determining whether the transferor is a CE requires access to information to which the recipient has no legal right. Indeed the IRS is prohibited from disclosing that information.

iii. While the IRS and Treasury worked hard to craft a workable system to implement § 2801, the proposed regulations come up short on many fronts. It should come as no surprise that the proposed regulations generated numerous comments pointing out these shortcomings. No additional guidance has been provided in the last three years. It may be that without corrective legislation, it is simply not possible to implement § 2801 in a fair and efficient manner. Time will tell.

b. The § 2801 Inheritance Tax in General:

i. Under § 2801(a), a US recipient of a "covered gift or bequest" is subject to a tax equal to the value of the covered gift or bequest multiplied by the highest estate tax rate in effect on the date of receipt. Currently that rate is 40%.[118] Unlike the estate and gift tax, which are imposed on the transferor, the US recipient of the gift or bequest is liable for the § 2801 tax.[119] The nature of the § 2801 tax creates a number of administrative challenges. How can the donee taxpayer know if the donor is a CE? How will they know if a distribution from a trust constitutes a covered gift or bequest? The proposed regulations are explicit that it is the responsibility of the donee to make these determinations, and that the presumption is a living donor is a CE making a covered gift.[120] The IRS is generally prohibited from providing the information needed to determine if someone is a CE, although it has promised guidance on how to request this information and on the limited circumstances when the IRS is authorized to release it.[121]

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[118] IRC § 2001(c).
[119] IRC § 2801(b); *see also* Prop. Treas. Reg. § 28.2801-4(a).
[120] Prop. Treas. Reg. § 28.2801-7.
[121] *Id.*

1. US Recipient: A US recipient includes a US citizen, a US domiciliary, a domestic trust, an electing foreign trust and "the U.S. citizen resident shareholders, partners, members, or other interest-holders, as the case may be (if any), of a domestic entity that receives a covered gift or covered bequest."[122]
    a. As of October 2018, there is no additional guidance on how to allocate a covered gift or bequest that is made to a non-trust entity among its owners. As a result, for taxpayers who are seeking certainty, it would be prudent to avoid making covered gifts or bequests to such entities.
2. Resident: For purposes of § 2801, an individual donee of a covered gift or bequest is a "resident," and therefore subject to § 2801, if domiciled in the US.[123]
    a. Prior to the release of the § 2801 proposed regulations, it was not entirely clear whether the domicile test under the estate and gift tax rules or the more objective income tax definition of residence would be used for § 2801 purposes. In the preamble to the proposed regulations the IRS explained, "[t]he Treasury Department and the IRS believe that, because section 2801 imposes a tax subject to subtitle B, the tax definition of resident under subtitle B generally should apply for purposes of section 2801."

ii. Electing Foreign Trust: An electing foreign trust is a foreign trust, as defined in § 7701(a)(31), that has elected to be treated as a domestic trust solely for purposes of § 2801. The method for making that election and retaining electing foreign trust status is discussed in greater detail below.[124]

iii. Expatriate and Covered Expatriate: In general these terms have the same meaning under § 2801 as they do under § 877A.[125] These rules are detailed in Section III above.

1. *PLANNING CONSIDERATION*: The proposed regulations have created an important exception to these parallel definitions. Section 2801(f) says, "For purposes of this section, the term 'covered expatriate' has the meaning given to such term by section 877A(g)(1)." While the plain meaning of this language appears to be that a taxpayer is a CE or not for purposes of both

[122] Prop. Treas. Reg. § 28.2801-2(e).
[123] *See* Prop. Treas. Reg. § 28.2801-2(b).
[124] Prop. Treas. Reg. § 28.2801-2(d)(2).
[125] Prop. Treas. Reg. § 28.2801-2(h) and IRC § 2801(f).

§§ 877A and 2801, the proposed § 2801 regulations create a distinction with regard to the § 877A(g)(1)(C) "resident" exception. Specifically, under the proposed regulations, an expatriate is not a CE for purposes of § 2801 if the expatriate is domiciled in the US, while for § 877A purposes an expatriate is not a CE if he is income tax resident in the US.[126] There is a clear logic to the IRS's position in that if a CE is domiciled in the US, all of their transfers will be subject to either estate or gift tax, so there would be no need to impose a tax under § 2801. Income tax residence does not appear relevant. While logical, it is not clear whether the proposed regulations are supported by the Code. This may be one of several areas where Section 2801 would benefit from clarifying legislation.

c. Covered Gift or Bequest

i. The most important term in the § 2801 regime is "covered gift or bequest." This term includes:

1. any property acquired by gift directly or indirectly from an individual who, at the time of such acquisition, is a CE;
2. any property acquired directly or indirectly by reason of the death of an individual who, immediately before such death, was a CE;[127] and
3. distributions from a foreign trust that is not an electing foreign trust (taking into account the § 2801 ratio of such trust).[128]

ii. It is not relevant where the transferred property is located, nor is it relevant whether the property was acquired by the CE before or after expiration.[129]

iii. Covered Gift: For § 2801 purposes, "Gift" has the same meaning as it does for US gift tax purposes. Note that the exceptions under § 2501(a)(2) (transfers of intangibles by non-residents from US gift tax), § 2501(a)(4) (transfers to § 527(e)(1) political organizations), § 2501(a)(5) (dealing with transfers of stock in certain foreign corporations by § 877 expatriates), § 2503(e) (exempting the direct payment of medical expenses and school tuition) and § 2503(f) (relating to certain pension rights) do not apply.[130] The annual exclusion exists but with some important nuances as detailed below.

[126] Prop. Treas. Reg. § 28.2801-2(h).
[127] IRC § 2801(e)(1).
[128] *Id.*
[129] *See* Prop. Treas. Reg. §§ 28.2801-2(f) and (g).
[130] Prop. Treas. Reg. § 28.2801-3(a).

1. *PLANNING CONSIDERATION*: Since § 2801 is imposed on the donee of a covered gift or bequest, the value of that gift or bequest should be based on what is received and not on what was transferred. For example, if a CE owns 100% of a company and bequeaths it equally to four individuals, a discount for lack of control may be appropriate.

iv. Covered Bequest: This term includes property transferred by bequest, devise, trust provision, beneficiary designation or similar arrangement. It also includes "any property that would have been includible in the gross estate of the covered expatriate under [the US estate tax] if the covered expatriate had been a US citizen at the time of death."[131] As a result, transfers that would be includible in the CE's estate under §§ 2036-2042 or 2044 would be considered covered bequests and trigger tax under § 2801.[132]

v. Domestic Trusts: A gift or bequest by a CE to a domestic trust or to an electing foreign trust is a covered gift or bequest, and § 2801 applies.[133]

vi. Indirect Gifts and Bequests

1. An indirect gift or bequest includes: (i) gratuitous transfers by a CE to a corporation or an entity, other than a trust or estate, with US citizen or resident owners; (ii) property acquired by a US citizen or resident through one or more foreign trusts, or other entities, or a person not subject to § 2801 (a so-called "straw person"); and (iii) the payment by a CE of a debt or liability of a US citizen or resident.

2. An indirect gift or bequest may also include property acquired by a US citizen or resident due to someone who is not a CE exercising a power of appointment granted to them by a CE.[134]

vii. Exceptions

1. Fair Market Value Transactions: While not explicitly identified by the statute, a covered gift or bequest cannot include a fair market value transaction, since such transactions are not gifts or transfers by reason of death.

2. Section 2801(c) Annual Exclusion Gifts: Section 2801 does not apply to gifts or bequests up to the § 2503(b) annual exclusion amount.[135]

a. *PLANNING CONSIDERATION:* Interestingly, § 2801(c) does not require the gift or bequest to meet the requirements of an annual exclusion gift. It merely says § 2801(a), which imposes the tax,

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[131] Prop. Treas. Reg. § 28.2801-3(b).
[132] *Id.*
[133] IRC § 2801(e)(4)(A). *See also* Prop. Treas. Reg. § 28.2801-3(d).
[134] Prop. Treas. Reg. § 28.2801-2(i)(4).
[135] IRC § 2801(c).

applies only to the extent that the value of a covered gift or bequest exceeds the § 2503(b) limit. For example, if a CE gifts $30,000 to a domestic trust that does not contain Crummey provisions, $15,000 will still be excluded as a § 2801(c) annual exclusion gift and § 2801 tax will be due on the remaining $15,000. In contrast, if a CE gave $30,000 to a foreign trust, no § 2801 tax would be due since the foreign trust is not a US recipient. If that foreign trust subsequently distributed $15,000 to each of two different US citizen beneficiaries, no § 2801 tax would be due since each of the US citizen beneficiaries would be entitled to a § 2801(c) annual exclusion.

b. Note there is no exception for § 2503(e) gifts to pay medical or educational expenses.[136]

3. Transfers Otherwise Subject to Estate or Gift Tax: A taxable gift subject to Chapter 12 or a bequest included in the gross estate of the CE and subject to Chapter 11 that is properly shown on a timely filed gift or estate tax return is not a "covered gift or bequest."[137] So, a CE who makes a transfer of US situs property, either for gift or estate tax purposes, is outside of the § 2801 regime, provided those transfers are properly reported. Instead of paying tax at the top flat rate of § 2801, such transfers benefit from the graduated rates applicable to gifts and bequests under §§ 2001 and 2502.[138] They would, however, potentially be subject to the GST tax as well, while transfers subject to § 2801 are not subject to the GST tax or an equivalent regime.

   a. *PLANNING CONSIDERATION*: The proposed regulations add the additional requirement that any gift or estate tax reported on the return must be timely paid in order for this exception to apply.[139] It is not clear whether Treasury has the authority to restrict this exception by adding the timely payment requirement, particularly since doing so increases the likelihood that both gift/estate tax and § 2801 will apply to the same transfer.

[136] Prop. Treas. Reg. § 28.2801-3(a).
[137] IRC § 2801(e)(2). Example 2 of Prop. Treas. Reg. § 28.2801-3(f) shows how the failure of an executor to timely file an estate tax return can result in 2801 tax for an estate beneficiary. Presumably this will not eliminate the estate tax liability, so the Treasury will collect two transfer taxes (estate and inheritance tax) on the same transfer.
[138] This benefit is fairly modest at this time, since a bequest of $1 million would currently produce a tax liability of $345,800 under § 2001(c) compared to a tax of $400,000 under § 2801(a). Still, every little bit helps!
[139] Prop. Treas. Reg. § 28.2801-3(c)(1) and (2).

b. *PLANNING CONSIDERATION:* A gift that is excluded from the definition of taxable gift, such as an annual exclusion gift, is not excluded from the definition of covered gift or bequest.[140]

   i. For example, assume a husband and wife are both CEs. They visit the US to see their daughter and they each give her exactly $15,000 in gold coins. Such a gift is subject to the US gift tax since it is a gift of tangible property in the US. These gifts also qualify for the gift tax annual exclusion of $15,000, so they are not "taxable gifts." Section 2801, therefore, does apply and the daughter can only exclude $15,000 from her calculation of § 2801 tax and would in fact owe § 2801 tax (40% rate) on the remaining $15,000.

   ii. In contrast, if wife alone gave $30,000 of gold coins to daughter, $15,000 would qualify for both the gift tax annual exclusion and the § 2801 tax annual exclusion. The remaining $15,000 of gold coins would be a taxable gift subject to a marginal gift tax of less than 20%, but excluded from the higher § 2801 tax (assuming a gift tax return is timely filed and any tax timely paid).

c. *PLANNING CONSIDERATION*: Note that the US estate and gift tax system is based on domicile, not income tax residence. A CE could continue to be subject to US estate and gift tax if he has not broken domicile in the US by establishing domicile in a new country. That is, the CE must be physically present in that country with the intent to remain permanently. In many situations it is incumbent on the CE to take steps to affirmatively establish that new domicile.

4. Transfers While US Tax Resident: As discussed above, gifts or bequests by a CE are not subject to § 2801 for any year the CE is US tax resident.[141] The proposed regulations take the position that this exception only applies if the CE is US-domiciled.

5. Transfers to Spouse or Charity: If a transfer would qualify for a deduction under §§ 2055 (charitable), 2056 (marital), 2522 (charitable) or 2523

[140] Prop. Treas. Reg. § 28.2801-3(c)(1).
[141] IRC § 877A(g)(1)(c).

(marital) if the decedent or donor was a US person, that transfer is not a covered gift or bequest.[142]

a. PLANNING CONSIDERATION: Chuck Rubin has noted an interesting inconsistency in the marital deduction regime as it relates to § 2801.[143] There is an exception to § 2801 for both inter-vivos and testamentary transfers to QTIP trusts, but under § 2044 QTIP property is only included in the gross estate of a surviving spouse if a deduction was allowed under § 2056 or § 2523. If the QTIP is funded by a non-resident with property that is not U.S. situs property for estate or gift tax purposes (as applicable), then no deduction was allowed under § 2056 or § 2523 and it appears that the QTIP assets can pass estate tax free at the death of the surviving spouse. Simply stated, a CE with a US-domiciled spouse could fund a QTIP trust with $1 billion of non-US situs property and there would be no tax under § 2801 because of the marital exception under § 2801(e)(3). When the surviving spouse died there would also be no estate tax on those assets because § 2044 does not reference § 2801.

b. Non-Citizen Spouses: A bequest to a Qualified Domestic Trust (QDOT) for which a QDOT election is made will qualify for this exception.[144] Note that there is no such thing as an inter-vivos QDOT, so this this exception cannot be used to mitigate the impact of the gift tax or the § 2801 tax on gifts to non-citizen spouses.

    i. PLANNING CONSIDERATION: QTIP and QDOT elections must be made on a Form 706 or 706-NA. If the CE dies with no US situs property, is it possible to make a valid QTIP or QDOT election? If a valid election is not made, § 2801 tax will be payable on the covered bequest to the "marital" trust.[145]

c. CE as QDOT Beneficiary: If a CE is the beneficiary of a QDOT (meaning it was created by the deceased spouse of the CE), the death of the CE does not result in a covered bequest so long as a valid election was made on the predeceased spouse's Form 706 or

[142] IRC § 2801(e)(3).
[143] *LISI International Tax Planning Newsletter #9* (May 17, 2016).
[144] Prop. Treas. Reg. § 28.2801-3(c)(4).
[145] Id. See also Rubin, *LISI International Tax Planning Newsletter #9* (May 17, 2016).

706-NA to treat the trust as a QDOT.[146] Those QDOT assets will be subject to estate tax under the normal § 2056A rules.

d. Disclaimer: A qualified disclaimer by a CE, as defined in § 2518(b), does not result in a covered gift or bequest.[147]

e. Gifts to Non-Citizen Spouses: Gifts by a CE to a non-citizen spouse qualify for the "supersized" annual exclusion gift exemption under § 2523(i)(2).[148] Because an individual must be US-domiciled to be a US recipient for § 2801 purposes, this exception is most likely to apply when the spouse of a CE is a green card holder.

f. *PLANNING CONSIDERATION:* While gifts and bequests to foreign trusts do not trigger § 2801 tax, the "wait and see" approach to taxing foreign trusts does not apply for transfers to spouses or charity. That is, if a covered gift or bequest is made to a foreign trust and a subsequent distribution from that trust is made to the CE's spouse or to a charity, the marital and charitable exemptions to § 2801 will not apply and § 2801 tax will be due.

d. Reporting:

i. Any covered gift or bequest received since June 17, 2008 is subject to the new § 2801 tax and will eventually be reported on Form 708.[149] Form 708 will not be issued until the § 2801 regulations are finalized. The service has promised "a reasonable period of time" between when the form is finally issued and the due date for outstanding covered gifts and bequests.[150]

1. *PLANNING CONSIDERATION*: Given that taxpayers may eventually be asked to report on transactions that are more than a decade old, it would be prudent for advisors to preserve the information necessary to file Form 708 when it is eventually released. While it is not possible to anticipate all the information that may eventually be necessary, basic data on: (1) what property was received; (2) the value of that property; and (3) evidence indicating that the donor was or was not a CE should be retained.

ii. It is the recipient of the covered gift or bequest who must file Form 708, although no form is required if the total of all covered gifts and bequests received is less than or equal to the § 2801(c) annual exclusion amount.[151]

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[146] Prop. Treas. Reg. § 28.2801-3(c)(4).
[147] Prop. Treas. Reg. § 28.2801-3(c)(5).
[148] Prop. Treas. Reg. § 28.2801-3(f) Ex 1.
[149] Announcement 2009-57.
[150] *Id. See also* Prop.Treas.Reg. § 28.6071-1(d).
[151] Prop. Treas. Reg. § 28.6011-1(a).

iii. If a donee reasonably[152] concludes the gift or bequest was not a covered gift or bequest, he may still choose to file a protective Form 708 setting forth all of the information otherwise required by Form 708, as well as an affidavit signed under penalties of perjury setting forth the information that the taxpayer relied on in concluding that the transfer was not a covered gift or bequest.[153]

    1. It is interesting to note that for gifts there is "a rebuttable presumption that the donor is a CE and that the gift is a covered gift."[154] In contrast, if a distribution from a trust is received and the trustee lacks sufficient records to calculate the section 2801 ratio or the U.S. recipient cannot obtain the necessary information there is an" assumption that the entire distribution for purposes of section 2801 is attributable to a covered gift or covered bequest"[155] It seems unlikely that Treasury intended for there to be a meaningful difference between the "presumption" and the "assumption" in these cases, so perhaps this inconsistent language will be modified when the regulations are finalized.

iv. If Form 708 is required to be filed, it is due on June 15 of the appropriate year. An automatic 6 month extension for filing Form 708 may be requested on Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns.* As usual, an extension to file does not extend the due date for payment of any applicable § 2801 tax.[156]

v. The year when Form 708 is due can vary depending on the nature of the covered gift or bequest.

    1. In general, Form 708 is due June 15th of the second calendar year after the covered gift or bequest was received.[157] The date of receipt is determined under Prop. Treas. Reg. § 28.2801-4(d).
        a. For example, if a covered gift is received in February of 2015, the associated Form 708 will be due June 15, 2017.
    2. With respect to a bequest, if the date of receipt is not the date of death under § 28.2801-4(d)(3) (as discussed in detail below), the due date for Form 708 will be the later of:
        a. June 15 of the second calendar year after the CE died; or

[152] For a discussion of what steps a donee can take to reasonably conclude that a gift or bequest is not a covered gift or bequest see "IRC Section 2801: What U.S. Estate Planners Need to Know," Stephen Liss and Marianne Kayan, *Trusts & Estates Magazine*, November 2016.
[153] Prop. Treas. Reg. § 28.6011-1(b).
[154] Prop. Treas. Reg. §28.2801-7(b)(2). Emphasis added.
[155] Prop. Treas. Reg. §28.2801-5(c)(3). Emphasis added.
[156] Prop. Treas. Reg. § 28.6081-1.
[157] Prop. Treas. Reg. § 28.6071-1(a).

b. June 15 of the calendar year following the calendar year in which the covered bequest was received.[158]

e. Foreign Trusts:

   i. Section 2801 is not triggered by a gift or bequest to a foreign trust, given that the trust is not a US recipient. The code takes a "wait and see" approach to this situation. If a CE makes a transfer to a foreign trust, § 2801 will apply to "any distribution attributable to such gift or bequest from such trust (whether from income or corpus) to a United States citizen or resident in the same manner as if such distribution were a covered gift or bequest."[159]

   ii. The proposed regulations broadly define "distribution" to include "any direct, indirect, or constructive transfer from a foreign trust."[160] Grantor trust status is irrelevant in making this determination, nor does it matter whether the US recipient is a beneficiary of the trust. For example, an individual who receives property from a foreign trust pursuant to the exercise, release or lapse of a power of appointment (whether or not a general power of appointment) is considered to have received a trust distribution.[161]

      1. *PLANNING CONSIDERATION:* A loan bearing fair market interest should not be considered a distribution. Such a fair market value transaction is not a distribution, nor is it equivalent to a gift or bequest. This situation is analogous to loans made by foreign trusts with undistributed net income (UNI) to US beneficiaries. Prior to the introduction of § 643(i) in 1996, foreign trusts could make loans to US beneficiaries and they were not considered distributions for purposes of UNI calculations. That said, the language in the proposed regulations is sufficiently broad that the treatment of loans is not free from doubt. The same principles apply to the uncompensated use of trust-owned assets, such as a residence.

   iii. The Section 2801 Ratio

      1. Where every contribution to a foreign trust was a covered gift or bequest, it is clear that every distribution to a US recipient will result in § 2801 tax for the US recipient. The proposed regulations, however, provide a mechanism for determining the § 2801 tax attributable to a distribution from a foreign trust to a US recipient where the foreign trust had been only partially funded through covered gifts or bequests.

[158] *Id.*
[159] IRC § 2801(e)(4)(B)(i).
[160] Prop. Treas. Reg. § 28.2801-5(b).
[161] *Id.*

2. Distributions from a foreign trust are deemed to come proportionately from the share that is attributable to covered gifts or bequests and the share that is not. The proposed regulations require calculation of the foreign trust's "section 2801 ratio," and that ratio is then used to determine the percentage of each distribution that is potentially subject to § 2801 tax.[162] A foreign trust funded exclusively with covered gifts or bequests will have a section 2801 ratio of one, while a trust that has never received a covered gift or bequest will have a section 2801 ratio of zero.
    a. This is very similar to the concept of a generation-skipping transfer (GST) tax inclusion ratio.
    b. Note that if the trustee does not have adequate information to calculate the section 2801 ratio or if the US recipient cannot obtain this information, the US recipient must assume that the section 2801 ratio of the foreign trust is one, and therefore the entire distribution is subject to § 2801.[163]
    c. *PLANNING CONSIDERATION:* The § 2801 proposed regulations do not contain an equivalent to the GST qualified severance rules as set forth in Treas. Reg. § 26.2642-5. Perhaps consider drafting trusts to require segregation of covered gifts and bequests in order to avoid a section 2801 ratio of between zero and one.
3. Calculating the Section 2801 Ratio: After each contribution, the section 2801 ratio equals (X+Y)/Z. X is the value of the trust attributable to covered gifts and bequests immediately before the contribution and is determined by multiplying the fair market value of the trust assets prior to the contribution by the pre-contribution section 2801 ratio. Y is the portion of the current contribution that is a covered gift or bequest. Z is the fair market value of all trust assets immediately after the contribution.[164]
    a. For example, on January 5, a trust with $100,000 had a 40% section 2801 ratio and on January 6 it received a covered gift of $60,000. The section 2801 ratio after January 6 would be calculated as (100,000*40%)+60,000)/160,000. So the ratio is 100,000/160,000 or 62.5%. As a result, 62.5% of any future distribution from the trust to a US recipient will be subject to § 2801 tax.

[162] Prop. Treas. Reg. § 28.2801-5(c)(1).
[163] Prop. Treas. Reg. § 28.2801-5(C)(3).
[164] Prop. Treas. Reg. § 28.2801-5(c)(1)(ii).

4. If § 2801 tax is timely paid on property that remains in a foreign trust, for purposes of calculating the section 2801 ratio, that property is no longer considered to be attributable to a covered gift or bequest.[165]
   a. For example, a trust may have at one time elected to be treated as a domestic trust for § 2801 purposes, resulting in a § 2801 "purging" election as detailed below. If such a trust ceases to be an electing foreign trust, the section 2801 ratio of the trust will remain zero unless an additional covered gift or bequest is received. Similarly, if a foreign trust's purging election is somehow defective, to the extent the trust timely paid § 2801 tax on a covered gift or bequest, the associated property is no longer considered to be attributable to a covered gift or bequest for purposes of calculating the section 2801 ratio.[166]
5. _PLANNING CONSIDERATION:_ Note that § 2801(c) does not remove the annual exclusion amount from the definition of a covered gift or bequest, so it is generally included in the calculation of a section 2801 ratio. If that gift is reported on Form 708, however, it is treated as though the § 2801 tax had been timely paid. As a result, it is important that foreign trusts timely report § 2801(c) annual exclusion gifts so as not to increase the section 2801 ratio of the foreign trust.[167]
   a. For example, if a foreign trust with a section 2801 ratio of zero and $85,000 received a covered gift of $15,000 and timely filed and reported that gift on Form 708, it would continue to have a section 2801 ratio of zero. If it did not, however, the section 2801 ratio would be calculated as ($85,000 X 0% + $15,000) / $100,000, which would result in a section 2801 ratio of 15%. This is a trap for the unwary given that a foreign trust that is not an electing foreign trust would not normally file a Form 708.

iv. Because distributions from foreign trusts funded by a CE may result in both current income taxation (based on the normal Subchapter J rules) as well as the § 2801 tax, the § 2801 tax is permitted as a deduction under § 164 to the extent that the § 2801 tax is imposed on the portion of the distribution that is included in the gross

[165] Prop. Treas. Reg. § 28.2801-5(c)(2).
[166] Prop. Treas. Reg. § 28.2801-5(d)(7). Pursuant to Prop. Treas. Reg. § 28.2801-5(e) Example 4, this would apply to an imperfect election even though the -5(d)(7) regulation refers to an election that "was not in fact a valid election…"
[167] Prop. Treas. Reg. § 28.2801-5(c)(2).

income of a US citizen or resident.[168] Prop. Treas. Reg. § 28.2801-4(a)(3)(ii) contains guidance on the calculation of this deduction.

v. Note that the "throwback rules" of § 665 *et seq.* will also apply to any distribution from a foreign trust to a US person.[169] Such a distribution could therefore trigger ordinary income and a substantial interest charge, in addition to the § 2801 tax.

vi. Electing Foreign Trusts: A foreign trust may elect to be treated as a domestic trust solely for purposes of § 2801.

1. The initial election to be treated as a domestic trust (a § 2801 purging election) subjects the trust to § 2801 tax on: (i) all covered gifts and bequests received by the trust during the year of election; and (2) the portion of the trust attributable to prior year covered gifts or bequests based on the section 2801 ratio of the trust. Thereafter the section 2801 ratio of the electing foreign trust will be zero.[170]
2. Just like a domestic trust, the electing foreign trust will be subject to § 2801 tax on any covered gift or bequest received in a future year.
3. Note that this election is valid for § 2801 purposes only. For all other purposes, including information reporting and § 665 throwback taxation, the trust remains a foreign trust.
4. The § 2801 purging election is made on a timely filed Form 708 and may be made regardless of whether a covered gift or bequest was received in the year of the election.[171] In addition to paying the tax associated with the § 2801 purging election and showing how that tax was calculated, the electing foreign trust must: (i) designate and authorize a US agent; (ii) agree to file Form 708 annually; (iii) list the amounts and year of all prior distributions attributable to covered gifts and covered bequests made to US recipients (as well as the name, address and Taxpayer Identification Number of each US recipient); (iv) notify each permissible US distributee of the § 2801 purging election AND provide to the IRS the name, address and TIN of each permissible US distributee.[172]
   a. *PLANNING CONSIDERATION:* The inclusion of at least two of these requirements in the proposed regulations appears to be unnecessarily burdensome on taxpayers. Specifically, the

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[168] IRC § 2801(e)(4)(B)(ii).

[169] A full discussion of the throwback rules is beyond the scope of these materials. For a thorough explanation of this topic, however, see *A Guide to International Estate Planning*, second edition, Chapter 7 (III)(C).

[170] Prop. Treas. Reg. § 28.2801-5(d)(2).

[171] Prop. Treas. Reg. § 28.2801-5(d)(3). If the electing foreign trust did not receive a covered gift or bequest in the year of election, Form 708 must be filed on or before the 15th day of the 6th month of the calendar year following the close of the calendar year for which the election is made. Prop. Treas. Reg. § 28.6071-1(c).

[172] *Id.*

requirement that an electing foreign trust file Form 708 each year even when no covered gift or bequest is received[173] and the requirement of identifying all prior distributions attributable to foreign gifts or bequests. The annual filing requirement provides no additional information to the IRS while requiring that the taxpayer incur an annual cost. As for prior distributions, each should have already been reported by the US recipient.

5. US Agent: The trustee must agree to provide the US agent with all information "necessary to comply with any information request or summons issued by the Secretary. Such information may include, without limitation, copies of the books and records of the trust, financial statements, and appraisals of trust property."[174]
6. Termination of Election: A foreign trust will cease to be an electing foreign trust if: (i) it fails to file Form 708 annually; (ii) it fails to timely pay the § 2801 tax required by Form 708; or (iii) as a result of an imperfect election (detailed below). The election is terminated as of the first day of the calendar year for which the trustee fails to make the required filing or pay the required § 2801 tax. A foreign trust may reelect to be treated as a domestic trust in a future year.[175]
7. Imperfect Elections:
    a. The Commissioner may dispute the calculation of the § 2801 tax of an electing foreign trust. This may be due to a dispute as to the value of a covered gift or bequest received by the trust or for any other reason. In such an event the Commissioner will notify the trustee, who may reach an agreement with the Commissioner and pay any additional amounts required without impacting the validity of the § 2801 purging election.[176]

[173] Form 708 must be filed by such a trust on or before the 15th day of the 6th month of the calendar year following the close of that calendar year. Prop.Treas.Reg. § 28.6071-1(c).
[174] Prop. Treas. Reg. § 28.2801-5(d)(3)(iv).
[175] Prop. Treas. Reg. § 28.2801-5(d)(5)(ii) and (iii).
[176] Prop. Treas. Reg. § 28.2801-5(d)(6)(i) and (ii).

b. If the trustee and the Commissioner cannot agree on the additional tax, interest and penalties due with respect to the purging election (or any subsequent filing of Form 708 by an electing foreign trust that reports a covered gift or bequest), the foreign trust's election will terminate and become an "imperfect election" retroactive to the first day of the calendar year for which the disputed Form 708 was filed.[177]

c. Despite making an imperfect election, the value reported by the trust and upon which it paid § 2801 tax is not considered a covered gift or bequest for purposes of calculating the section 2801 ratio of the foreign trust, but the US recipient of distributions from the foreign trust must also take into account the additional value determined by the IRS on which § 2801 tax was not timely paid. The section 2801 ratio of the foreign trust, therefore, will be between zero and one.[178] The US recipient of a distribution from a foreign trust with an imperfect election will need to file Form 708 and pay any resulting tax.[179]

d. *PLANNING CONSIDERATION*: Each US recipient may dispute the value used by the IRS, so it is theoretically possible that a foreign trust will have different section 2801 ratios for different US recipients in the event of an imperfect election.

e. The US recipient's failure to file and pay any resulting 2801 tax will be deemed reasonable and not due to willful neglect for purposes of § 6651 provided that Form 708 is filed and any resulting § 2801 tax is paid within a reasonable period of time (not more than six months) after the taxpayer is notified by the trustee of the foreign trust or otherwise becomes aware of the imperfect election.[180]

f. *PLANNING CONSIDERATION:* Example 5 of Prop. Treas. Reg. § 28.2801-5(e) explains that a foreign trust that has previously made an imperfect election may elect in a future year to be an electing foreign trust. The example says that the trustee must pay the "section 2801 tax on the portion of the trust attributable to covered gifts and covered bequests." The most likely cause of an imperfect election is a dispute about the value of a covered gift or

[177] Prop. Treas. Reg. § 28.2801-5(d)(6)(iii)(A).
[178] *Id.*
[179] Prop. Treas. Reg. § 28.2801-5(d)(6)(iii)(D).
[180] Prop. Treas. Reg. § 28.2801-5(d)(6)(iii)(C). See also Prop. Treas. Reg. § 28.2801-5(e) Example 4.

bequest. If the IRS and trust beneficiaries ultimately agree on multiple values for that gift (either through a negotiated settlement or through a court finding), it is not clear which value the foreign trust would use or if the valuation issue would yet again be open for dispute between the foreign trust and the IRS.

g. Each of the permissible US distributees who is notified of a § 2801 purging election must also be notified in the event of an imperfect election.[181]

vii. <u>Trust Migration:</u> If a foreign trust that has previously received a covered gift or bequest becomes a domestic trust (as defined in § 7701(a)(30)(E)), it must file Form 708 in the year it becomes a domestic trust and pay § 2801 tax as though it had made a § 2801 purging election under Prop. Treas. Reg. § 28.2801-5(d).[182]

1. If a foreign trust becomes a domestic trust, Form 708 will be due June 15 of the calendar year following the close of the calendar year in which the foreign trust becomes a domestic trust.[183]
2. For § 2801 purposes, a migrating trust is treated as a domestic trust for the entire year. As a result, distributions made by the trust to a US person at any time during the year are <u>not</u> subject to § 2801 tax.
3. <u>*PLANNING CONSIDERATION:*</u> A trust migration may be better than a § 2801 purging election for several reasons, including the fact that a migrating trust will have all of the normal rights of a US taxpayer to dispute a valuation issue associated with the payment of § 2801 tax. That said, migration also brings with it significant income tax and reporting changes that would need to be carefully considered in each situation.

f. <u>Powers of Appointment:</u> The treatment of a power of appointment is addressed by the proposed regulations in a number of situations.

i. <u>Indirect Gifts or Bequests:</u> If someone who is not a CE exercises a power of appointment in favor of a US citizen or resident and that power of appointment was granted by a CE over property not held in trust, it may be treated as a covered gift or bequest by the CE.[184]

1. <u>*PLANNING CONSIDERATION:*</u> It is not entirely clear what a power of appointment over property not held in trust is since the proposed regulations do not provide an example. Perhaps Treasury will merely use this provision to address a straw person.

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[181] Prop. Treas. Reg. § 28.2801-5(d)(6)(iii)(B).
[182] Prop. Treas. Reg. § 28.2801-4(a)(2)(iv).
[183] Prop. Treas. Reg. § 28.6071-1(b).
[184] Prop. Treas. Reg. § 28.2801-2(i)(4).

ii. CE as Holder of a GPOA:

1. If a CE exercises or releases a general power of appointment (GPOA) for the benefit of a US citizen or resident, the exercise is a covered gift or bequest.
2. The lapse of a GPOA is treated as a release to the extent it exceeds $5,000 or 5% of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied.
3. A CE's exercise of a power of appointment creating another power of appointment as described in § 2041(a)(3) or § 2514(d) for the benefit of a US citizen or resident is a covered gift or bequest.[185]

iii. A CE's grant to a US citizen or resident of a GPOA over property not transferred in trust is a covered gift or bequest.[186]

1. *PLANNING CONSIDERATION:* Once again, it is not entirely clear what a power of appointment over property not held in trust is.

iv. Creation of a GPOA in a Foreign Trust: Example 3 of Prop. Treas. Reg. § 28.2801-3(f) contains an interesting example of the interplay between § 2801 and the general gift tax rules. In that example a CE makes a gift to a foreign trust. The terms of the trust give a GPOA to CE's child, who is a US person. Pursuant to the example, funding the trust is a covered gift, but because it is a foreign trust, no § 2801 tax is due at that time. The child subsequently exercises his GPOA and appoints $100,000 to CE's grandchild, also a US person. That exercise constituted a distribution from the foreign trust attributable to a covered gift, so § 2801 tax was imposed on the gift to the grandchild. At the same time, the child had exercised a GPOA and had therefore made a gift of $100,000 to the grandchild. In this scenario, it was necessary for the child to file Form 709 to report the gift and for the grandchild to file Forms 708 and 3520 to disclose the covered gift and the distribution from the foreign trust.

v. Valuation:

1. The value of a gift made by a CE through the exercise, lapse or release of a power of appointment is determined on the date of that exercise, lapse or release.
2. In contrast, the value of a covered bequest effected through the exercise, lapse or release of a power of appointment is determined on either the date that the property subject to the power is distributed from the CE's estate or revocable trust or the date of the CE's death if the property

[185] Prop. Treas. Reg. § 28.2801-3(e)(1).
[186] Prop. Treas. Reg. § 28.2801-3(e)(2).

passed by operation of law, beneficiary designation or a similar arrangement.[187]

3. If a CE grants a GPOA over property to a US person and the property is not in trust, the valuation of the covered gift or bequest will be made when both the power is exercisable by the US person AND the property subject to that power of appointment is in fact irrevocably transferred by the CE.[188]

g. Payment of § 2801 Tax and Associated Reporting

i. A US person receiving a covered gift or bequest is liable for payment of the § 2801 tax and for filing Form 708.[189]

ii. Section 2801 Tax Calculation: The § 2801 tax is calculated by multiplying the net covered gifts or bequests received by a US recipient during the calendar year by the higher of the maximum estate or gift tax rate in effect (currently 40%).[190]

1. A taxpayer's net covered gifts or bequests is the total of the covered gifts or bequests received during the year reduced by the annual exclusion amount per § 2801(c).[191]

iii. Valuation Under § 2801:

1. Fair market value for § 2801 purposes is based on the willing buyer/willing seller methodology used for estate and gift tax purposes. The special valuation rules of Chapter 14 apply for these purposes. Valuation is determined as of the date that the property is received by the US recipient.[192]

a. *PLANNING CONSIDERATION:* Since the § 2801 tax is imposed on the donee, it is the asset received that should be valued and not the asset transferred. This is an important distinction from traditional gift and estate tax valuation that the proposed regulations do not directly address.

2. Date of Receipt:

a. For a covered gift, the date of receipt is based on traditional gift tax principles.

b. For a covered bequest, it is the date of the covered expatriate's death for property passing by operation of law, but otherwise is the "date of distribution from the estate or the decedent's

[187] Prop. Treas. Reg. § 28.2801-4(d)(5)(i).
[188] Prop. Treas. Reg. § 28.2801-4(d)(6)(ii).
[189] Prop. Treas. Reg. § 28.2801-4(a).
[190] Prop. Treas. Reg. § 28.2801-4(b)(1).
[191] Prop. Treas. Reg. § 28.2801-4(b)(2).
[192] Prop. Treas. Reg. § 28.2801-4(c).

revocable trust rather than the date of death of the covered expatriate."[193]

c. If there is a bona fide dispute with respect to bequeathed property, however, the date of receipt is when that claim is extinguished.

d. Distributions from a foreign trust are valued on the date of the distribution.[194]

iv. <u>Credit For Foreign Gift or Estate Tax:</u> The tax imposed under § 2801(a) on a covered gift or bequest is reduced by the amount of any gift or estate tax paid to a foreign country with respect to such covered gift or bequest.[195] This would allow a covered expatriate domiciled in a foreign country with a material estate or gift tax to largely avoid the impact of § 2801.

1. <u>*PLANNING CONSIDERATION:*</u> The interaction of the § 2801 tax and a foreign tax regime can be complicated, yet the proposed regulations provide very little guidance. For example, under the UK inheritance tax bequests above the available "nil rate band" of GBP 325,000 are subject to a 40% tax rate,[196] so there would essentially be a dollar-for-dollar credit that would eliminate the impact of § 2801. Gifts to individuals, however, are not subject to any UK inheritance tax as long as the donor survives 7 years after the transfer (with the applicable rate steadily reduced if the donor lives more than 3 years but dies in fewer than 7).[197] This could lead to an initial payment of § 2801 tax and then a claim for refund if the donor died and ultimately paid UK inheritance tax on the gift. The statute of limitations for claiming refunds, however, is generally the later of 3 years from the date the return was filed or 2 years from the date the tax was paid.[198]

2. <u>*PLANNING CONSIDERATION:*</u> In the UK, lifetime transfers to trusts are generally subject to a 20% UK inheritance tax (with the potential for additional tax if the donor dies fewer than 7 years after the transfer), and the trust would then pay 6% of its fair market value as an additional inheritance tax every 10 years (or a portion of that 6% on periodic trust

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[193] Prop. Treas. Reg. § 28.2801-4(d)(2) and (3).
[194] Prop. Treas. Reg. § 28.2801-4(d)(4).
[195] IRC § 2801(c).
[196] *See* Foster's Inheritance Tax/Part D Transfers on death/Division D1 Charge on death/Calculating the IHT/Cumulation and tax rate. *See also* Foster's Inheritance Tax/Part D Transfers on death/Division D1 Charge on death/Calculating the IHT/Nil-rate band transfer.
[197] *See* Foster's Inheritance Tax/Part C Lifetime transfers/Division C5 Calculating the tax on lifetime transfers/Potentially exempt transfers/Cumulation and tax rates.
[198] IRC § 6511(b)(1).

distributions).[199] How will such a system be credited? Moreover, if the transfer is to a US domestic trust, the § 2801 tax and the UK 20% tax would be triggered at the same time, making a credit relatively easy, but a transfer to a foreign trust would not result in an immediate § 2801 tax. How will a future distribution from the foreign trust that triggers a 2801 tax be credited with the UK inheritance tax that was paid at the time of the initial gift (and any subsequent 6% tax)?

3. How will this credit work for countries that do not have an "estate or gift" tax, but merely treat such gratuitous transfers as recognition events that trigger a capital gain?

v. Credit for US Gift or Estate Tax: Under § 2012, there is an estate tax credit for any gift taxes paid on property that is ultimately included in the taxable estate of a taxpayer and subjected to estate tax. The purpose of this credit is to ensure that gift or estate tax is paid on a transfer, but not both.

1. PLANNING CONSIDERATION: There is no equivalent provision under the proposed § 2801 regulations. As a result, if both an estate/gift tax and a 2801 tax are imposed on the same transfer, both taxes will in fact be payable.

h. Miscellaneous Provisions

i. Charitable Remainder Trusts

1. When a domestic CRT receives a covered gift or bequest, it must calculate the value of the charitable remainder interest as of the date the trust received the contribution (the "Remainder Interest"). This calculation is based on the regulations under § 664.

2. No § 2801 tax is due with respect to the Remainder Interest, but since the CRT is a domestic trust, § 2801 tax will be due on the portion of the balance of the covered gift or bequest (the "Taxable Interest"). The Taxable Interest, of course, represents that portion of the covered gift or bequest that is projected to be consumed by the annuity or unitrust beneficiary.[200]

3. For example, if a $150 covered gift is made to a CRUT and the Remainder Interest is projected to be $50, a § 2801 tax of $40 will be owed on the $100 value of the Taxable Interest.

[199] *See* Foster's Inheritance Tax/Part C Lifetime transfers/Division C5 Calculating the tax on lifetime transfers/Immediately chargeable transfers - while the transferor is living/Cumulation and tax rates. *See also* Foster's Inheritance Tax/Part E Settled property/Division E4 Settlements without a qualifying interest in possession: calculation of IHT/Charges at ten-year anniversaries.

[200] Prop. Treas. Reg. § 28.2801-4(a)(2)(iii).

a. *PLANNING CONSIDERATION:* It is interesting that the proposed regulations call for the CRUT to pay the $40 of § 2801 tax, as opposed to the unitrust beneficiary. What the above example really means is that if $150 were given to the CRUT, we would expect $50 to be left for charity when the unitrust beneficiary dies, but after paying the $40 of § 2801 tax, the CRUT really only has $110 left to invest. There should, therefore, be less than $50 left when the unitrust beneficiary dies. This system appears to slightly benefit the non-charitable beneficiaries of a CRT.

ii. Generation-Skipping Tax

1. Section 2801 does not have the equivalent of a generation-skipping tax (GST) component. As a result, a CE can make gifts or bequests to US resident grandchildren or more remote descendants and pay only one 40% tax so long as the transferred property does not have a US situs for estate or gift tax purposes.[201]

2. *PLANNING CONSIDERATION:* Similarly, trusts funded by a CE can transfer assets to skip persons more efficiently than those established by US persons.

    a. A covered gift or bequest to a domestic trust will immediately trigger a 40% tax, but thereafter distributions can be made to skip persons without any additional transfer tax.

    b. A covered gift or bequest to a foreign trust will not trigger an initial § 2801 tax, and future distributions to skip persons will only pay a single 40% tax, regardless of how many generations the distributee is removed from the settlor. The throwback rules of § 665 *et seq.*, of course, must still be accounted for.

3. Paying GST Tax: If a domestic trust or a foreign electing trust that is not GST exempt receives a covered gift or bequest, the payment of the associated § 2801 tax will not be treated as a taxable distribution for GST purposes.[202]

iii. Basis: The basis of a donee of a covered gift or bequest is determined under the normal rules of §§ 1014 and 1015. As a result, the basis of a bequest is generally date of death valuation, while a gift generally results in carryover basis.

[201] Prop. Treas. Reg. § 28.2801-6(b).
[202] Prop. Treas. Reg. § 28.2801-4(a)(2)(ii).

1. PLANNING CONSIDERATION: The donee does not receive any basis increase as a result of paying § 2801 tax.[203]

iv. Form 3520: Prop. Treas. Reg. § 28.2801-6(c) contains a surprising change to Form 3520 reporting requirements. The proposed regulation would require someone who was US-domiciled to file Form 3520 reporting a covered gift, a covered bequest or the receipt of a distribution from a foreign trust even if that taxpayer was not a US income tax resident.

1. *PLANNING CONSIDERATION:* The proposed regulations provide that someone who is a US resident as defined in § 28.2801-2(b), which is domicile based, is included within the definition of US person for purposes of § 6039F and required to report a distribution from a foreign trust under § 6048(c). The statutory basis for this position is unclear. Sections 6039F and 6048(c) require Form 3520 be filed by a United States Person. That term is defined in § 7701(a)(30) and includes a resident of the United States. The term "resident" is then defined in § 7701(b)(1), which explicitly says that except for purposes of subtitle B (which contains the estate, gift and § 2801 tax regimes) a resident is a green card holder, someone who fails the substantial presence test or someone who properly elects to be treated as a US resident, that is, an income tax resident. Sections 6039F and 6048 are in subtitle F of the Internal Revenue Code, so it is the income tax definition of "resident" that they reference. This interpretation is confirmed by a review of the instructions to Form 3520. As a result, the regulatory expansion of the Form 3520 reporting requirement appears to be contrary to the explicit language of the code.

v. Penalties:

1. Prop. Treas. Reg. § 28.2801-6(d) states that the substantial valuation understatement penalty of § 6662(g), the gross valuation misstatement penalty of § 6662(h) and the § 6695A penalty for substantial and gross valuation misstatements are applicable to covered gifts and bequests.

   a. *PLANNING CONSIDERATION:* Since §§ 6662 and 6695A apply to estate or gift tax valuations and yet make no reference to § 2801, Prop. Treas. Reg. §28.2801-6(d) appears unsupported by the code.

2. The proposed regulations state that the § 6651 penalty for failure to file and failure to pay shall apply to Form 708.

   a. *PLANNING CONSIDERATION*: Yet again the statutory authority for imposing this penalty appears to be absent. Section 6651(a)(1)

[203] Prop. Treas. Reg. § 28.2801-6(a).

imposes a penalty on the failure "to file any return required under authority of subchapter A of chapter 61…" Subchapter A of 26 USC 61 includes §§ 6001-6096. The Heroes Earnings Assistance and Relief Tax Act of 2008 added §§ 877A and 2801. It also modified § 6039G by inserting references to § 877A, but it did not add any references to § 2801. The author is unaware of any references to § 2801 in Chapter 61, and electronic searching has not revealed any. The IRS, however, may attempt to rely on the general authority contained in § 6011 for the imposition of the § 6651 penalty.

VI. SOME OTHER ISSUES

a. Existing re-entry rule

i. The "Reed Amendment" was part of the Illegal Immigration Reform and Immigrant Responsibility Act of 1996. Under the amendment, "[a]ny alien who is a former citizen of the United States who officially renounces United States citizenship and who is determined by the Attorney General to have renounced United States citizenship for the purposes of avoiding taxation by the United States is inadmissible."[204]

ii. The intention was that if an individual was motivated by taxation to give up citizenship, that individual would not be allowed to reenter the United States. It does not appear that to date any individual has been denied admission to the US based on the Reed Amendment, though rumors of enforcement have circulated.

iii. It has been reported that at least one expatriate, Roger Ver, has been denied re-entry to the US.[205] This decision was apparently based on § 214(b) of the Immigration and Nationality Act, not the Reed Amendment. Section 214(b) reads, in part "[e]very alien shall be presumed to be an immigrant until he establishes to the satisfaction of the consular officer, at the time of application for a visa that he is entitled to non-immigrant status…" Essentially, this provision permits a consular officer to deny a visa if the officer is not convinced the applicant will (and will be able to) leave the US before the visa expires.

b. The Ex-PATRIOT Act

i. In 2011 Facebook co-founder Eduardo Saverin expatriated, which became news as the 2012 Facebook IPO approached. In response, the Expatriation Prevention by Abolishing Tax-Related Incentives for Offshore Tenancy Act (Ex-Patriot Act) was introduced.

ii. The law would presume that anyone with a net worth of $2 million or more expatriated with a tax motivation and if this presumption was not rebutted, future capital gains would be subject to a 30% tax, regardless of where the taxpayer resided.

iii. The rule would apply not only to those who expatriate after its passing, but to anyone who expatriated in the prior ten years.

iv. If a taxpayer is found to have expatriated for tax purposes, even if the individual pays the 30% tax on future capital gains, he would be barred from re-entering the US.

[204] 8 U.S.C. § 1182(a)(10)(E).
[205] See e.g. http://blogs.angloinfo.com/us-tax/2015/01/24/bitcoin-entrepreneur-banned-from-entering-usa-after-expatriating/.

v. The Ex-PATRIOT Act died in committee in 2012. It was reintroduced as an amendment to the Border Security, Economic Opportunity and Immigration Modernization Act of 2013, but was not included in the version of the bill that passed the Senate.

Foreign Trust Tax Issues for Domestic Taxpayers

November 8, 2018

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NORTHERN TRUST

BACKGROUND ISSUES

Taxation of Citizens and Residents vs Non-Citizen Non-Residents:

1. Income Tax Residency vs Estate Tax Domicile

2. Income Taxation vs Estate Taxation

PRIMARY DISCUSSION TOPICS

1. **WHAT IS A FOREIGN TRUST?**

2. **TAXATION OF FUNDING AND DISTRIBUTIONS**

3. **REPORTING REQUIREMENTS**

WHAT IS A FOREIGN TRUST?

Definitions

"**Administration**" is the performance of duties imposed by the terms of the trust and applicable law, *e.g.*, maintaining records, filing tax returns, managing trust assets, defending the trust from claims of creditors, and determining the amount and timing of distributions from the trust. ***Treas. Reg. § 301.7701-7(c)(3)(v).***

"**Control**" means that no foreign person has the authority to make or veto any substantial decision of the trust. ***Treas. Reg. § 301.7701-7(d)(1)(iii).***

"**Court**" is defined as any federal, state, or local U.S. court. ***Treas. Reg. § 301.7701-7(c)(3)(i).***

A court "**is able to exercise**" primary supervision if the court has the authority under applicable law to issue orders or judgments regarding trust administration. ***Treas. Reg. § 301.7701-7(c)(3)(iii).***

WHAT IS A FOREIGN TRUST?

Definitions - Continued

"**Primary supervision**" is the authority to determine substantially all issues regarding the trust's administration. ***Treas. Reg. § 301.7701-7(c)(3)(iv).***

A "**substantial decision**" is a decision that a person is authorized or required to make under the trust instrument and is not ministerial in nature. Substantial decisions include: (1) making and timing of distributions of income/principal; (2) amounts of distributions; (3) determination of beneficiaries; (4) allocation of receipts to income/principal; (5) termination of trust; (6) removal or replacement of trustees and appointment of successor trustees; and (7) investment decisions. ***Treas. Reg. § 301.7701-7(d)(1)(ii).***

A "**U.S. person**" is an individual citizen or resident of the U.S., a U.S. partnership or corporation, or a U.S. estate or trust. ***I.R.C. § 7701(a)(30)(E).***

WHAT IS A FOREIGN TRUST?

<u>Two Part Test</u>

A Foreign Trust is any trust other than a U.S. Trust…

To be considered a U.S. Trust, a trust must meet two tests:

1) The “Court Test”

2) The “Control Test”

WHAT IS A FOREIGN TRUST?

Court Test

To meet the **Court Test**, a *court* within the U.S. must *be able to exercise primary jurisdiction* over the trust's *administration*. ***I.R.C. § 7701(a)(30)(E).***

A safe harbor exists if (i) the trust instrument does not direct that the trust be administered outside the U.S., (ii) the trust is in fact administered exclusively in the U.S., and (iii) the trust is not subject to an automatic migration provision. ***Treas. Reg. § 301.7701-7(c)(1).***

WHAT IS A FOREIGN TRUST?

Control Test

To meet the **Control Test**, one or more *U.S. persons* must have the authority to *control* all *substantial decisions* of a trust. ***I.R.C. § 7701(a)(30)(E)*.**

Grace Period for Change in Trustee Structure:

Generally, if there is a change in the Trustee structure of a U.S. trust that is inadvertent which would make such trust a foreign trust, there is a twelve month period to make changes to the Trustee structure for such trust to retain its status as a U.S. trust. ***Treas. Reg. § 301.7701-7(d)(2)(i)*.**

UNITED STATES TAXATION

Tax Effects of Transfer to Foreign Trusts

Grantor Trust Treatment…

A foreign trust created by a U.S. person is *always* treated as a foreign grantor trust if the trust has U.S. beneficiaries.

A U.S. grantor of a foreign trust is treated as the owner of any portion of the trust attributable to the property gratuitously transferred by the U.S. grantor for any year in which the trust has U.S. beneficiaries, whether or not the U.S. grantor has any of the powers over the trust described in I.R.C. §§ 671-678. ***I.R.C. § 679*****.**

UNITED STATES TAXATION

Tax Effects of Transfer to Foreign Trusts

Sale or Exchange Treatment for Transfers to Foreign Trusts…

Generally, the transfer of property by a U.S. person to a foreign trust is treated as a sale or exchange of that property. ***I.R.C. § 684(a)*.**

The U.S. transferor must recognize gain on the excess of (i) the fair market value of the property transferred to the trust over (ii) the adjusted basis of property in the hands of the transferor. ***I.R.C. § 684(a)*.**

A transferor may not recognize loss on transfers of assets to a foreign trust. ***Treas. Reg. § 1.684-1(a)(2)*.**

UNITED STATES TAXATION

Tax Effects of Transfer to Foreign Trusts

Exception for Grantor Trusts…

There is an exception to immediate gain recognition when there is a transfer to a grantor trust. ***I.R.C. § 684(b)*.**

A U.S. person who directly or indirectly transfers property to a foreign trust is treated as the owner of the portion of the trust attributable to such transfer under I.R.C. § 671 for any taxable year in which there is a U.S. beneficiary of the trust, unless (1) the transfer occurred by reason of the death of the transferor or (2) the transfer was made in exchange for consideration equal to the fair market value of the transferred property. ***I.R.C. § 679(a)(1), (2)*.**

UNITED STATES TAXATION

Tax Effects of Transfer to Foreign Trusts

But…

Upon the death of the U.S. person who was treated as the owner of the foreign trust, the trust's grantor trust status terminates and the U.S. person recognizes gain to the extent of the fair market value of the trust property, unless the trust property is included in the U.S. owner's gross estate for estate tax purposes and the basis of the assets in the hands of the foreign trust is determined under I.R.C. § 1014(a).

UNITED STATES TAXATION

<u>Taxation of U.S. Beneficiaries of Foreign Non-Grantor Trusts</u>

As with U.S. trusts, a foreign trust generally receives a deduction for income distributed (or required to be distributed) to a beneficiary, and the beneficiary includes the income distributed (or required to be distributed) in his or her gross income.

A U.S. beneficiary of a foreign non-grantor trust must include in gross income for the taxable year (1) the amount of trust income required to be distributed to the beneficiary (whether or not actually distributed) from any "simple trust" to the extent of the beneficiary's share of the trust's distributable net income ("DNI") for the year; (2) the amount of trust income required to be distributed to the beneficiary from any "complex trust" to the extent of the beneficiary's share of the trust's DNI; and (3) any other amount required to be distributed to the beneficiary (whether or not actually distributed to the beneficiary) or properly and actually distributed to the beneficiary from any other "complex trust" to the extent of the beneficiary's share of DNI for the year. ***I.R.C. § 651(a); I.R.C. § 662(a)(1), (2).***

UNITED STATES TAXATION

<u>Taxation of U.S. Beneficiaries of Foreign Non-Grantor Trusts</u>

Key differences from U.S. Trusts…

The DNI of a foreign trust must also include the following: (1) capital gains; (2) the amount of income from non-U.S. sources reduced by amounts that would be deductible in connection with non-U.S. source income in the absence of I.R.C. § 265; and (3) the amount of income excluded from gross income by treaty under I.R.C. § 894. ***I.R.C. § 643(a)(6)*.**

UNITED STATES TAXATION

Taxation of U.S. Beneficiaries of Foreign Non-Grantor Trusts

Distributions…

If a foreign non-grantor trust makes a distribution in excess of DNI for the taxable year (an "accumulation distribution"), the U.S. beneficiary's income tax on such distribution is calculated according to the "throwback rules", except as limited by the amount of the trust's undistributed net income ("UNI") for that taxable year.

An "accumulation distribution" is the amount by which the amount distributed under I.R.C. § 661(a)(2) (*i.e.*, amounts properly paid or required to be distributed in excess of trust accounting income required to be distributed currently) exceeds the trust's DNI for the year reduced (but not below zero) by trust accounting income required to be distributed currently. ***I.R.C. § 665(b).***

UNITED STATES TAXATION

Taxation of U.S. Beneficiaries of Foreign Non-Grantor Trusts

The amount of an accumulation distribution that is subject to tax is limited by the amount of the trust's UNI for the tax year.

The trust's UNI for the taxable year is equal to the trust's DNI for the year less (1) trust accounting income required to be distributed currently; (2) any other amounts properly paid or credited or required to be distributed, and (3) taxes imposed on the trust that are attributable to the trust's DNI for that taxable year. ***I.R.C. § 665(a).***

A trust's UNI carries over from year to year, so that if a trust has no UNI in the year of the distribution, but has UNI from previous years, the accumulation distribution will be subject to throwback tax to the extent of the trust's UNI in prior years. ***I.R.C. § 666.***

A trust's UNI for a taxable year may be reduced by accumulation distributions made in later years to the extent that such accumulation distributions are deemed to have been made in that taxable year. ***I.R.C. § 666.***

REPORTING REQUIREMENTS

Transfers to Foreign Trusts

I.R.S. Form 3520 (Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts) - a U.S. person who is treated as the owner of a foreign trust must report the creation of the foreign trust or the transfer of property to the foreign trust. Furthermore, the U.S. owner of a foreign trust must file an annual report detailing the existence of the trust, its taxpayer identification number, the identities of any other owners of the trust, the country the trust was created in and the date on which it was created, and the Internal Revenue Code section which treats the U.S. person as an owner of the trust.

I.R.S. Form 3520-A (Annual Return of Foreign Trust with U.S. Beneficiaries) - the foreign trust should file a Form 3520-A which accounts for all trust activities during the taxable year.

REPORTING REQUIREMENTS

Distributions

Generally, a U.S. person, including a beneficiary, who receives a distribution from a foreign trust must make a return disclosing the name of the trust and the aggregate distributions made during the year to the U.S. person by filing a Form 3520.

REPORTING REQUIREMENTS

Penalties

If any notice or return required to be filed under I.R.C. § 6048 is not timely filed, does not include all required information, or includes incorrect information, the person required to file the notice or return must pay a penalty equal to the greater of $10,000 and 35% of the gross reportable amount. ***I.R.C. § 6677(a)*****.**

The U.S. owner of a foreign trust who does not file Form 3520-A also must pay a penalty of 5% of the value of the trust assets that are owned by the U.S. person at the close of that year. ***I.R.C. § 6677(b)*****.**

Note that the filing deadline for Form 3520-A is March 15th, as opposed to April 15th for Form 3520.

REPORTING REQUIREMENTS

Other Potential Reporting Requirements

FinCEN Form 114 – Report of Foreign Bank and Financial Accounts ("FBAR") - A U.S. person must file an FBAR to report all foreign bank accounts and financial accounts which have an aggregate value in excess of $10,000 with respect to which such person has a financial interest or signatory authority.

Form 8938 – Statement of Foreign Financial Assets - (which is filed with an individual's income tax return) – used to disclose interests held in certain foreign assets.

Foreign Tax Account Compliance Act ("FATCA") Reporting

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Global Intangible Low-Taxed Income ("GILTI")

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I. Introduction To GILTI.

A. Income Inclusion that Ends Deferral.

1. Similar to Subpart F income, a U.S. Shareholder has a *pro rata* income inclusion of the GILTI of a controlled foreign corporation ("CFC").

2. GILTI is included in gross income in the same manner as inclusions for Subpart F income.[1] GILTI is taxed differently from Subpart F income in the hands of C corporations.

B. Although GILTI is similar in many ways to Subpart F income, unlike Subpart F income, GILTI is determined at the U.S. Shareholder level.

1. Subpart F income is determined at the CFC level.

2. A U.S. Shareholder determines GILTI by reference to all its CFCs.

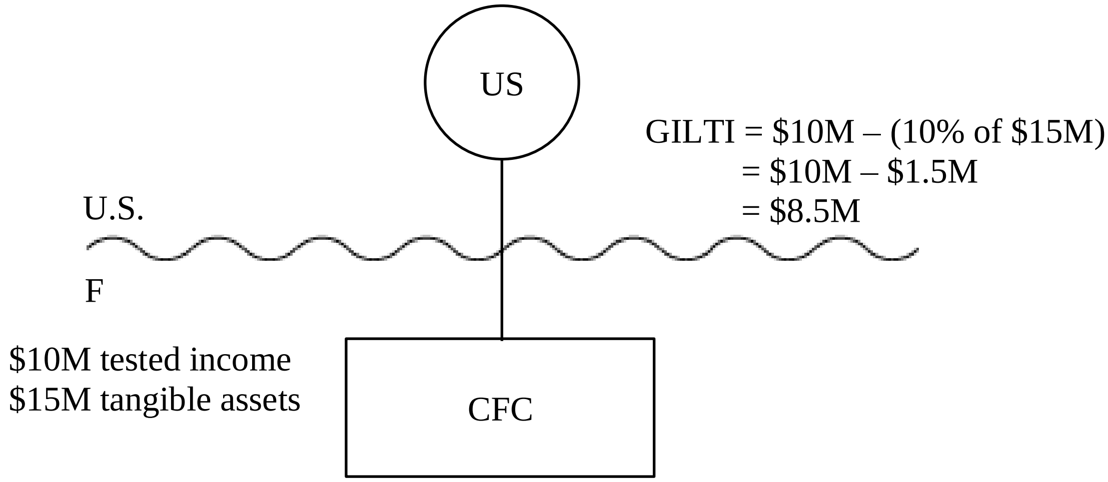
C. Definition of GILTI. GILTI is the excess of (1) the U.S. Shareholder's net CFC tested income over (2) the U.S. Shareholder's net deemed tangible income return. The deemed tangible income return is 10% of QBAI.

II. The Definitions Comprising GILTI.

A. Net tangible income return: The excess of (1) 10% of the aggregate of its *pro rata* share of the qualified business asset investment ("QBAI") of the CFC over (2) the amount of interest expense taken into account in determining its next CFC tested income to the extent that the interest expense exceeds the interest income allocable to the net CFC tested income.

Example 1:

U.S. individual owns a CFC that has $10 million of tested income and $15 million of tangible assets. The GILTI is $8.5 million, which is based on $10 million (the net CFC tested income) less 10% of the $15 million of tangible assets (the deemed tangible income return).



1. GILTI assumes that a CFC's income in excess of a 10% return on depreciable assets is income from intangibles.

2. More specifically, GILTI is the U.S. Shareholder's tested income less 10% of the adjusted basis of depreciable assets (“property”) net of any interest expense.

3. The *pro rata* share is based on:

   (a) Direct and indirect ownership.[2]

   (b) A year-end hypothetical distribution of the CFC's earnings.[3]

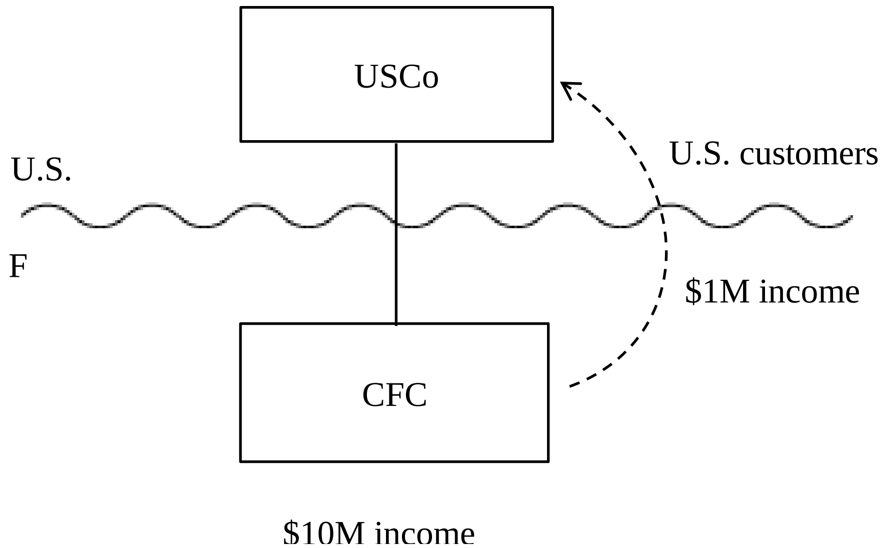
B. Net CFC Tested Income and Loss. A CFC's net tested income for the year is gross income less properly allocated deductions.

1. CFC net tested income excludes the following:

   (a) Effectively connected income;

Example 2:

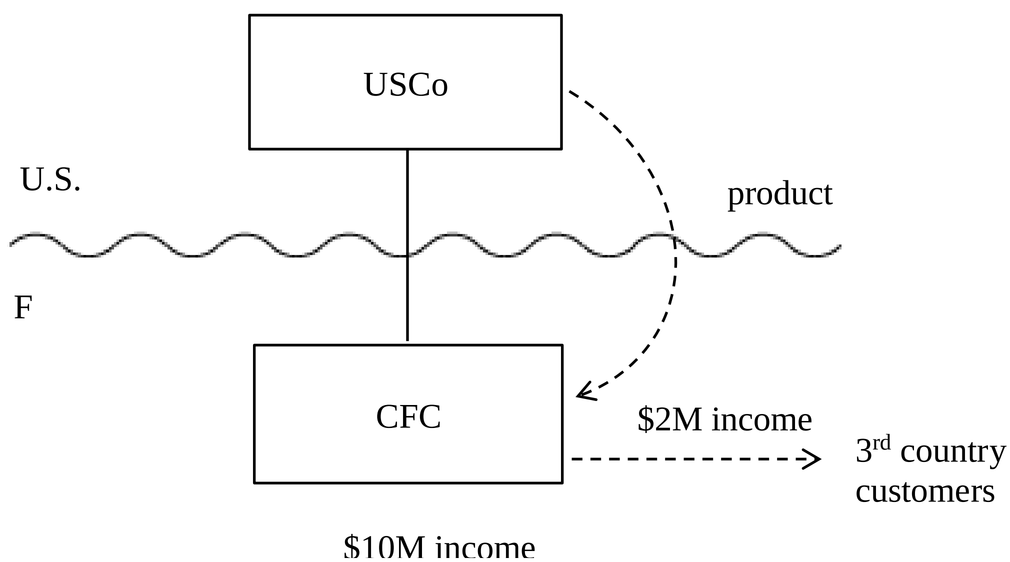
CFC has $10 million of income from sales of liquid soap. $1 million of the income is attributable to sales that a sales employee inadvertently makes to U.S. customers after creating a trade or business in the United States. CFC net tested income is $9 million.



(b) Subpart F income (not limited to e&p); and

Example 3:

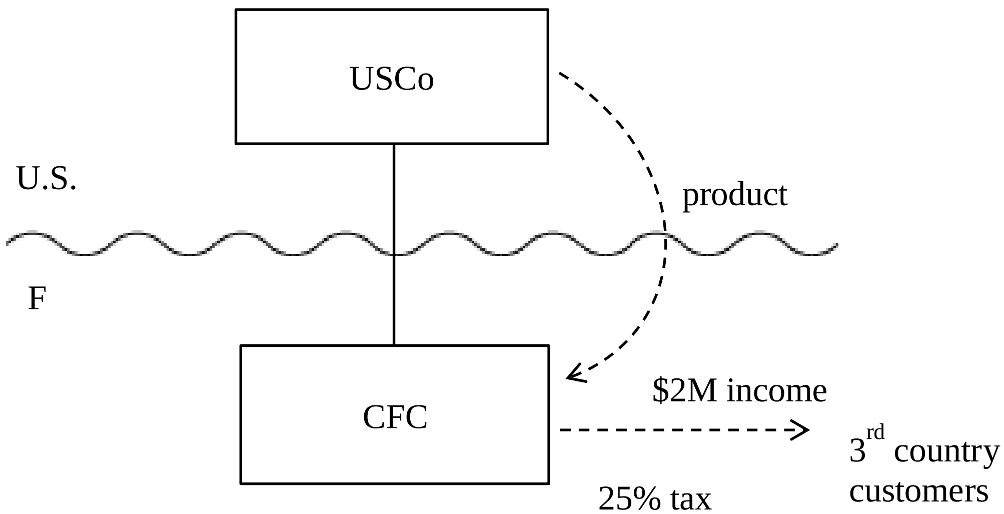
CFC earns $10 million of income, $2 million of which is derived from sales in a third country for product manufactured by USCo, CFC's U.S. parent. As a result, the $2 million is Subpart F income and only $8 million of the $10 million is tested income.



(c) Income excluded from Subpart F due to the high-tax exclusion election.[4]

Example 4:

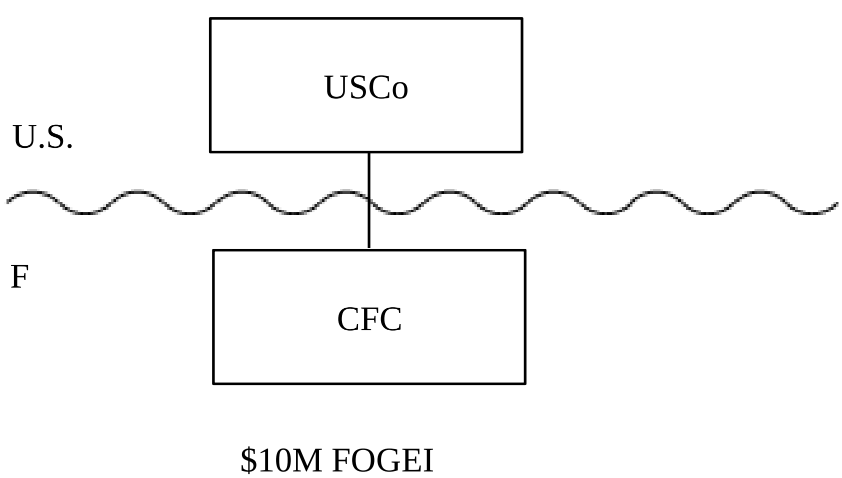
CFC earns $10 million of income, $2 million of which CFC earns from purchases of USCo's products for sale in a third country where CFC incurs tax at a 25% rate. Because the effective rate of tax on the CFC is greater than 90% of the U.S. tax rate (90% of 21% is only 18.9%), CFC elects to exclude the $2 million from Subpart F income and the income is also not tested income.



(d) Foreign oil and gas extraction income.[5]

Example 5:

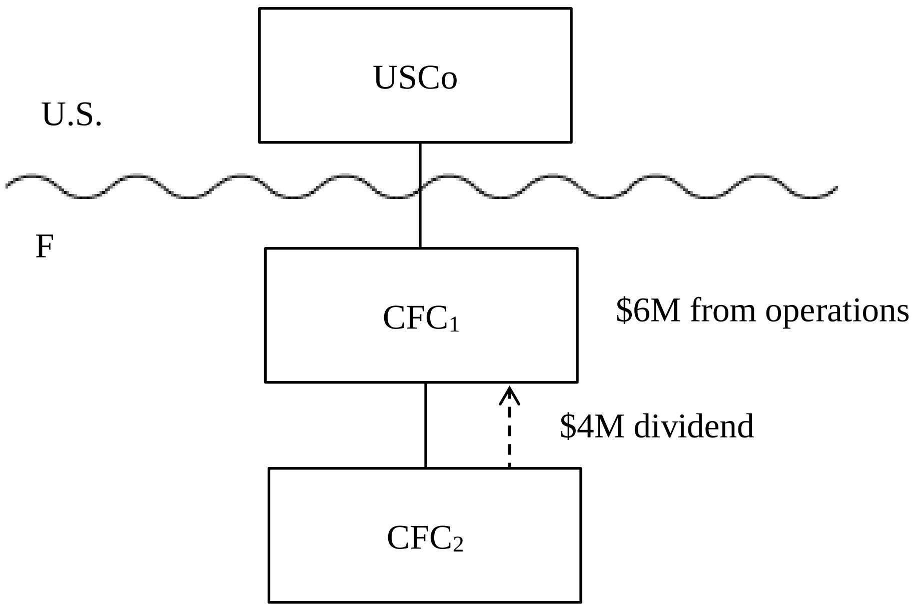
CFC earns $10 million of income, all of which is foreign oil and gas extraction income. None of the $10 million is tested income.



(e) Dividends received from related persons.[6]

Example 6:

CFC_1 earns $10 million of income, $6 million from operations, and $4 million of dividends received from CFC_2, which is incorporated in the same country as CFC_1. Because the $4 million dividend satisfies the same-country related person exception from Subpart F income, the $4 million is neither Subpart F income nor GILTI. Tested income is only $6 million.



2. Does the CFC have income or loss for the year?

(a) Tested Income CFC – CFC has net income.

(b) Tested Loss CFC – allowable deductions exceed gross tested income.

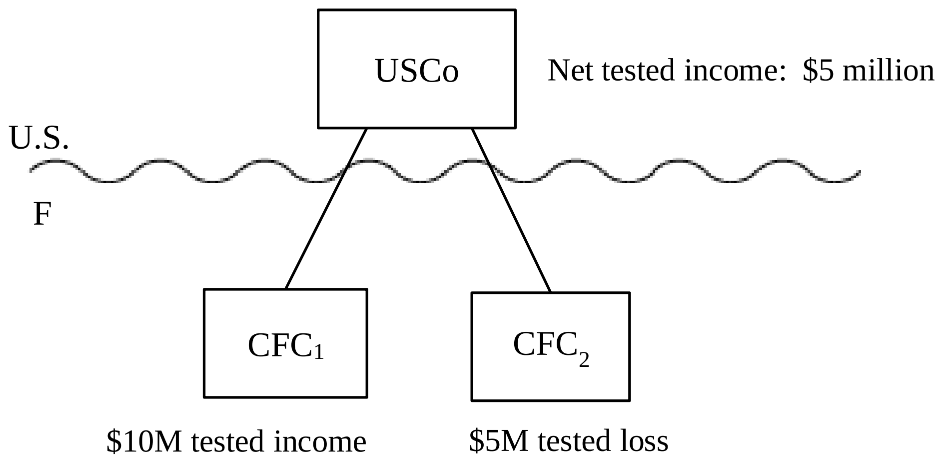
(i) Determine allowable deductions pursuant to an allocation and apportion methodology similar to that used for Subpart F.[7]

(ii) A tested loss CFC does not have any specified tangible property (see QBAI).

(c) Include income of both Tested Income CFCs and losses of Tested Loss CFCs in the hands of the U.S. Shareholder.

Example 7:

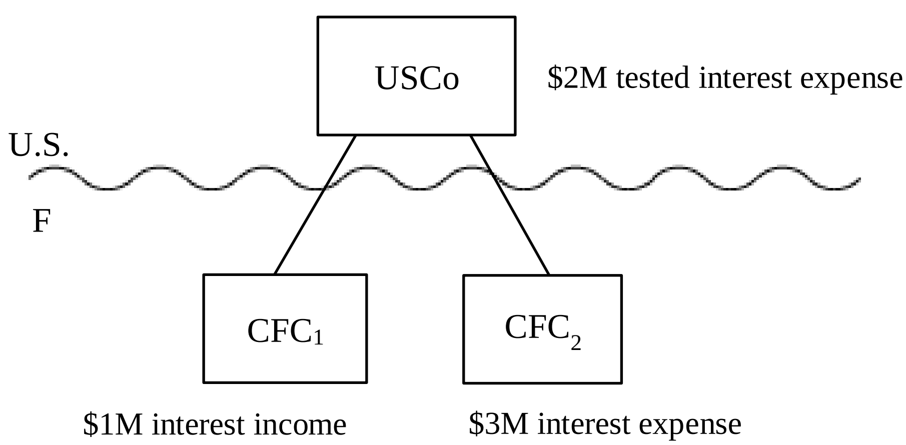
USCo owns two CFCs – CFC1 and CFC2. CFC1 has $10 million of tested income and, therefore, is a Tested Income CFC. CFC2 has a $5 million loss and, therefore, is a Tested Loss CFC. The net tested income of USCo is $5 million.



3. Tested interest income and tested interest expense are broadly defined and a U.S. Shareholder nets them against the deemed tangible income return to determine the net deemed tangible income return.[8]

Example 8:

USCo owns two CFCs – CFC1 and CFC2. CFC1 has interest income of $1 million and CFC2 has interest expense of $3 million. USCo's tested interest expense is $2 million.



(a) Interest expense taken into account to determine tested income or loss is also used to determine a U.S. Shareholder's specified interest expense.[9]

(b) Is this double counting?

4. Deductions against GILTI.

(a) Properly allocate deductions, applying rules similar to section 954(b)(5).

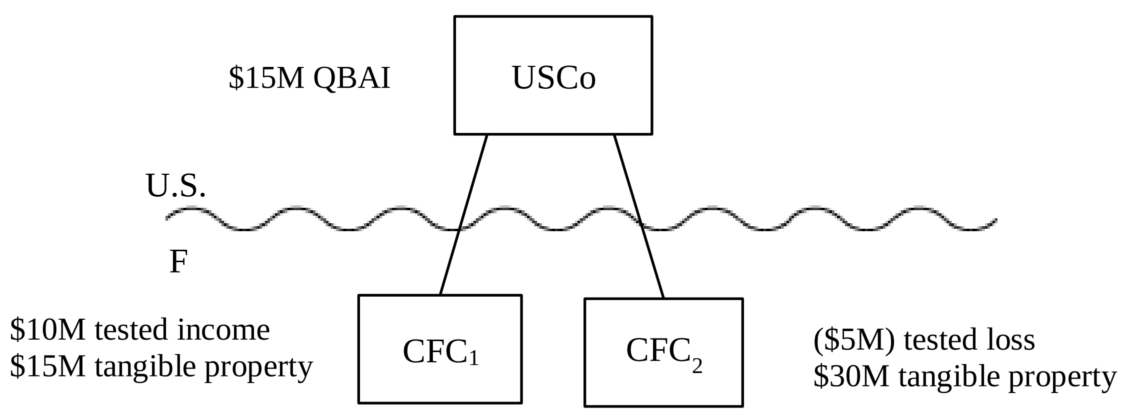
(b) Do not deter a U.S. Shareholder's deductions to the extent they are included in GILTI.[10]

C. Qualified Business Asset Investment ("QBAI").

1. QBAI is specified tangible property used in a trade or business that is depreciable under Code Sec. 167 - essentially depreciable assets. Remember, only a Tested Income CFC has specified tangible property.

Example 9:

USCo owns two CFCs – CFC1 and CFC2. CFC1 has $10 million of tested income and $15 million of specified tangible property. As a Tested Income CFC, CFC1 has $50 million of specified tangible property. CFC2 has a $5 million net loss and $30 million of tangible property, but because CFC2 is a Tested Loss CFC, $30 million of tangible property is not specified tangible property. Accordingly, USCo's QBAI is only the $15 million specified tangible property from CFC1.



2. The adjusted basis of the property is determined using the alternative depreciation system under Code Sec. 168(g) and allocating

depreciation deductions for the property ratably to each day during the period in the tax year to which the depreciation relates.[11]

3. QBAI is the CFC's average aggregate adjusted basis as of the close of each quarter of the tax year in the property.[12]

Example 10:

CFC, which keeps its books and records on a calendar year, owns depreciable assets in the following amounts at the end of each quarter:

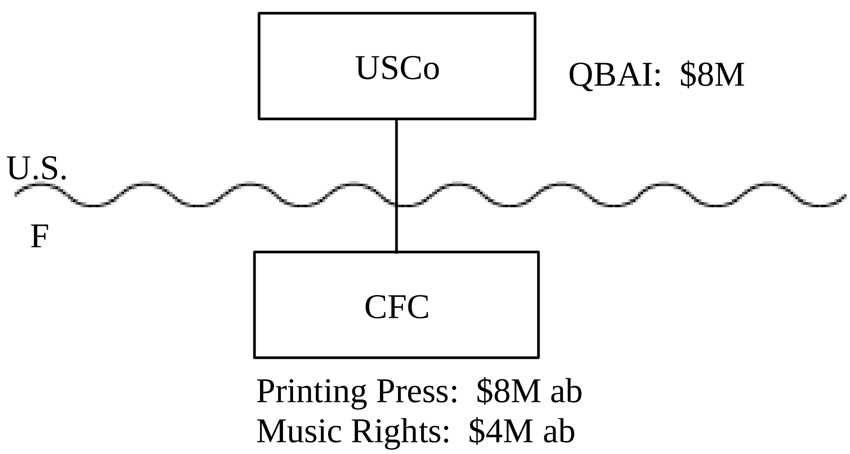
March 31:	$12 million
June 30:	$8 million
September 30:	$16 million
December 31:	20 million

The QBAI is $14 million, which is the quarterly average of depreciable assets.

4. Specified tangible property is any tangible property used in the production of tested income. Allocate tangible property between tested income and non-tested income.

Example 11:

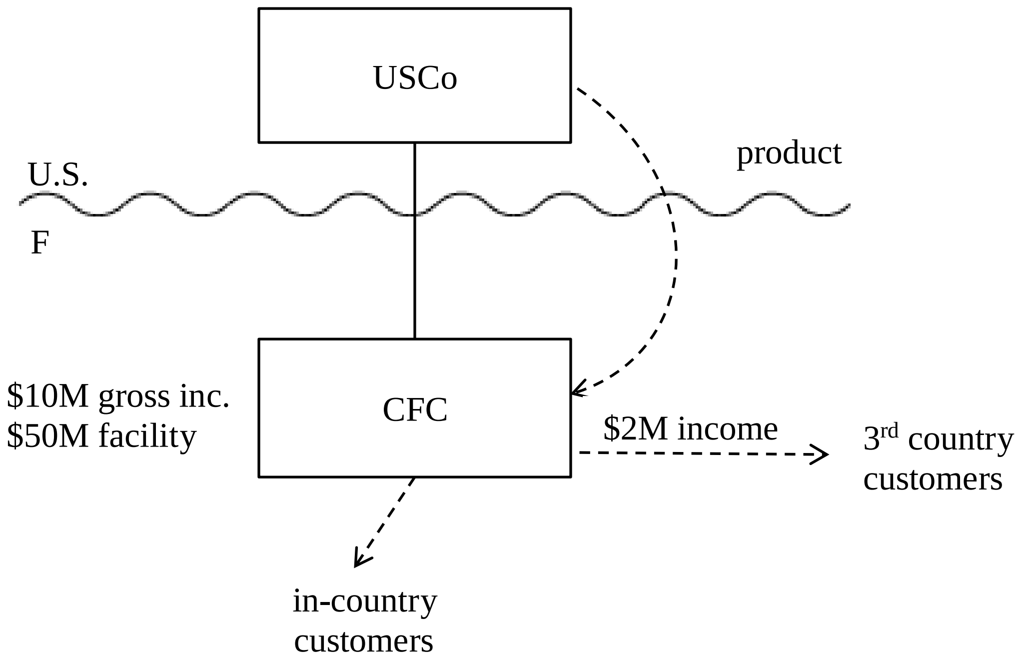
CFC is in the music publishing business. CFC purchased a printing press, whose adjusted basis is currently $8 million. CFC recently purchased the rights to Leo Sayer's music for $4 million. The QBAI for CFC is $8 million as we do not include the music rights, which are not depreciable.



5. Pro rate property that has a dual use (i.e., property that produces both GILTI and Subpart F income) based on the percentage of gross income.[13]

Example 12:

CFC owns a distribution facility that has an adjusted basis of $50 million. CFC earns $10 million of gross income - $8 million for widgets purchased in CFC's country and $2 million that CFC purchases from USCo for sale to third party customers. Because 20% of CFC's income is Subpart F income, then only 80% of the gross income is not Subpart F income, and QBAI is $42 million.



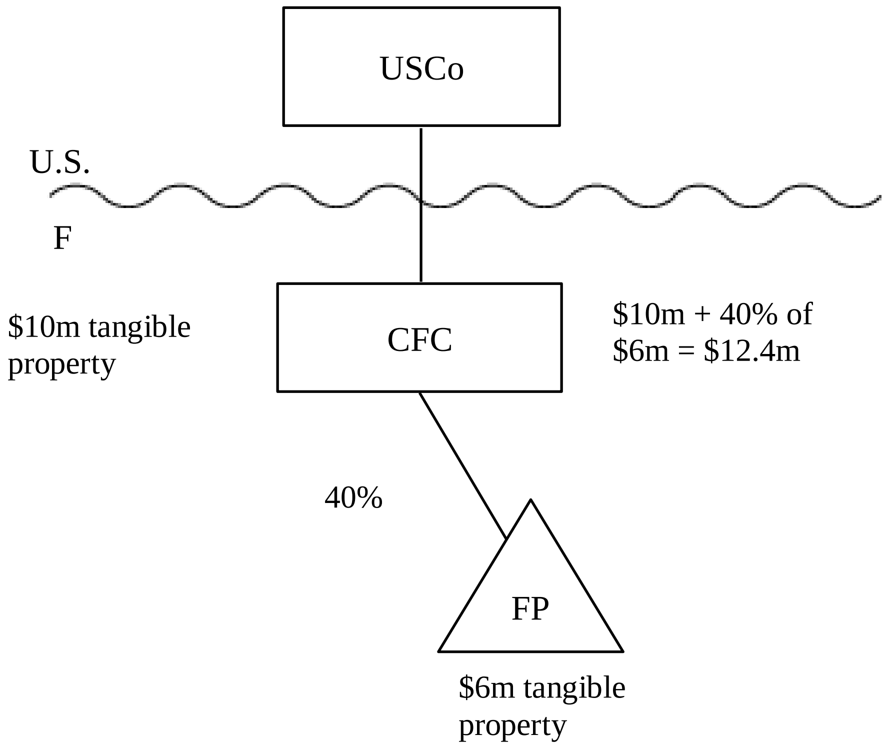
6. Basis in Partnership Assets

(a) If the CFC holds an interest in a partnership at the end of the CFC's tax year, the CFC takes that into account its distributive share of the aggregate of the partnership's adjusted basis tangible property if the property is used in the trade or business of the partnership, is of a type to which a deduction is allowed under Code Sec. 167, and is used in the production of tested income.

(b) A CFC's share of a partnership's assets is its "distributive share"[14] based on the CFC partner's gross tested income relative to the gross income produced by the partnership's property.[15]

Example 13:

CFC owns $10 million of specified tangible property and 40% of a foreign partnership. The foreign partnership owns $6 million of tangible property. CFC's QBAI is $12.4 million, comprised of $10 million plus 40% of $6 million.



(c) The CFC's distributive share of the adjusted basis of any property is the CFC's distributive share of income with respect to the property.

7. Broad regulatory authority to prevent avoidance of GILTI with QBAI through anti-abuse.

(a) Disregard specific tangible property acquired with the principal purpose of avoiding a GILTI inclusion.[16] Presumed to be a principal purpose if held less than 12 months.

(b) Transfers from one CFC to another CFC during a gap period.[17]

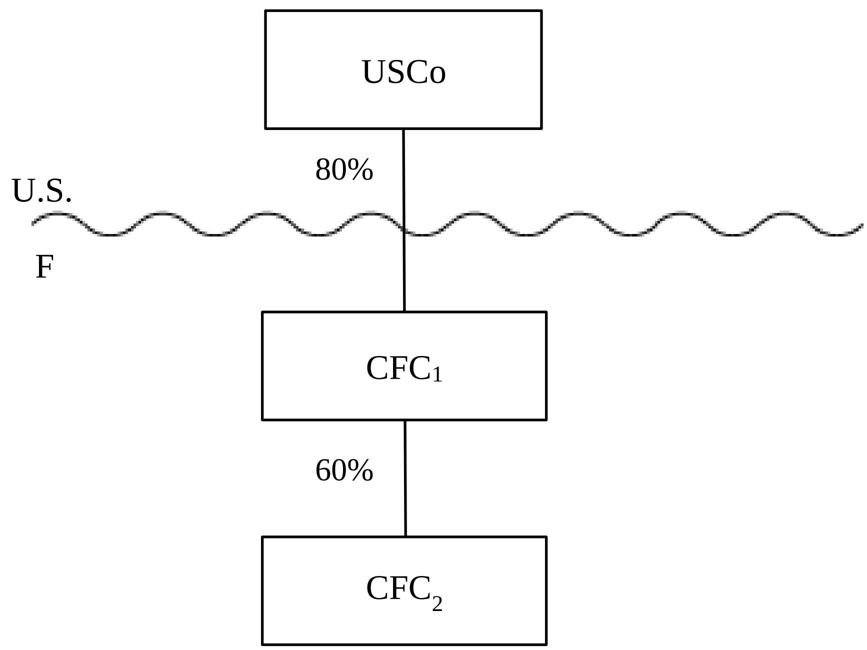
D. *Pro Rata* Share.

1. A U.S. Shareholder's *pro rata* share for the purpose of determining GILTI and tested income is determined under the rules of Code Sec. 951(a)(2)(N) with respect to Subpart F income.[18]

(a) As with Subpart F income, the inclusion is based on direct and indirect ownership,[19] which is referred to as "Section 958 Stock."[20]

Example 14:

USCo owns 80% of CFC1 and CFC1 owns 60% of CFC2. USCo's pro-rata share of CFC1 is 80% and USCo's pro-rata share of CFC2 is 48% (80% of 60%).



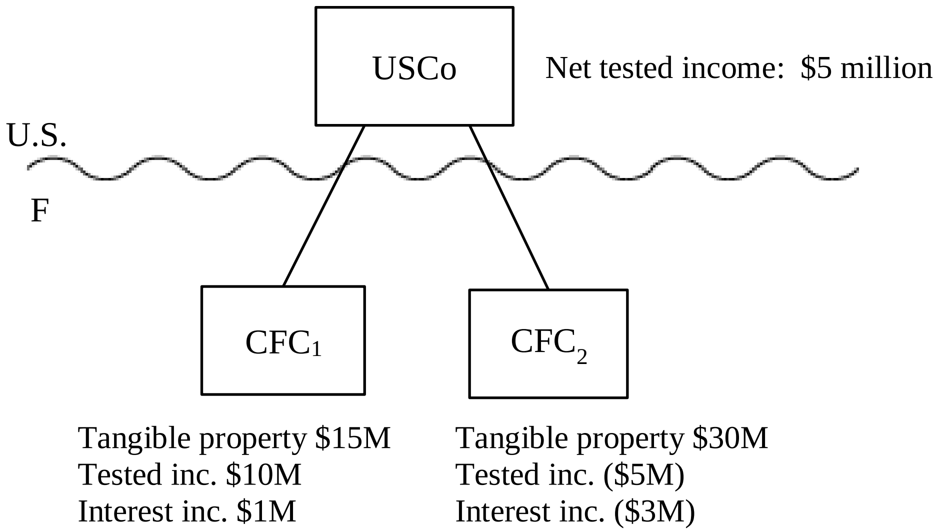
(b) Constructive ownership is irrelevant.

2. The *pro rata* shares are taken into account in the tax year of the U.S. Shareholder within which the tax year of the CFC ends.[21]

3. A foreign corporation is a CFC if it is a CFC at any time during the year.[22]

Example 15:

USCo owns two CFCs – CFC1 and CFC2. CFC1 has tangible property of $15 million, tested income of $10 million, and interest income of $1 million. CFC2 has tangible property of $30 million, a $5 million tested loss, and a $3 million interest expense. USCo's QBAI is $15 million from CFC1, but as a Tested Loss CFC, CFC2's tangible property is excluded. The tested income from both CFCs is $5 million and the net interest expense is $2 million (tested income and interest of the two CFCs are netted). The deemed tangible income return is $1.5 million (10% of $15 million QBAI). The net deemed intangible return is 0 because the $1.5 million doesn't exceed the net interest expense. Therefore, all the net tested income of $5 million is GILTI.



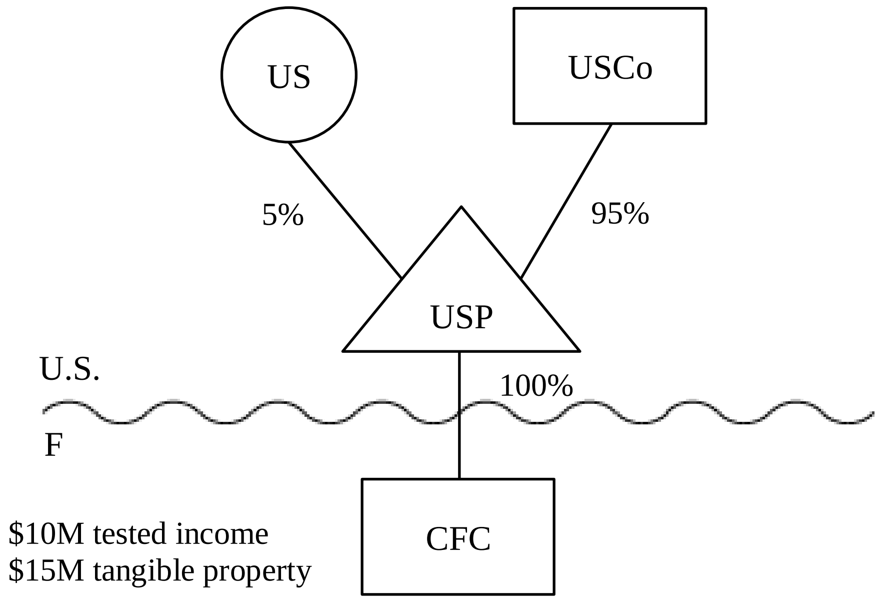
4. Hybrid treatment of U.S. Partnerships.

   (a) A U.S. Shareholder of a U.S. Partnership takes its distributive share of the U.S. Partnership's items before calculating its GILTI (aggregate approach).[23]

   (b) A non-U.S. Shareholder of a U.S. Partnership takes its distributive share of the U.S. Partnership's GILTI (entity approach).[24]

Example 16:

U.S. individual owns 5% of a U.S. partnership and USCo owns 95% of the U.S. partnership. The U.S. partnership owns 100% of a CFC, which has $10 million of tested income and $15 million of tangible assets. Because the U.S. individual is not a U.S. Shareholder, the U.S. individual takes a 5% share of the U.S. Partnership's GILTI of $8.5 million ($10 million of tested income less 10% of the $15 million of tangible property) for $425,000. As a U.S. Shareholder, USCo does not include 95% of the U.S. Partnership's GILTI. Instead, USCo takes 95% of tested income for $9.5 million and 95% of the $15 million of tangible property for $14.25 million of tangible property. USCo will use these items when determining its GILTI along with the items for any other CFCs for which USCo is a U.S. Shareholder.

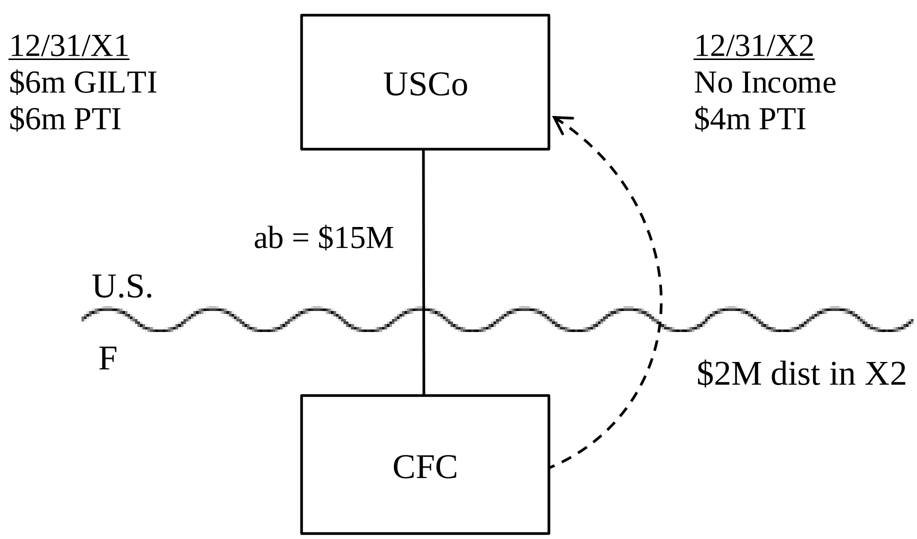


5. GILTI is treated in "the same manner" as Subpart F income.[25]

(a) Previously-Taxed Income ("PTI").[26]

Example 17:

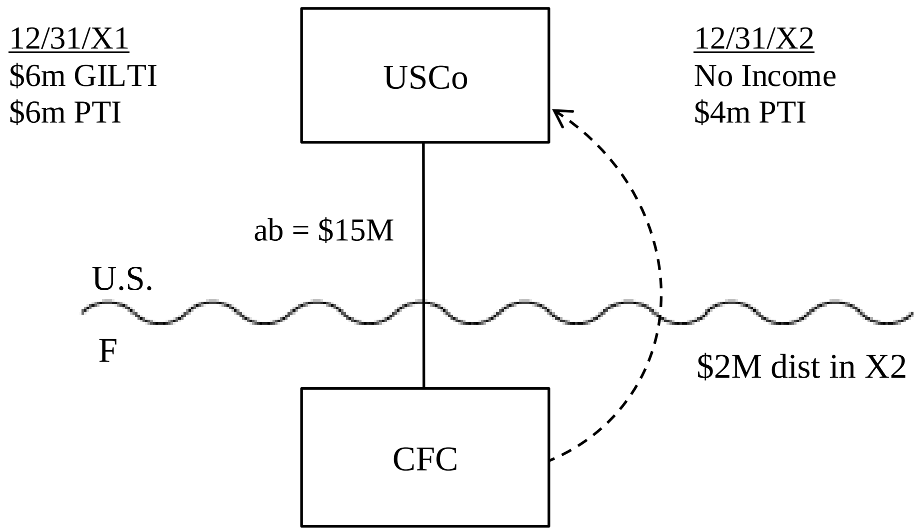
USCo begins the year with an adjusted basis in its CFC of $15 million. USCo reports $6 million of GILTI in year 1 through CFC. The $6 million constitutes PTI. In year 2, the CFC does not earn any income, but distributes $2 million of cash. The $2 million is not taxable to USCo and PTI decreases to $4 million.



(b) Adjustments to basis.[27]

Example 18:

USCo has an adjusted basis of $15 million in shares of a CFC. In year 1, USCo earns $6 million of GILTI in year 1 through CFC, increasing USCo's adjusted basis in CFC to $21 million. When receiving a distribution of $2 million in year 2, USCo's adjusted basis decreases to $19 million.



(i) A U.S. corporate shareholder reduces basis by the amount of the tested loss used to offset tested income.[28]

(ii) Otherwise, the loss would result in a double benefit.

(c) Tax on net investment income[29] applies as it does to Subpart F.[30]

(d) The IRS will address GILTI as unrelated business taxable income for tax-exempt entities in future guidance.

E. Foreign Tax Credits.

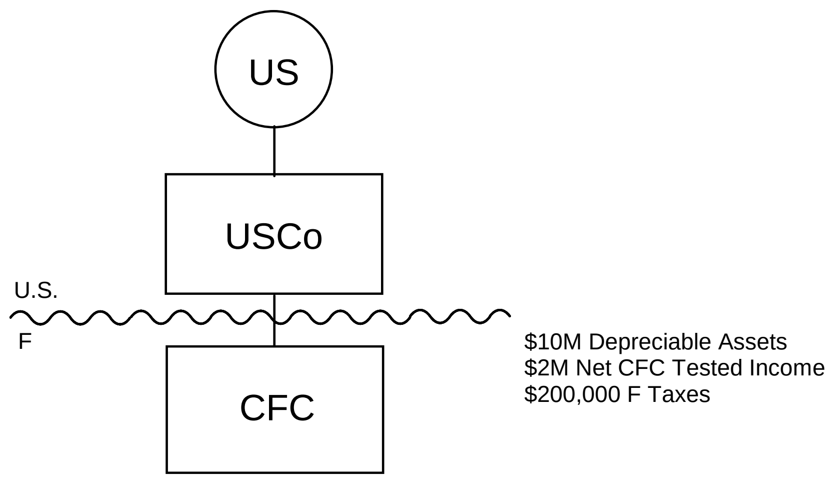
1. Foreign tax credits are for all of foreign income taxes paid on GILTI included in the gross income of a U.S. C corporation as a gross-up.

2. The foreign tax credits are restricted to 80% of the U.S. corporation's inclusion percentage when multiplied by the foreign income taxes of the CFC.

3. The inclusion percentages ratio is the U.S. C corporation's GILTI divided by the aggregate amounts of the U.S. Shareholder's *pro rata* share of the tested income of each CFC.[31]

Example 19:

U.S. individual owns a U.S. C corporation that owns a CFC. The CFC has $10 million of QBAI, $2 million of net CFC tested income, and has paid $200,000 of foreign income taxes. The GILTI is $1 million, which is $2 million less 10% of $10 million. Because the GILTI of $1 million is 50% of the tested income of $2 million, the section 78 gross-up is $100,000 (50% of the foreign income taxes), which results in a foreign tax credit of $80,000 (80% of $100,000).



GILTI = $2M - (10% of $10M) = $1M

4. This is a deemed-paid foreign tax credits for taxes properly attributed to tested income.

   (a) GILTI has a separate foreign tax credit limitation category.

   (b) Excess tax credits in the GILTI limitation may not carryback or carryforward.[32]

5. Foreign Tax Credits to be covered in future proposed regulations:

   (a) Look-through rules.

   (b) The limitation category for section 78 gross-ups.

(c) Withholding taxes on subsequent distributions of PTI from GILTI.

6. The proposed regulations do not discuss foreign tax credits, but anticipate future guidance.

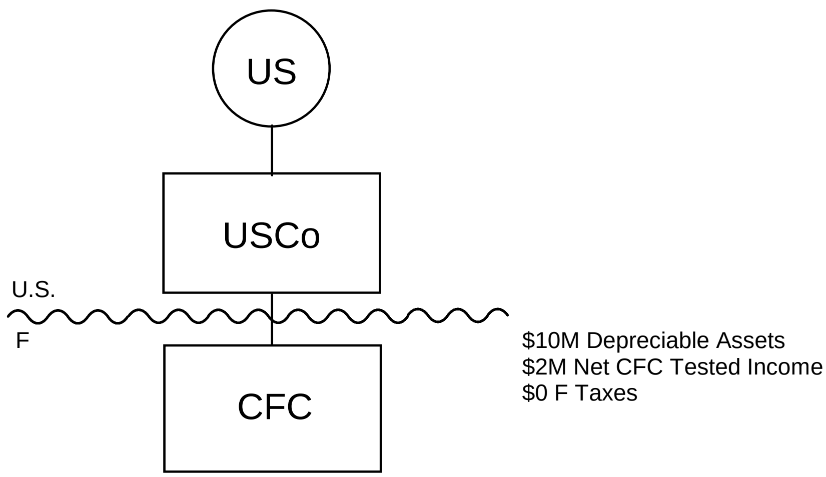
F. GILTI Deduction for U.S. C Corporations.

1. All U.S. Shareholders—individuals or entities—are subject to GILTI.

2. U.S. C corporations—and only U.S. C corporations—are entitled to a deduction of 50% of GILTI.[33] The IRS will address the 50% deduction in future regulations.

Example 20:

U.S. individual owns a U.S. C corporation that owns a CFC. The CFC has $10 million of QBAI, $2 million of net CFC tested income, but has not paid any foreign income taxes. The GILTI is $1 million, which is $2 million less 10% of $10 million. Moreover, the 50% GILTI deduction reduces the $1 million of GILTI to $500,000.



GILTI = $2M - (10% of $10M) = $1M

G. Consolidated Returns.

1. A consolidated group member determines its GILTI by reference to the relevant items of each CFC owned by members of the same consolidated group.

2. The calculations:[34]

   (a) Consolidate group tested income.

   (b) Determine each group member's share of consolidated group tested income by each member's percentage contributed.

   (c) Consolidate group tested losses.

   (d) Based on the percentage of tested income contributed, determine:

      (i) Net tested losses;

      (ii) Interest expense; and

      (iii) QBAI.

III. Compliance for U.S. Shareholders at any time during the year.[35]

A. New Form 8992, U.S. Shareholder Calculation of Global Intangible Low-Taxed Income.

B. New Schedule I-1, Information for Global Intangible Low-Taxed Income, to Form 5471.

C. Revised Schedule K-1 for Form 1065 will provide for:

   1. Distributive share of GILTI; and

   2. Proportional share of tested items of any CFCs the partnership owns.

IV. GILTI Planning.

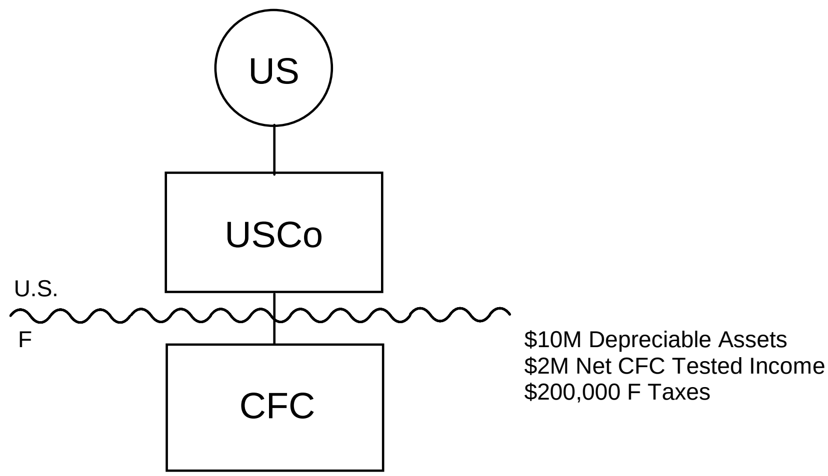
A. GILTI for C Corporations.

   1. C corporations receive a 50% deduction.

   2. C corporations receive the deemed paid foreign tax credit at 80%.

Example 21:

U.S. individual owns a U.S. C corporation that owns a CFC. The CFC has $10 million of QBAI, $2 million of net CFC tested income, and has paid $200,000 of foreign income taxes. The GILTI is $1 million, which is $2 million less 10% of $10 million. Because the GILTI of $1 million is 50% of the gross income of $2 million, the section 78 gross-up is $100,000 (50% of the foreign income taxes), which results in a foreign tax credit of $80,000 (80% of $100,000).



GILTI = $2M - (10% of $10M) = $1M

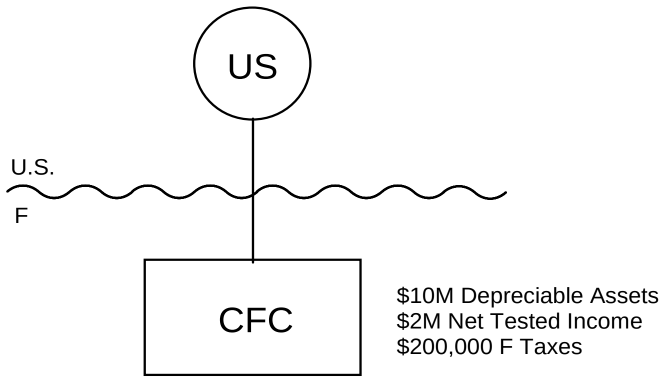
The tax on the GILTI is $35,500, computed as U.S. Tax = 21% of [50% of ($1M + $100,000)] – 80% of ($200,000 X $1m/$2M) = (21% of $550,000) – (80% of $100,000) = $115,500 - $80,000 = $35,500.

B. GILTI for Individuals.

1. U.S. individuals do not receive either the 50% deduction or the deemed-paid foreign tax credit at 80%.

Example 22:

U.S. individual owns a CFC that has $10 million of QBAI, $2 million of net tested income, and has paid $200,000 of foreign taxes. The GILTI is $1 million, representing $2 million less 10% of the QBAI. The U.S. tax on this $1 million at a 37% rate is $370,000.

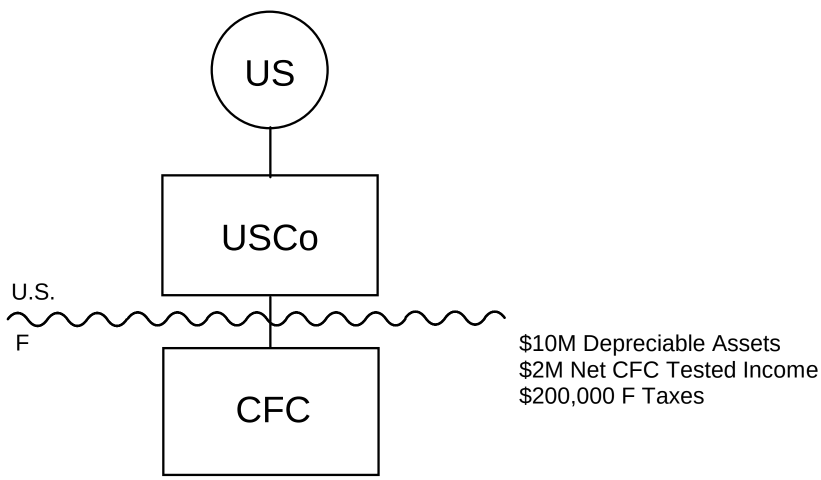


GILTI = $2M – (10% of $10M) = $1M
TAX = 37% of $1M = $370,000

2. The U.S. individual should consider exploring other options.

C. Contribution of foreign corporations to C corporations.

Example 23: By contributing the shares of the foreign corporation to a U.S. C corporation, the U.S. individual can pay a lower amount of tax in the United States.



GILTI = $2M - (10% of $10M) = $1M

As before, the U.S. tax to the C corporation is $35,500, determined as follows: U.S. Tax = 21% of [50% of ($1M + $100,000)] – 80% of ($200,000 X $1m/$2M) = (21% of $550,000) – (80% of $100,000) = $115,500 - $80,000 = $35,500. Because the GILTI of $1 million is 50% of tested income of $2 million, the section 78 gross-up is $100,000 (50% of the foreign income taxes), which results in a foreign tax credit of $80,000 (80% of the $100,000).

However, the U.S. individual does not have the cash at this point. Assuming a distribution of $964,500 ($1 million less the $35,500 of U.S. corporate income tax), which is PTI, taxed at a 23.8% rate, the U.S. individual will incur a U.S. tax of approximately $230,000. $35,500 + $230,000 is $265,000, which is less than the $370,000 without the C corporation.

D. Section 962 elections.

1. By making the section 962 election, U.S. individuals will be taxed on their GILTI inclusion at the corporate tax rate of 21%.

2. On an actual distribution of PTI, the U.S. individual will be taxed as if it were an actual distribution.

3. Some advocates of section 962 elections presume that this provides the same tax impact as the previous example.

4. Issues

(a) Eligibility for the 50% deduction?

(b) Is the distribution of a qualified dividend?

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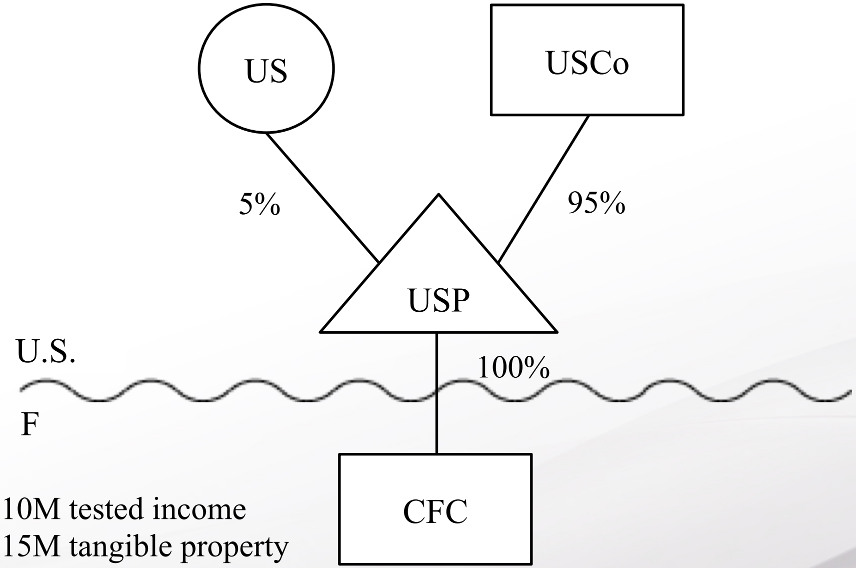
[1] Code Sec. 951(a)(1)(A).
[2] Prop. Reg. § 1.951A-1(d)(1).
[3] Prop. Reg. § 1.951A-1(d)(2)(i).
[4] Code Sec. 954(b)(4).
[5] Code Sec. 907(c)(1).
[6] Code Sec. 954(d)(3).
[7] Prop. Reg. § 1.958A-2.
[8] Prop. Reg. § 1.951A-1(c)(3)(ii).
[9] Prop. Reg. § 1.951A.
[10] Prop. Reg. § 1.951A-6(c)(1).
[11] Code Sec. 551A(d)(3).
[12] Code Sec. 951A(d)(1); Prop. Reg. § 1.951A-3(b).
[13] Prop. Reg. § 1.951A-3(d)(1).
[14] Code Sec. 951A(d)(3).
[15] Prop. Reg. § 1.951A-3(g)(2).
[16] Prop. Reg. § 1.951A-3(h))(1).
[17] Prop. Reg. § 1.951A-3(h)(2).
[18] Prop. Reg. § 1.951A-1.
[19] Code Sec. 958(a).
[20] Code Sec. 951A(e)(2).
[21] Code Sec. 951A(a)(1n).
[22] Code Sec. 951A(e)(3).
[23]Prop. Reg. § 1.951A-5(b).
[24] Prop. Reg. § 1.951A-5(c).
[25] Code Sec. 951A(f)(1).
[26] Code Sec. 959.
[27] Code Sec. 961.

[28] Prop. Re. § 1.956A-6(e).
[29] Code Sec. 1411.
[30] Prop. Reg. § 1.951A-6(b)(1).
[31] Code Sec. 951A(d)(2).
[32] Code Sec. 960(d).
[33] Code Sec. 251.
[34] Prop. Reg. § 1.1502-5(e).
[35] Prop. Reg. § 1.6038-2(a) and § 1.6038-5.

Ex. 16: Hybrid Treatment of U.S. Partnership



5% of [$10M – (10% of $15M)]

$425,000

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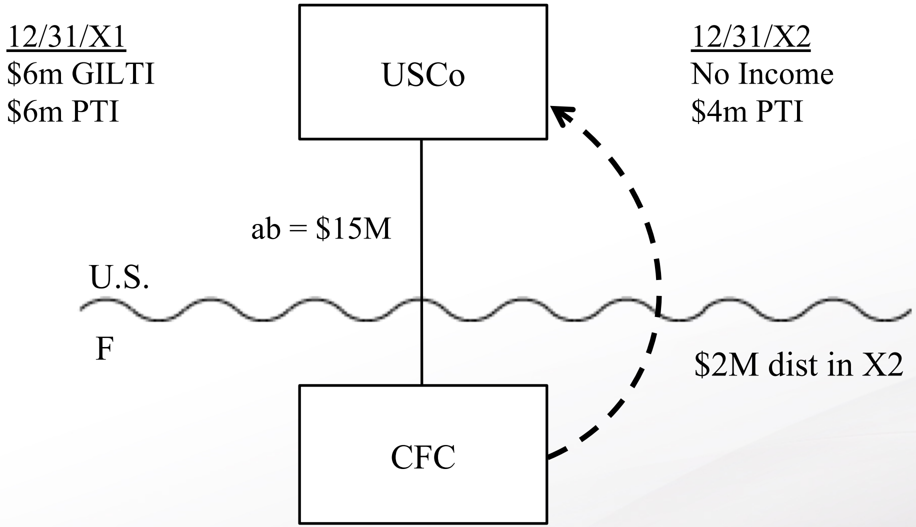
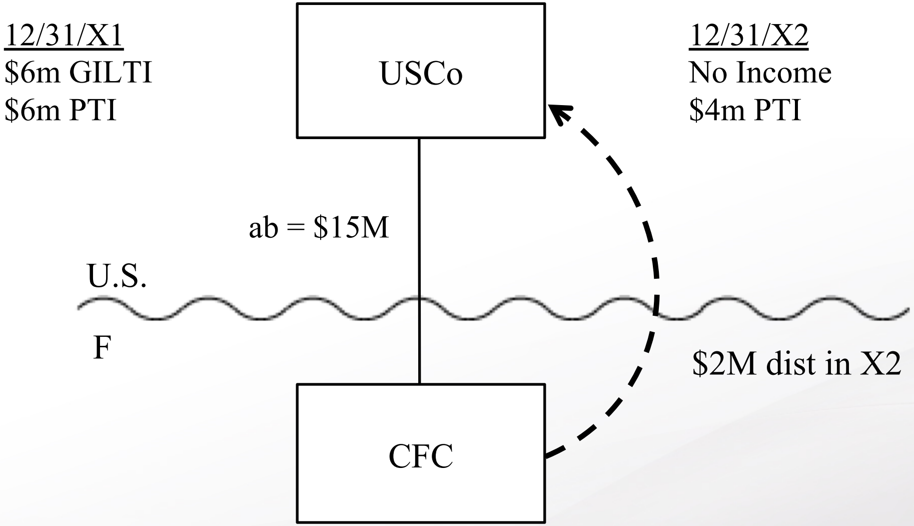
Ex. 17: Adjustment for Previously-Taxed Income



Ex. 18: Adjustments to Basis



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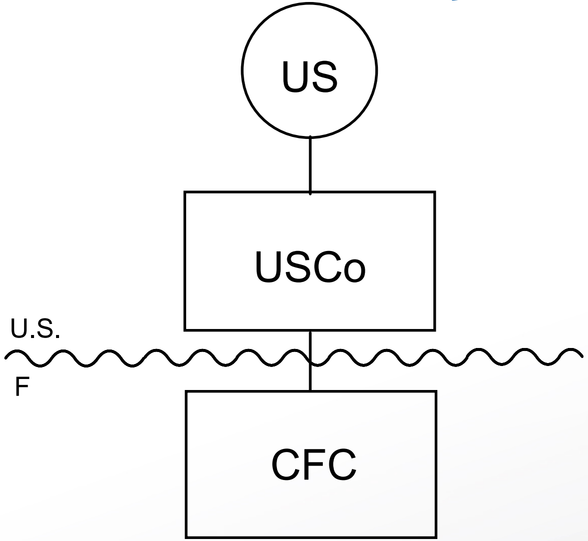
Foreign Tax Credits

1. 100% Gross-Up
2. But only 80% credit
3. Separate GILTI limitation
4. Future Guidance

Ex. 19: Foreign Taxes are Fully Grossed-Up, But Credited At Only 80%



$10M Depreciable Assets
$2M Net CFC Tested Income
$200,000 F Taxes

GILTI = $2M – (10% of $10M) = $1M
Gross-Up = $200,000 x ($1M/$2M) = $100,000
FTC = $80,000

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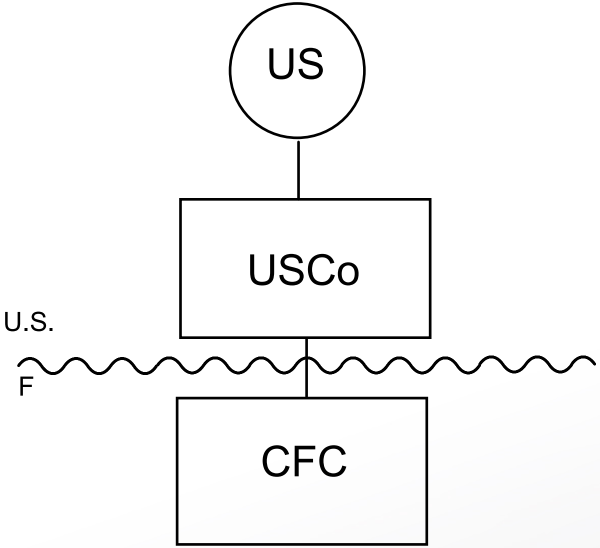
GILTI Deduction

1. 50% for C corporations only
2. Future guidance

Ex. 20: The 50% GILTI Deduction



$10M Depreciable Assets
$2M Net CFC Tested Income
$0 F Taxes

GILTI = $2M – (10% of $10M) - 50% [$2M - (10% of $10M)]
= $500,000

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Consolidated Returns

1. Use the ratio of each group members portion of the group's tested income.
2. Apply the ratio to all items.

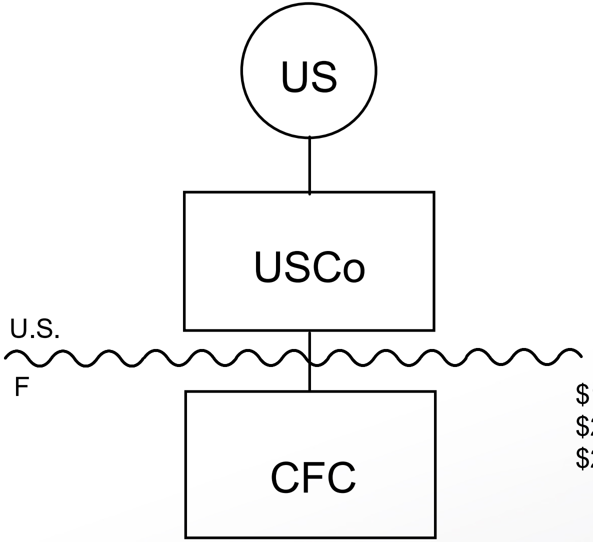
Compliance

1. New Form 8992
2. New Schedule I-1
3. Revised Schedule H-1

GILTI Planning

1. Foreign Tax Credit
2. 50% Deduction

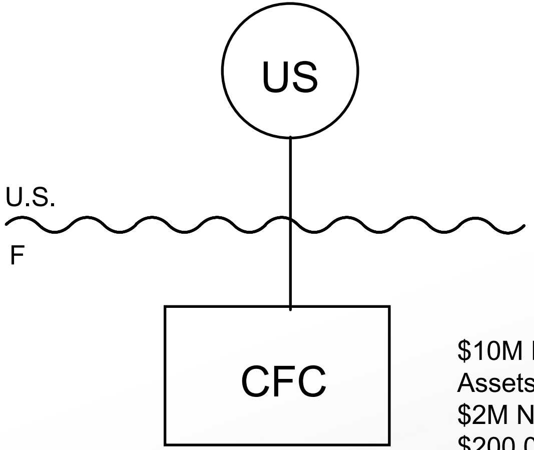
Ex. 21: GILTI For C Corporations



$10M Depreciable Assets
$2M Net CFC Tested Income
$200,000 F Taxes

GILTI = $2M – (10% of $10M) = $1M
Gross-Up = $200,000 x ($1M/$2M) = $100,000
FTC = $80,000
Tax = 21% of [50% of ($1M + $100,000)] - $80,000
= $35,500

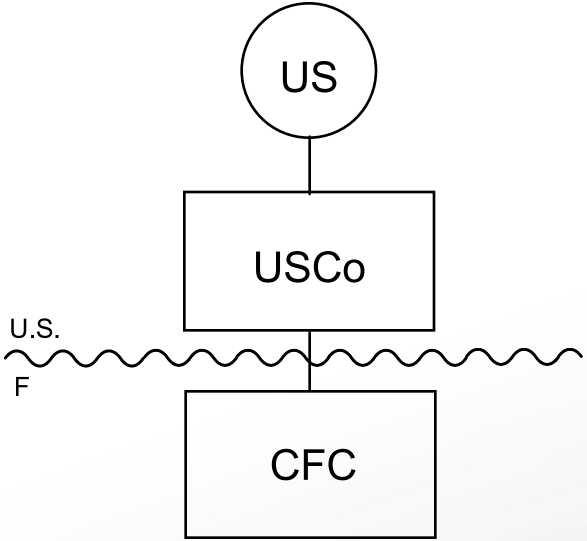
Ex. 22: GILTI For Individuals



$10M Depreciable Assets
$2M Net Tested Income
$200,000 F Taxes

GILTI = $2M – (10% of $10M) = $1M
TAX = 37% of $1M = $370,000

Ex. 23: Planning for Individuals



GILTI = $1M
Gross-Up = $100,000
FTC = $80,000

$10M Depreciable Assets
$2M Net CFC Tested Income
$200,000 F Taxes

Corp Tax = 21% of [50% of $1M + $100,000)] - $80,000
= $35,500
Distribution of $964,500
Individual Tax = 23.8% of $964,500
= $230,000

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About Robert Misey

Robert Misey leads the International Department for the law firm of Reinhart Boerner Van Deuren and is a former trial attorney for the IRS Chief Counsel (International) in Washington, DC. Robert is Chair of the International Tax Committee for the ABA and a member of the bar in California, Wisconsin, and the District of Columbia. He is also the author of the books *A Practical Guide to U.S. Taxation of International Transactions* and *Federal Taxation: Practice and Procedure*.

Robert can be reached at either 312-207-5456 or 414-298-8135 or rmisey@reinhartlaw.com

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"Tax Me Like a Corporation, Please": Does the Section 962 Election Reduce Tax?

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HodgenLaw PC
Pasadena, California
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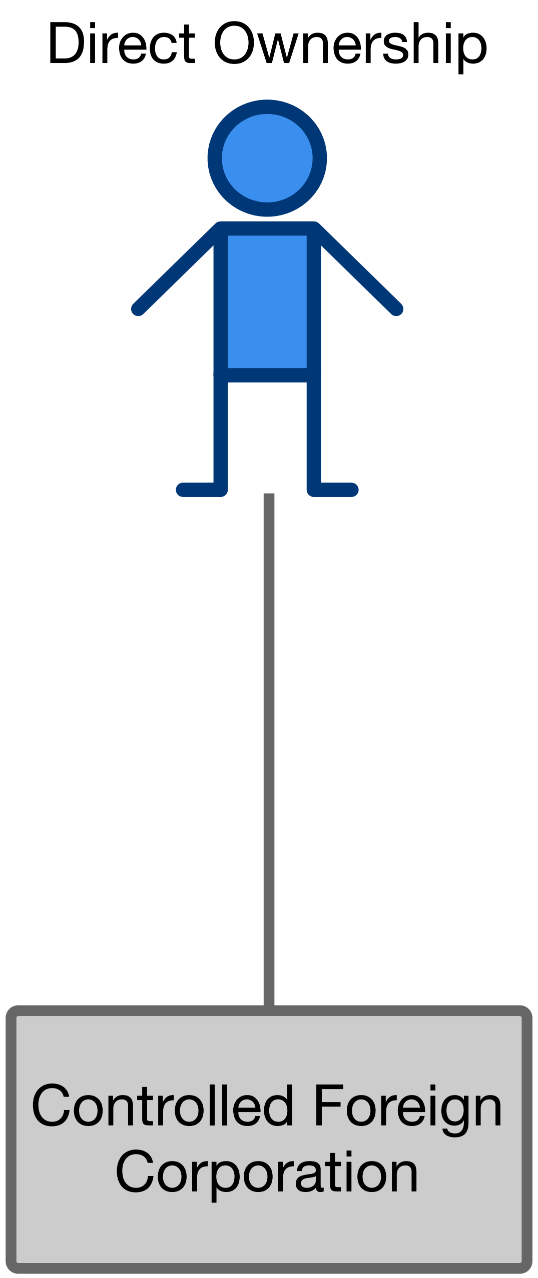
Texas International Tax Symposium
November 9, 2018

Table of Contents

Part 1.
A Brief Overview of the Section 962 Election

Is this the best way to own a CFC?

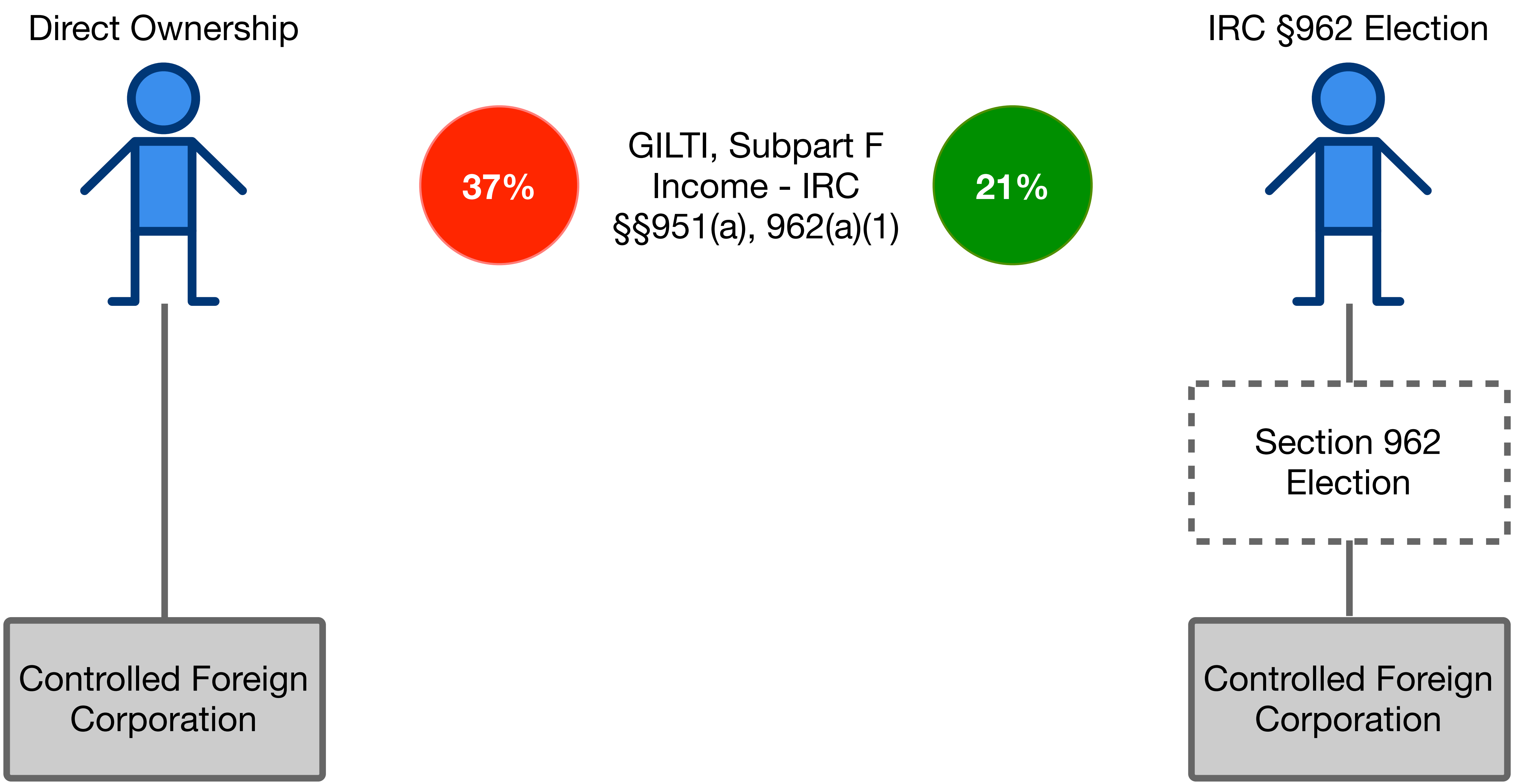


“I heard about this at a cocktail party”

?

Section 962 is Awesome

Section 962 is awesome: lower tax rate



What is IRC §951(a) income?

- The normal rules of corporate taxation apply to foreign corporations and their shareholders

- Shareholders aren't taxed on corporate earnings until they receive a distribution (e.g., a dividend)

- Some types of income earned by a foreign corporation are taxed taxed to shareholders immediately

    - Subpart F income - IRC §952 (passive income, mostly)

    - GILTI - IRC §951A(f)(1)(A) (operating income)

GILTI explained super quickly

- Take your CFC's operating income (not Subpart F income)
- Subtract a small amount based on a deemed 10% rate of return on the CFC's depreciable assets
- Subtract some more for a few other items
- Individuals: pay tax now on the 100% of the amount remaining
- Corporate shareholders: pay tax now on 50% of the amount remaining

GILTI + Section 962 = Deduction allowed?

- Section 951A: include GILTI in gross income
- Section 962: tax an individual’s GILTI as if the human is a domestic corporation
- Section 250: domestic corporations get a deduction equal to 50% of GILTI in computing gross income
- So in theory, if you make a Section 962 election you can take the IRC §250 deduction in calculating your gross income if you have GILTI income—because you are taxed like a domestic corporation

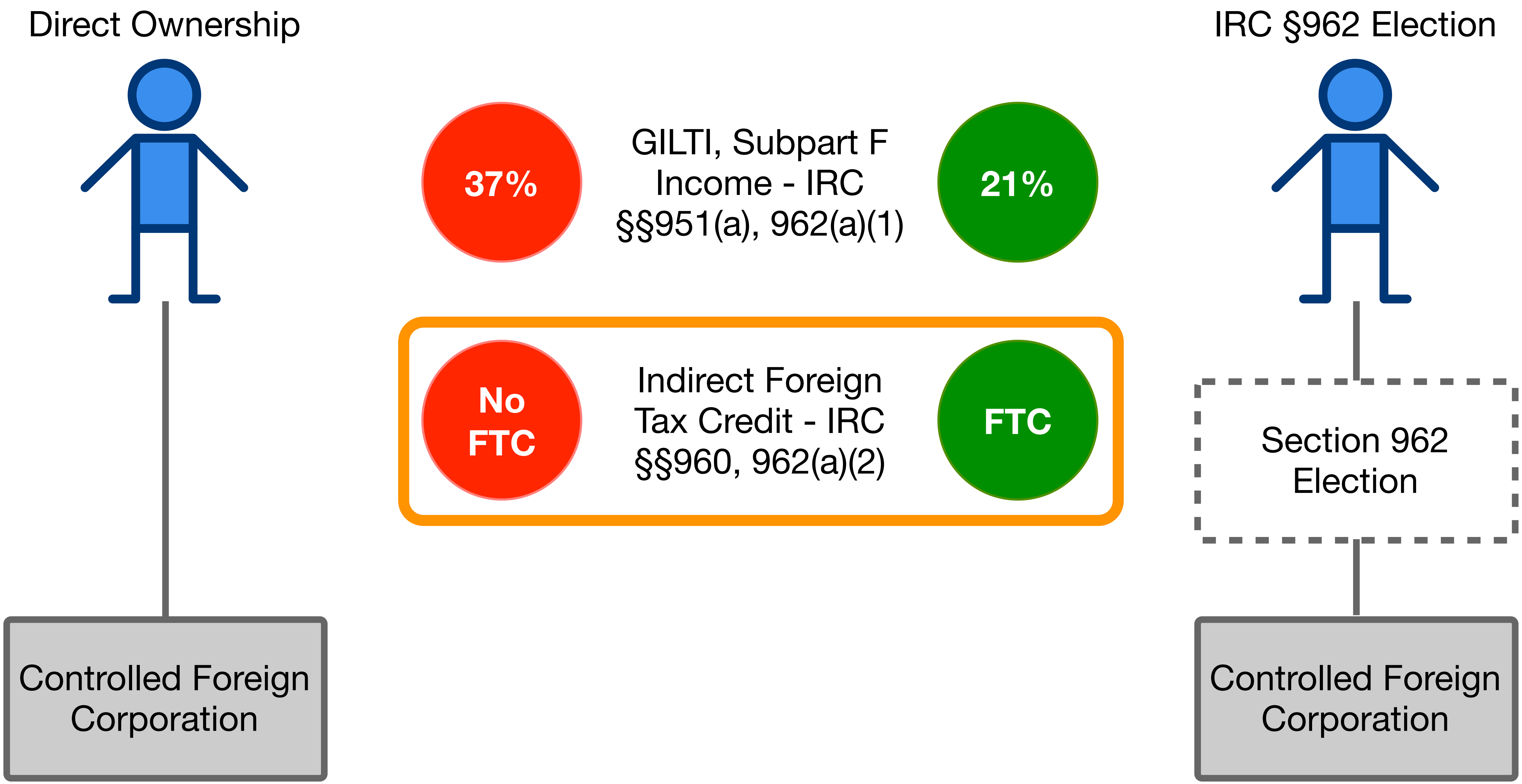
GILTI + Section 962 = Deduction not allowed?

- Reg. §1.962-1(b)(1)(i): if you make a Section 962 election, *can't take any deductions* in calculating gross income
- Does this prevent you from using the Section 250 deduction to reduce gross income from GILTI by 50%?
- Nobody knows (yet)

Anyhoooo . . .

- We will only talk about Subpart F today, not GILTI
- Just know that if your foreign corporation has lots of GILTI there is an unresolved anomaly that creates risk if you make a Section 962 election: you don't know if you are taxed on 50% or 100% of GILTI
- The basic point of "Section 962 is awesome" remains: a 21% tax rate is better than a 37% tax rate

Section 962 is awesome: foreign tax credit

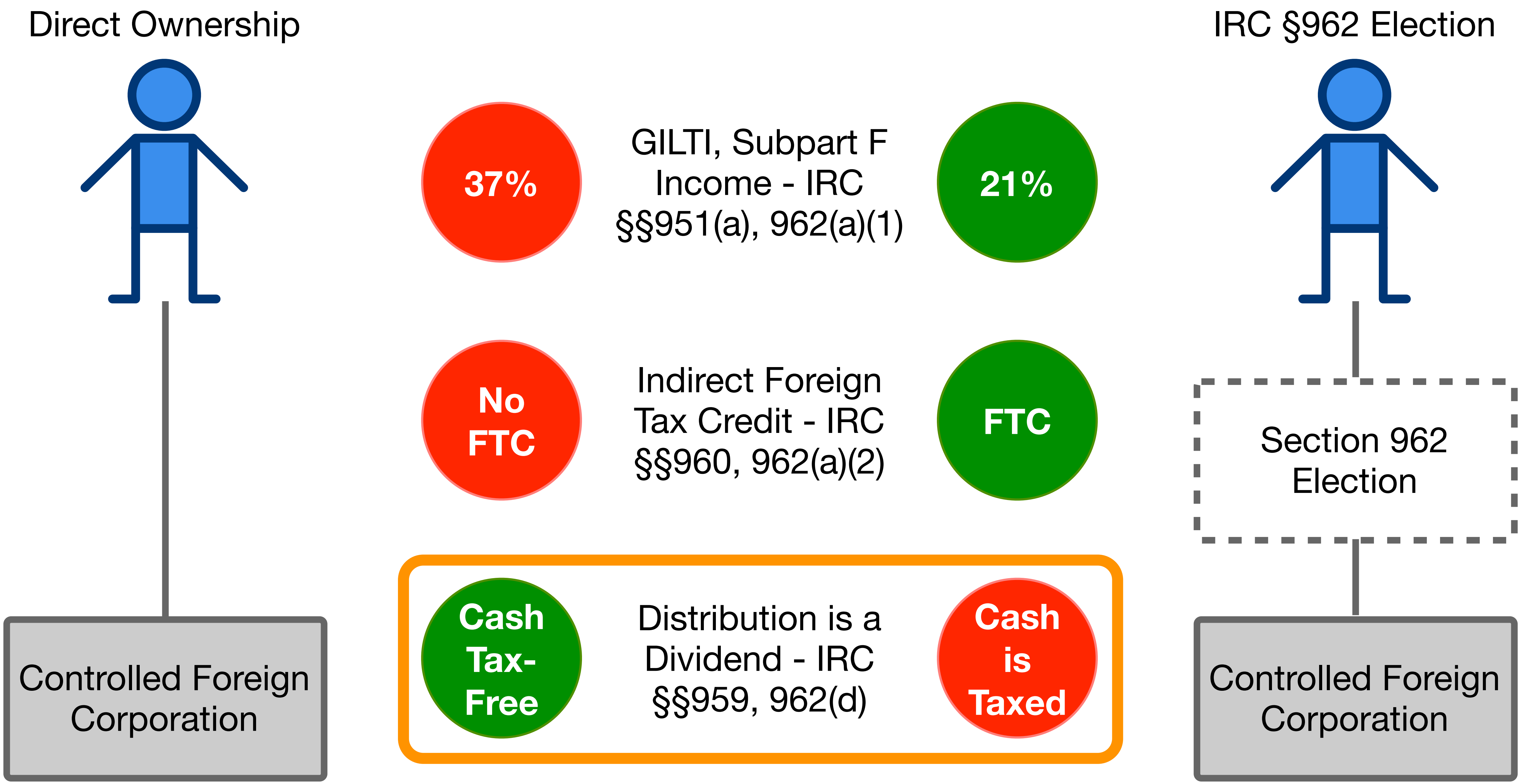


Indirect foreign tax credit

- The normal rule for foreign tax credit is "take the credit if you paid the tax" - IRC §901
- Domestic corporations (not humans) can take a foreign tax credit for foreign tax paid by their CFCs - IRC §960
- Section 962 says that humans are taxed as domestic corporations, and specifically. . .
- Humans who elect Section 962 treatment may take the IRC §960 indirect foreign tax credit - IRC §962(a)(2)

Section 962 Sucks

Section 962 sucks: extra gross income



Quoting the Tax Court 🙄

“By making [the section 962 election] petitioners got what they bargained for: immediate deemed-paid FTCs and a lower current tax rate on the section 951(a) inclusions. By requiring petitioners to forfeit in large part the benefits of section 959(a), [the section 962 election] may ultimately cause them to include more gross income than they would otherwise have had to include. *Unfortunately, that is sometimes how the cookie crumbles*.”

Smith v. Commissioner, 151 T.C. No. 5 (9/18/2018).

How Section 959 works (what you're giving up)

- When a foreign corporation makes a cash distribution to a shareholder, it is a dividend if the distribution comes from earnings and profits

- Section 951(a) imposes an immediate tax on earnings and profits of a foreign corporation, even if the corporation does not distribute cash to the shareholder

- Section 959: "if your distribution comes from *previously taxed* earnings and profits, *don't* treat it like a dividend" —the distribution does not increase gross income

How Section 962 (mostly) takes away Section 959

- If you make the Section 962 election to be taxed as a domestic corporation on Subpart F income, cash distributions from previously taxed earnings and profits are (mostly) included in your gross income - IRC §962(d)

- The amount of gross income you have (if you make the Section 962 election) = distribution you receive minus the income tax you paid on the earnings and profits from which the distribution was made

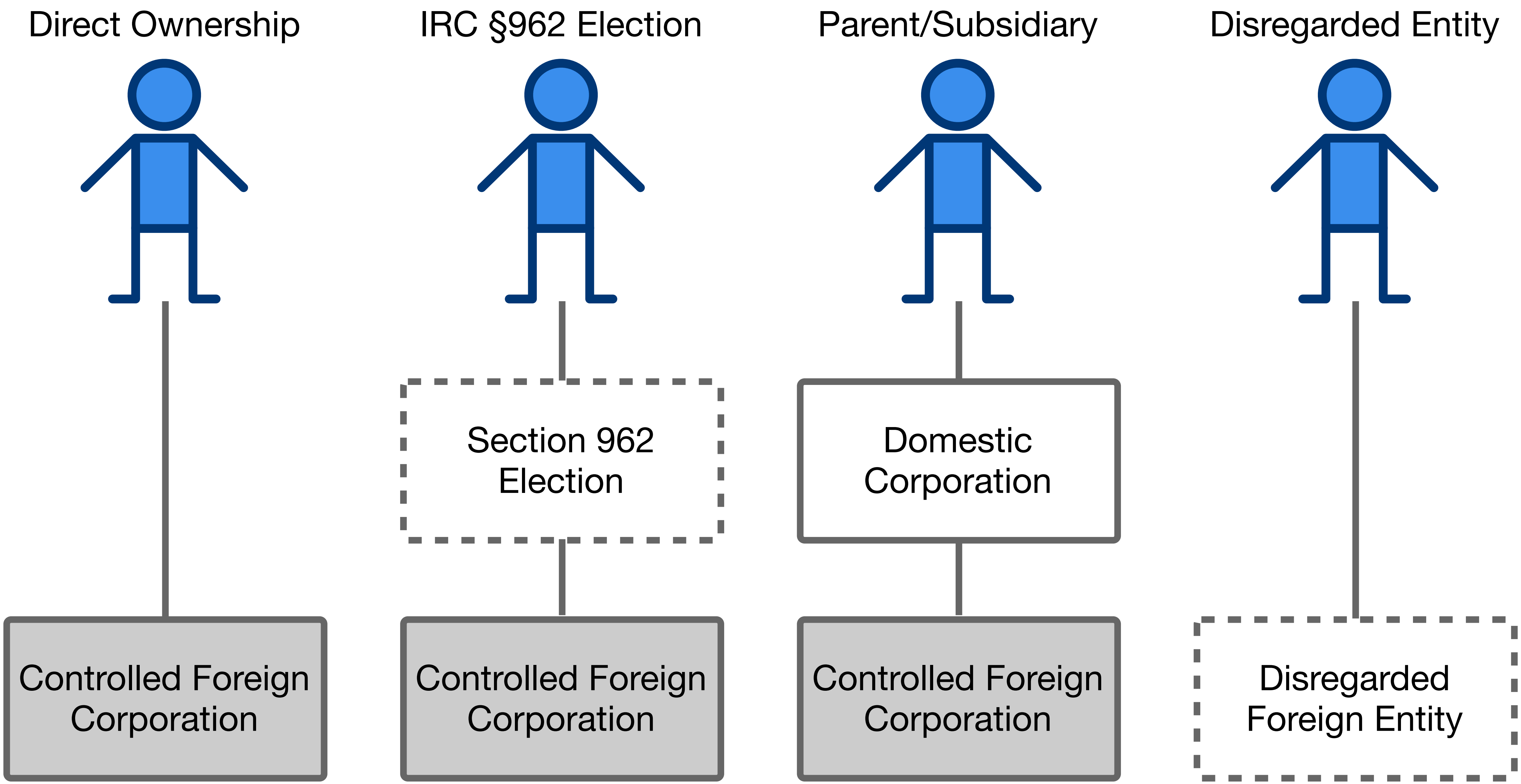
- Examples later, but key concept: Section 962 creates extra taxable income

So. Section 962 . . . Make the Election or Not?

Does Section 962 make sense?

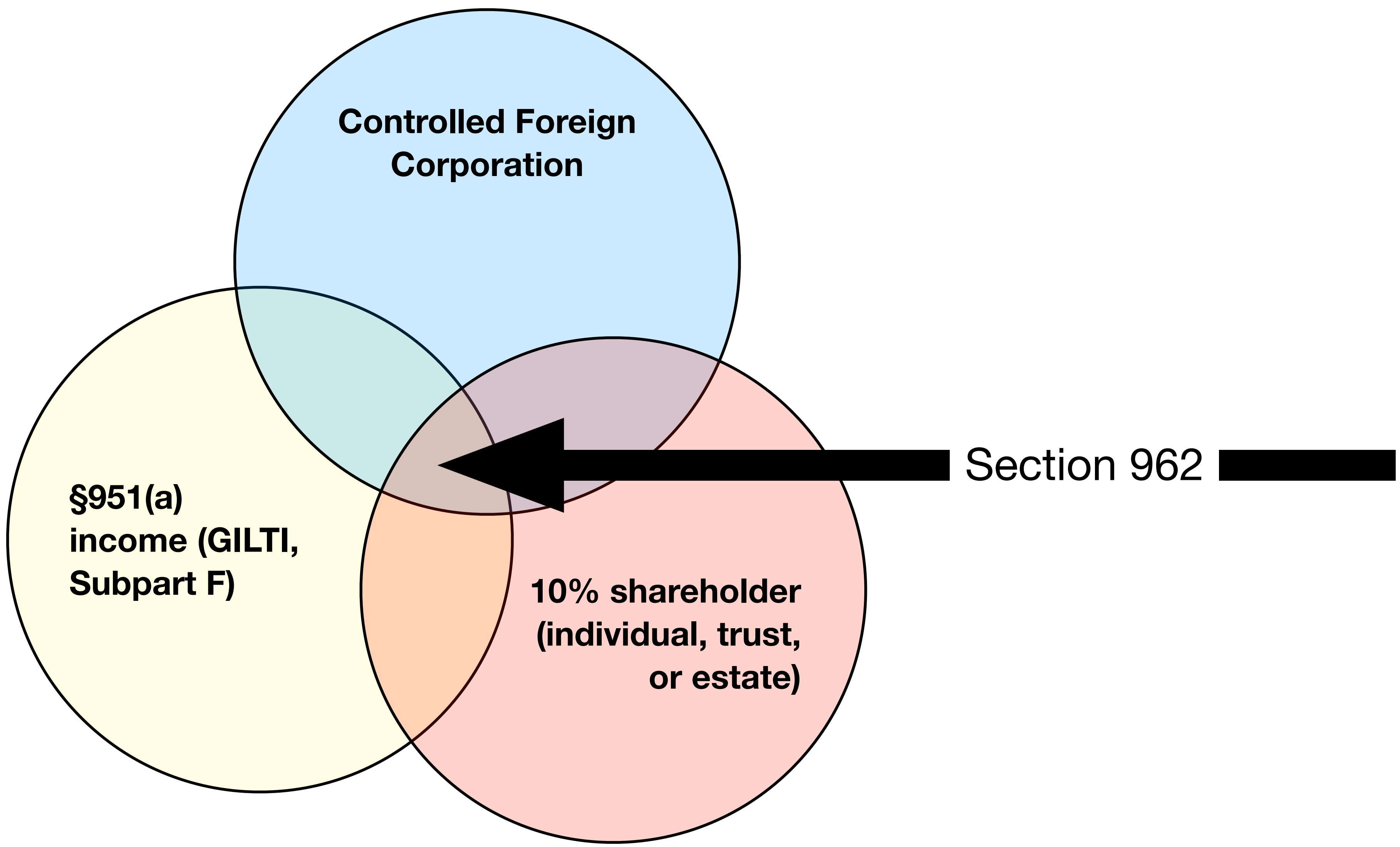
Subpart F income taxed at a lower rate	🙂
Take an indirect foreign tax credit	🙂
Pay more income tax when the CFC pays dividends	🙁
When you put it all together . . .	?

And is Section 962 better than other choices?



Part 2.
When Section 962 is (Possibly) Useful

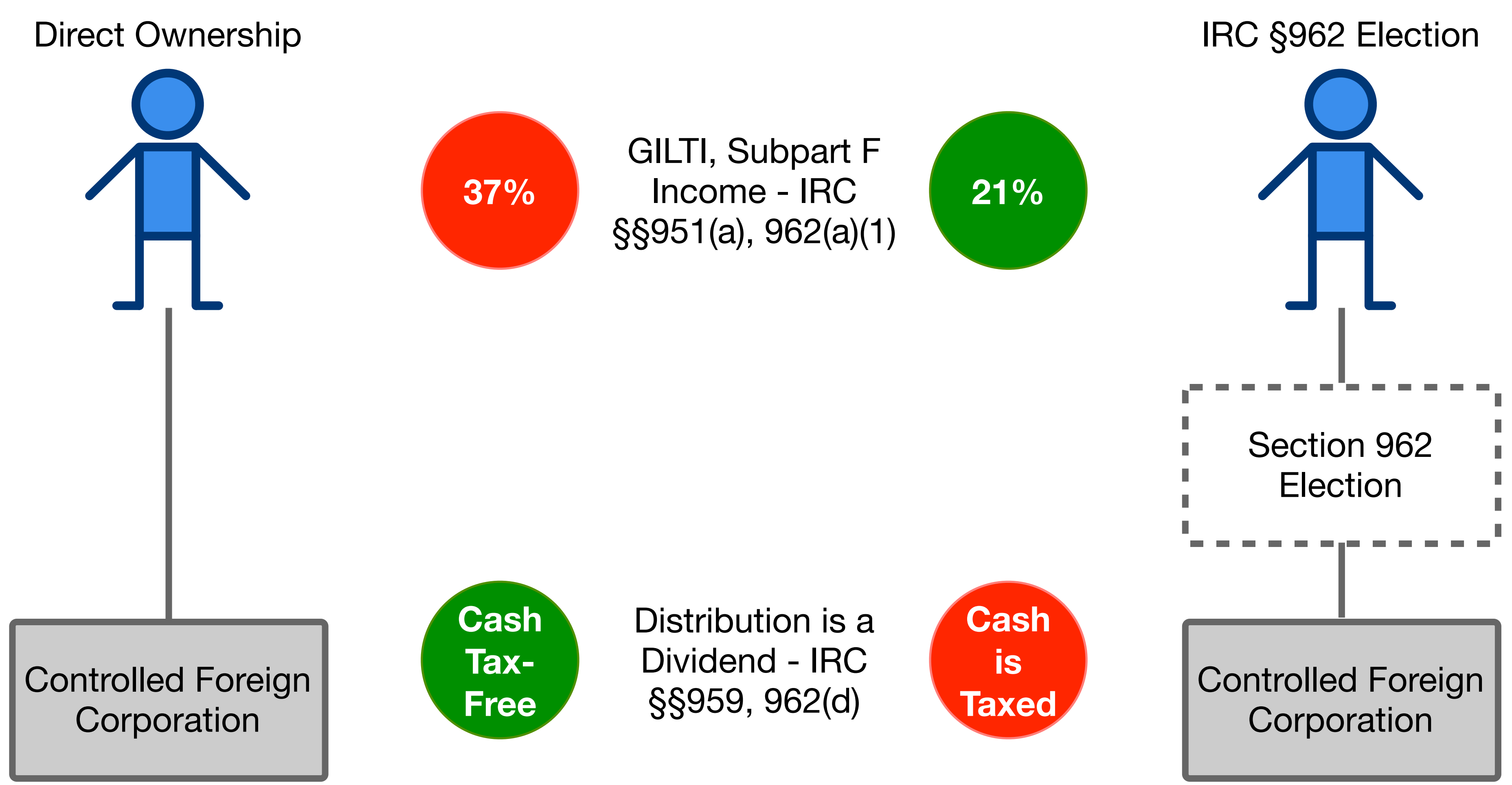
Three ingredients needed for Section 962



Part 3.
How Section 962 Works (No Tax Credit)

An example, without foreign tax credit, to show the impact of the lower income tax rate (good) and the added gross income from distributions (bad).

Does Section 962 Help? (No Foreign Tax Credit)



The facts

- $50,000 of Subpart F income
- No corporate-level foreign income tax for the controlled foreign corporation
- Compare “no cash distribution” and “cash distribution” scenarios, and see how a Section 962 election makes a difference

Income tax on Subpart F income: IRC §962(a)

	No Section 962 Election	Section 962 Election
CFC's income (Subpart F)	50,000	50,000
Shareholder's Subpart F income	50,000	50,000
Shareholder's taxable income	50,000	50,000
Income tax rate	37%	21%
Income tax	18,500	10,500

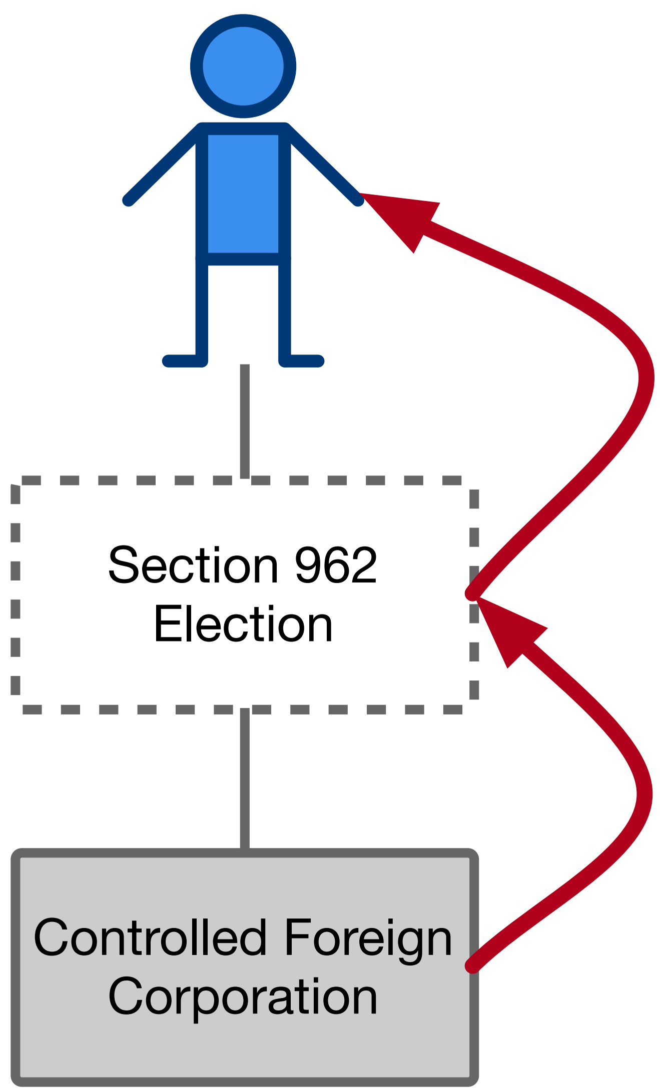
Income tax on distribution: IRC §§959(a)(1), 962(d)

	No Section 962 Election	Section 962 Election
Cash distribution	50,000	50,000
Total income to shareholder	**50,000**	**50,000**
Less previously taxed E & P - §959(a)	-50,000	
Less previous tax paid - §962(d)		-10,500
Additional taxable income	**0**	**39,500**
Income tax rate	37%	37%
Income tax	0	14,615

Why 37%? *Smith v. Commissioner*

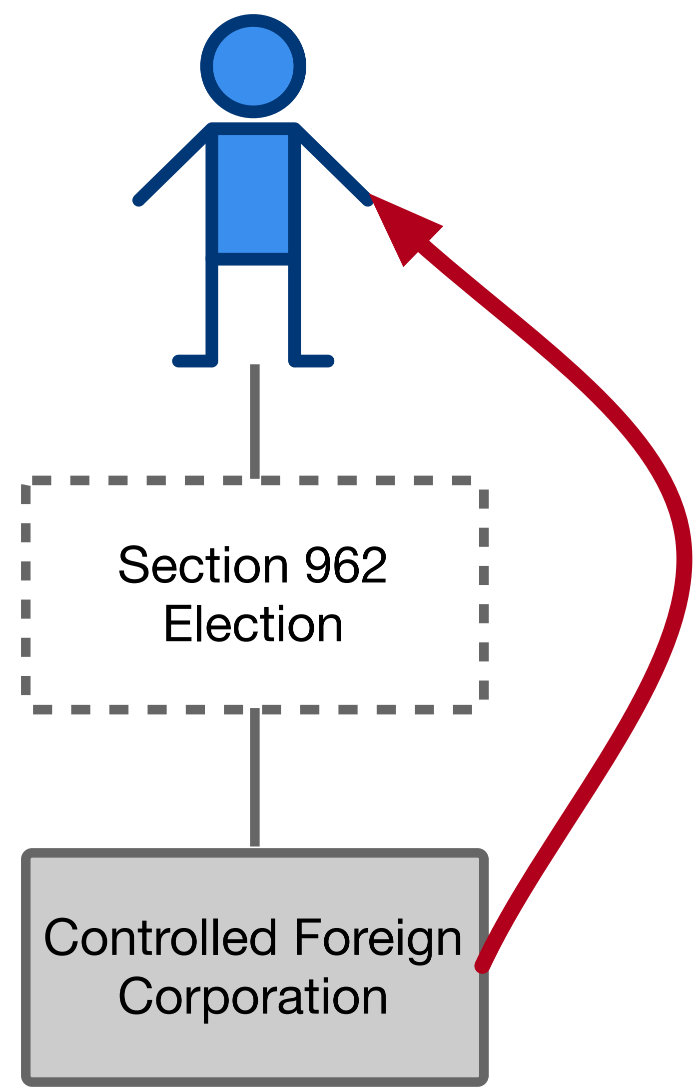
Taxpayer

"I received a qualified dividend from a deemed domestic corporation, so I pay a 20% tax."



Tax Court Judge

"No, you received a dividend from a foreign corporation, taxable at ordinary tax rates."



NIIT: add back deductions, compute tax

	No Section 962 Election	Section 962 Election
Distribution from previously-taxed E & P	50,000	50,000
Deduction for distribution of previously-taxed E & P - §959(a)(1)	-50,000	
Previously-taxed E & P deduction ignored	50,000	
Deduction for tax paid on distribution from previously-taxed E & P— §962(d)		-10,500
Add back deduction for income tax paid		10,500
Net investment income	**50,000**	**50,000**
Net investment income tax rate	3.8%	3.8%
Net investment income tax	**1,900**	**1,900**

HODGENLAW PC
INTERNATIONAL TAX

Total tax on Subpart F + cash distribution

	No Section 962 Election	Section 962 Election
Income tax on Subpart F income	18,500	10,500
Income tax on cash distribution	0	14,615
Net investment income tax on cash dist.	1,900	1,900
Total tax paid	18,500	27,015

Summary: What We Learned

- Subpart F income is taxed exactly the same; only the tax rate is different

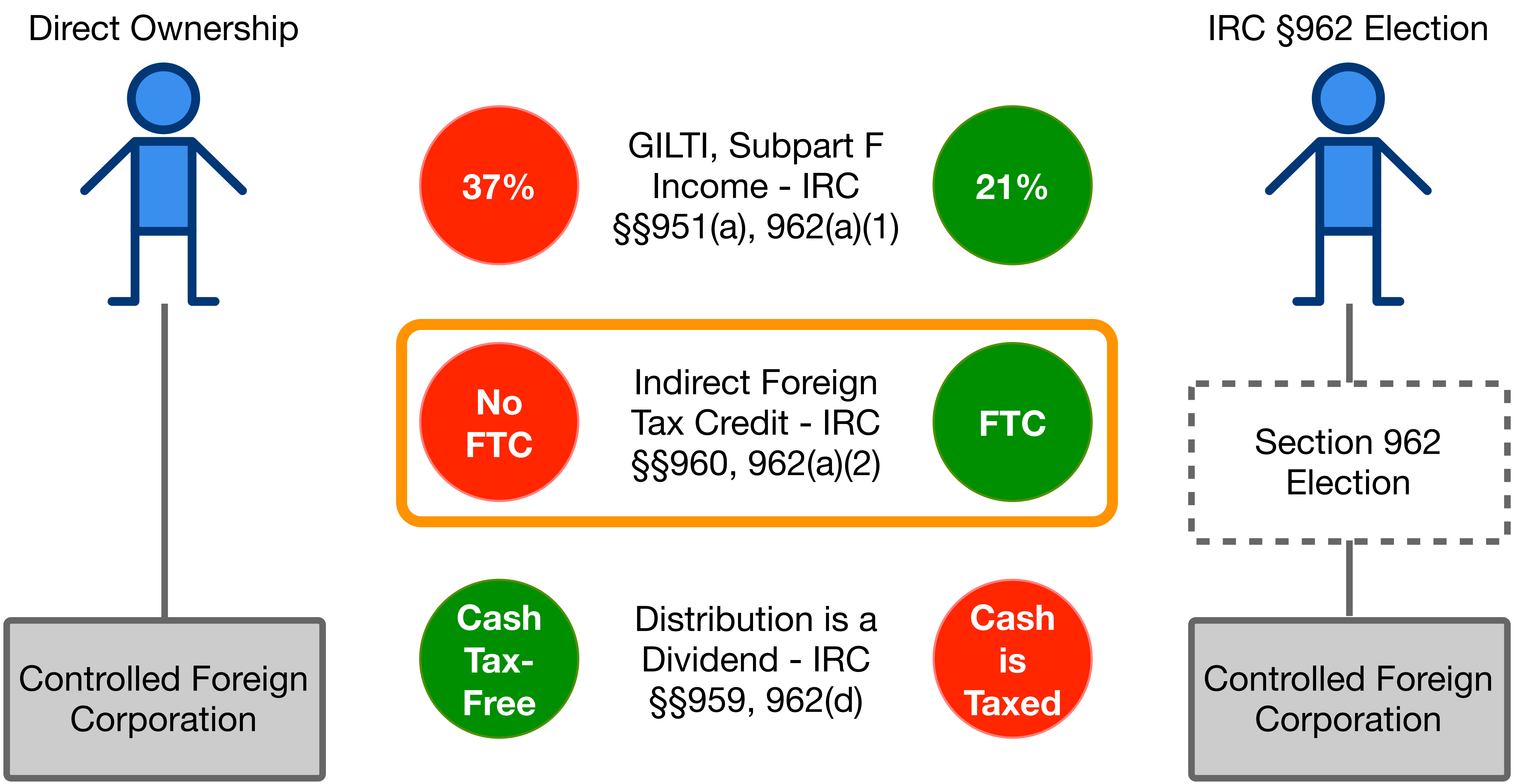
- Distributions from CFCs are treated wildly differently. The Section 962 election forces you to give up most of the tax-free treatment of those cash distributions.

- Net investment income tax is omnipresent

Part 4.
How Section 962 Works (With Tax Credit)

The previous example, but now with foreign tax credit.

Does Section 962 Help? (With Foreign Tax Credit)



The facts

- $50,000 of Subpart F income
- Distribute all available cash annually to the shareholder
- 25% income tax paid by controlled foreign corporation
- Compare no Section 962 election to Section 962 election

Income tax on Subpart F income: IRC §962(a)

	No Section 962 Election	Section 962 Election
CFC's income	50,000	50,000
Less foreign income tax paid	-12,500	-12,500
Subpart F income to shareholder	**37,500**	**37,500**
Gross-up income for FTC purposes	12,500	12,500
Taxable income to shareholder	**50,000**	**50,000**
Income tax rate	37%	21%
Income tax	18,500	10,500

Income tax on CFC cash distribution: IRC §962(d)

	No Section 962 Election	Section 962 Election
Cash distribution	37,500	37,500
Deemed dividend - §78	12,500	12,500
Total income to shareholder	**50,000**	**50,000**
Less previously taxed IRC - §959	-50,000	
Less previous tax paid IRC - §962(d)		-10,500
Additional taxable income	**0**	**39,500**
Income tax rate	37%	37%
Income tax	0	14,615

NIIT on cash distribution

	No Section 962 Election	Section 962 Election
Distribution from previously-taxed E & P (part actual, part deemed dividend)	50,000	50,000
Deduction for distribution of previously-taxed E & P - §959(a)(1)	-50,000	
Previously-taxed E & P deduction ignored	50,000	
Deduction for tax paid on distribution from previously-taxed E & P— §962(d)		-10,500
Add back deduction for income tax paid		10,500
Net investment income	**50,000**	**50,000**
Net investment income tax rate	3.8%	3.8%
Net investment income tax	**1,900**	**1,900**

Shareholder's foreign tax credit

	No Section 962 Election	Section 962 Election
CFC's taxable income	50,000	50,000
CFC's tax rate	25%	25%
CFC's income tax	**12,500**	**12,500**
Creditable foreign income tax - §960	0	12,500
U.S. tax on foreign income - §904 limit	0	10,500
Foreign tax credit allowable	0	10,500
Foreign tax credit carry forward		*2,000*

Total tax load (shareholder and foreign corporation)

	No Section 962 Election	Section 962 Election
Tax on Subpart F income	18,500	10,500
Tax on cash distribution	0	14,615
Net investment income tax	1,900	1,900
Foreign tax credit	0	-10,500
Total tax paid by shareholder	20,400	16,515
Unused foreign tax paid (carry forward)		2,000
Total tax load	20,400	18,515

With and without foreign tax credit? Who wins?

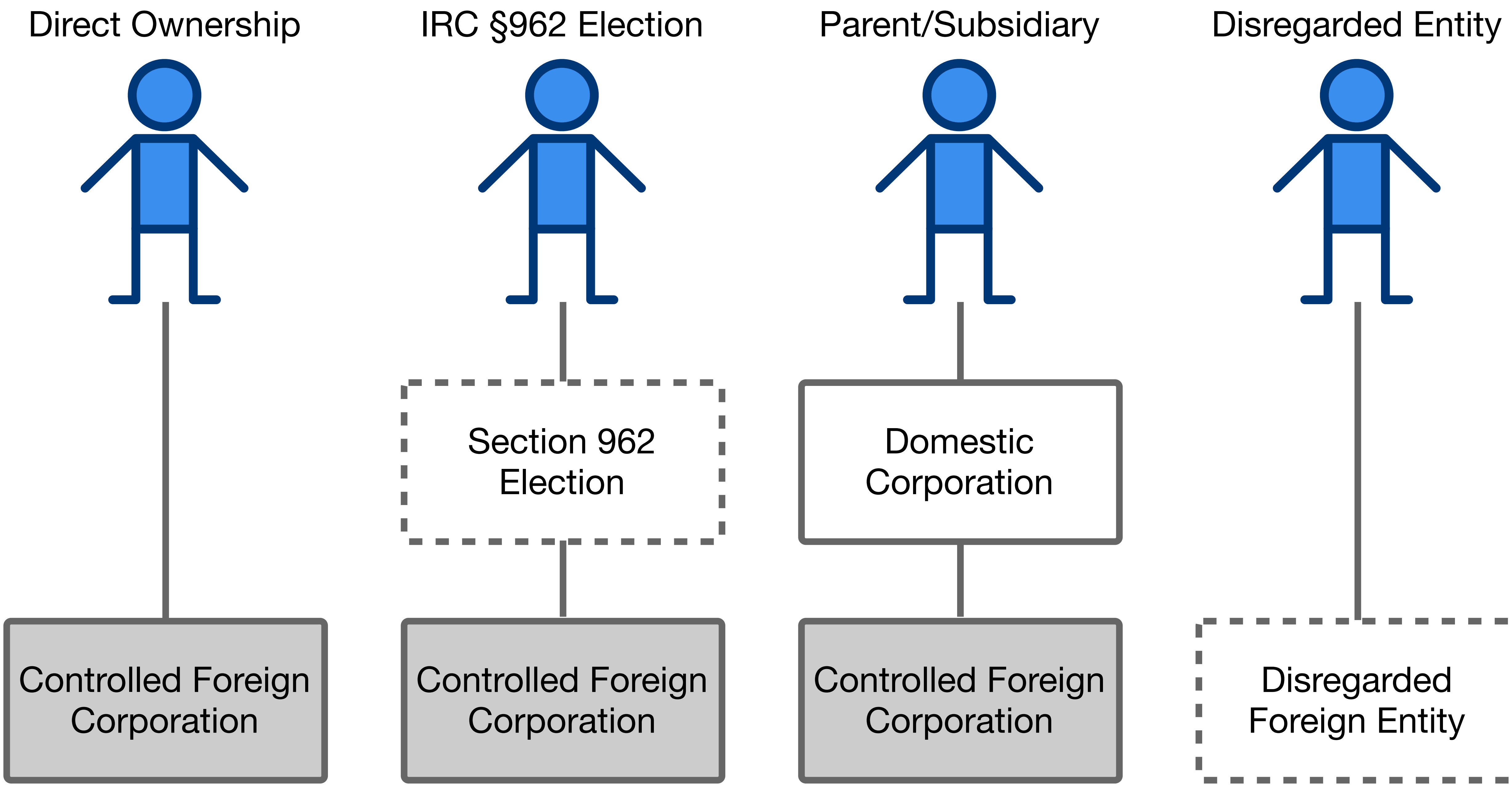
	No Foreign Tax Credit		Foreign Tax Credit	
	No Section 962 Election	Section 962 Election	No Section 962 Election	Section 962 Election
Shareholder tax - Subpart F	18,500	10,500	18,500	10,500
Shareholder tax - dividend		14,615	0	14,615
Shareholder - FTC			0	-10,500
NIIT	1,900	1,900	1,900	1,900
CFC - tax carry forward				2,000
Total tax	20,400	27,015	20,400	18,515

When Section 962 might make sense

- The indirect tax credit flipped the “best result” from “don’t use Section 962” to “Section 962 looks pretty good”
- Hunch:
    - Section 962 is not so useful in low (or no) corporate tax foreign jurisdictions
    - Section 962 might be useful in high corporate tax foreign jurisdictions

Part 5.
There Are Other Choices. Are They Better?

Let’s compare other ideas (no foreign tax credit)



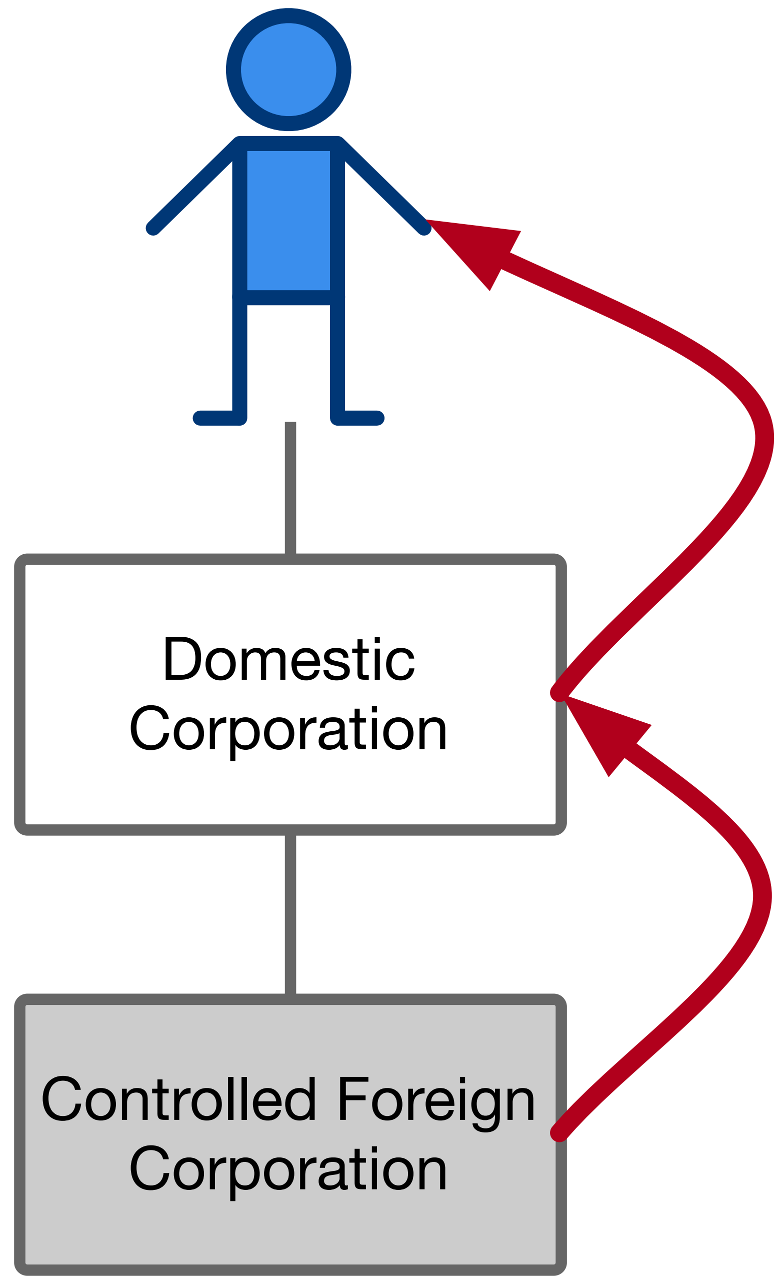
Fact assumptions

- $50,000 Subpart F income
- $50,000 cash distribution
- Zero foreign corporate income tax (to keep the math and the slides simple!)
- Compare all four structure choices

The Parent/Subsidiary Alternative

The Parent/Subsidiary Alternative

- The foreign corporation earns $50,000, pays it as a dividend to the U.S. corporation
- Then the U.S. corporation pays a dividend to the shareholder (key: this is a qualified dividend)



Parent/Subsidiary - U.S. parent's Subpart F income

	U.S. C Corporation
CFC's taxable income	50,000
Subpart F income to U.S. C corporation	**50,000**
Corporation income tax rate	21%
Total tax	10,500

Parent/Subsidiary - U.S. parent's dividend income

	U.S. C Corporation
CFC's dividend paid to U.S. parent	50,000
Dividend received deduction - IRC §245A	-50,000
U.S. parent corporation's taxable dividend income	0
Ordinary income tax rate	21%
U.S. parent corporation's tax on dividend income	0

Parent/Subsidiary - U.S. parent's total tax

	U.S. C Corporation
Tax paid on Subpart F income	10,500
Tax paid on dividend from CFC	0
U.S. parent corporation's total tax	10,500

Parent/Subsidiary - dividend to shareholder

	U.S. C Corporation
U.S. C corporation cash after income tax	39,500
Dividend paid to U.S. shareholder	39,500
Qualified dividend tax rate	20%
Income tax on qualified dividend	7,900
Net investment income tax on qualified dividend	1,501
Shareholder’s total tax on qualified dividend	9,401

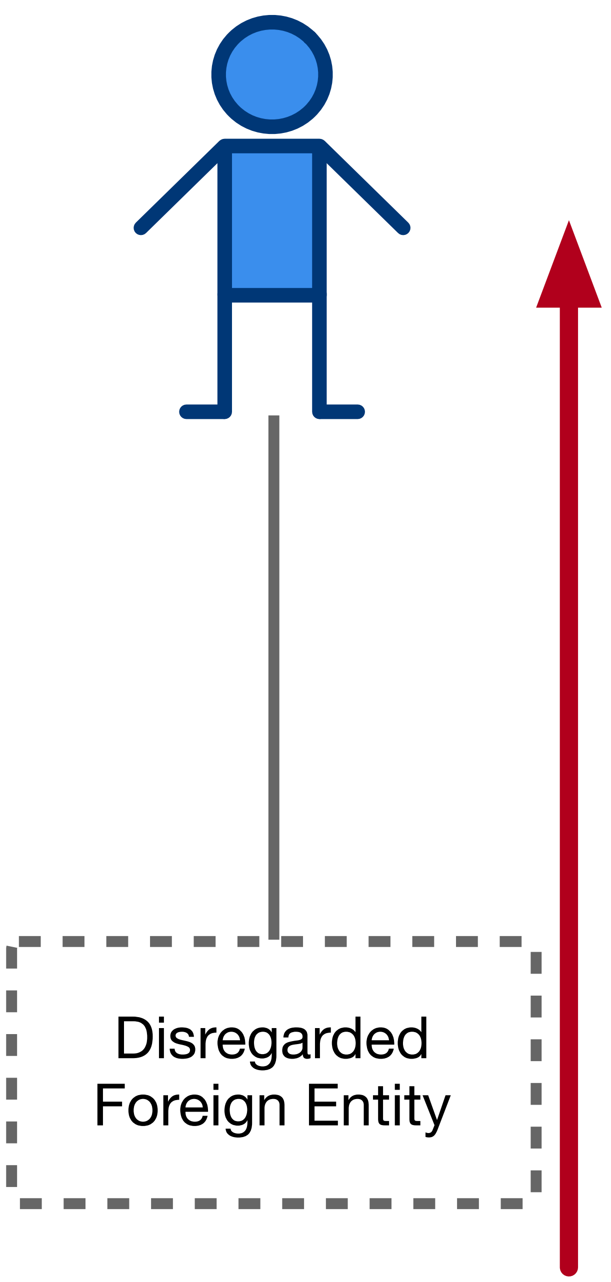
Parent/Subsidiary - total tax load

	Total Tax Load
U.S. parent corporation income tax	10,500
Shareholder’s income tax on qualified dividend	7,900
Shareholder’s net investment income tax	1,501
U.S. parent corporation + shareholder total tax	19,901

The Disregarded Entity Alternative

The Disregarded Entity Alternative

- Assume the foreign corporation is eligible for a "check the box" election.
- The U.S. shareholder is treated as the direct owner of the foreign corporation's assets, so reports the income on Form 1040.



Disregarded entity - tax cost to shareholder

	Disregarded Entity
Income to U.S. shareholder	50,000
Ordinary income tax rate	37%
Income tax	**18,500**
Tax on cash distributed to U.S. shareholder	0
Net investment income tax (maybe it's not taxable?)	1,900
Total tax	20,400

The Four Alternatives: How They Compare

The Shootout: No FTC, 100% Cash Distribution

	No Section 962 Election	Section 962 Election	Parent/ Subsidiary	Disregarded Entity
Sub F Tax	18,500	10,500	10,500	18,500
Tax (Dividend)	0	14,615	7,900	0
NIIT	1,900	1,900	1,501	1,900
Total tax	20,400	27,015	19,901	20,400

Part 6.
Conclusion

Conclusion

- Excel — financial modeling will tell you the answer
- Hunches:
  - Section 962 will work where the foreign corporation pays high income tax (because of the indirect foreign tax credit)
  - Otherwise, the parent/subsidiary or the disregarded entity concepts are likely to give a better result

The Boilerplate Disclaimer

Don't get your legal or tax advice from some dude in a suit (me) standing in front of a room full of intelligent, good-looking people (you), gesturing at PowerPoint slides with made-up numbers on them.

Do your own research or hire a professional.

And do the math. Getting this stuff wrong can be expensive. I mean, look at *Smith v. Commissioner*. Wow, that hurt.

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Section 965

After the Deadline

November 9, 2018

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Agenda

1. Introduction to section 965
2. Key terms
3. Basis Adjustments and PTI
4. Reporting
5. Payment

Agenda

1. **Introduction to section 965**
2. Key terms
3. Basis Adjustments and PTI
4. Reporting
5. Payment

Introduction to § 965

- Section 965 amended on December 22, 2017 by H.R. 1, "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018" (referred to herein as the Tax Cuts and Jobs Act)

- Proposed Regulations released on August 1, 2018.
    - Largely adopted guidance provided in Notices 2018-07, 2018-13, 2018-26

- Subpart F income of deferred foreign income corporation increased for last taxable year of such corporation beginning before January 1, 2018

- For many taxpayers, the inclusion year has already passed; deadline has not yet passed for some fiscal year end taxpayers and foreign corporations

Introduction to § 965

- For the last taxable year of a **deferred foreign income corporation** that ***begins before*** **January 1, 2018,**

- The **subpart F income** of the corporation (as otherwise determined for such taxable year under section 952)

- Shall be increased by the **greater of**

  (1) the accumulated post-1986 deferred foreign income of such corporation determined **as of November 2, 2017**, or

  (2) the accumulated post-1986 deferred foreign income of such corporation determined **as of December 31, 2017**

Introduction to § 965

- The § 965(a) inclusion amount of a deferred foreign income corporation ("DFIC") is subpart F income in its inclusion year

- Proposed regulations define "Section 965(a) inclusion amount":
  - U.S. shareholder pro rata share of the section 965(a) inclusion, *less*
  - Any allocable deficit from an E&P deficit foreign corporation

- Foreign tax credits permitted, after a haircut

Introduction to § 965

Participation exemption—section 965(c) deduction amount

- Calculated as a function of U.S. shareholder's aggregate foreign cash position
- Lower effective rate arrived at via rate equivalent deductions
- Calculate deduction to arrive at 15.5% effective rate for cash and cash equivalents and 8% effective rate for other E&P
    - Deduction calculated by reference to highest marginal section 11 rate
    - Fiscal year taxpayers must use blended rates
- Individuals and trusts may have a higher effective rate
    - Consider section 962 election

Introduction to § 965

Anti-abuse rules

- Certain transactions, changes in method of accounting, and entity classification elections disregarded if they result in a change to a "section 965 element"

- General conditions for transactions:
  - Transaction occurred after Nov. 2, 2017,
  - Principal purpose of changing the amount of a section 965 element, and
  - Changed the amount of the section 965 element of the United States shareholder

- General conditions for changes in method of accounting and entity classification elections
  - Form 3115 or 8832 filed on or after Nov. 2, 2017, and
  - Changed the amount of the section 965 element of the United States shareholder

Introduction to § 965

Anti-abuse rules

- Change in "section 965 elements":
  - Decrease to section 965(a) inclusion
  - Decrease aggregate foreign cash position (but only if less than shareholder's 965(a) inclusion amt)
  - Increase foreign income taxes of specified foreign corporation deemed paid under section 960 as a result of the section 965(a) inclusion
- Presumptions and per-se rules apply

Prop. Reg. § 1.965-4

Introduction to § 965

Statutory and Regulatory Elections

- Installment payment election
- S corporation shareholder deferral of net tax liability
- REIT deferral of section 965 gross income inclusion
- Election out of net operating loss deduction
- Alternative method for calculating November 2, 2017 post-1986 earnings and profits
- Basis adjustment election
- Eligible transferee exception

Agenda

1. Introduction to section 965
2. **Key terms**
3. Basis Adjustments and PTI
4. Reporting
5. Payment

Key Terms

Attributes

- Specified foreign corporation
- Deferred foreign income corporation
- E&P deficit foreign corporation
- Accumulated post-1986 deferred foreign income
- Aggregate foreign cash position

Specified Foreign Corporation

Key Concept: U.S. Shareholders of "specified foreign corporations"

Specified Foreign Corporation § 965(e)

For purposes of this section, the term "specified foreign corporation" means—

§ 965(e)(1)(A) any controlled foreign corporation, and

§ 965(e)(1)(B) any foreign corporation with respect to which one or more domestic corporations is a United States shareholder.

Highlights

- Applies to all United States shareholders if a domestic corporation is a United States shareholder
- Analysis requires careful consideration of United States shareholder definition— § 951(b)
- Consider application of § 958(b)(4) repeal
- PFICs excluded, unless CFC in hands of U.S. shareholder

Careful: SFC status applies to all U.S. shareholders, not just with respect to the 10% domestic corporate U.S. shareholders

Specified Foreign Corporation

United States shareholder definition invokes section 958(b)

§ 958(b)

For purposes of sections 951(b), 954(d)(3), 956(c)(2), and 957, **section 318(a)** (relating to constructive ownership of stock) shall apply to the extent that the effect is to treat any United States person as a United States shareholder within the meaning of section 951(b)…

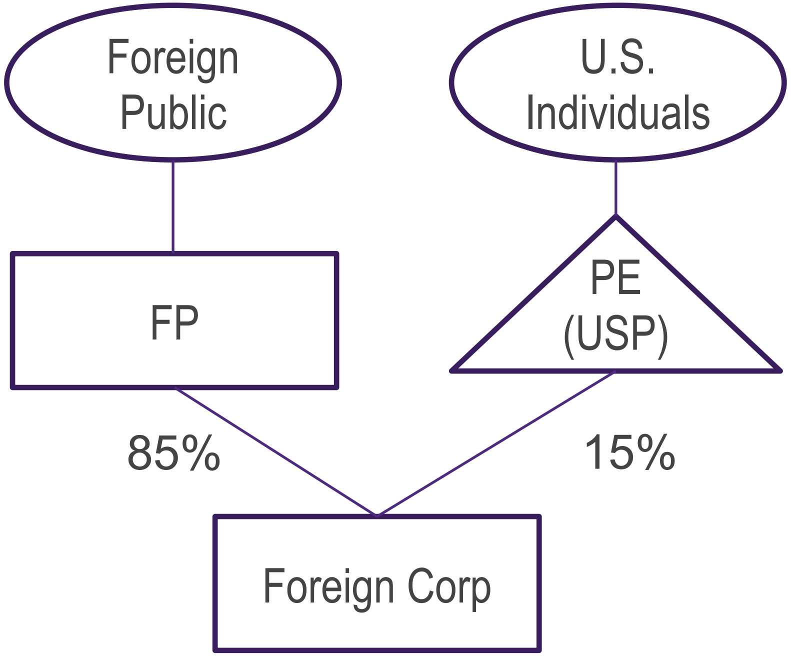
§ 318(a)

- 318(a)(2): Attribution from partnerships, estates, trusts, and corporations
- 318(a)(3): Attribution to partnerships, estates, trusts, and corporations
- 318(a)(3)(A): Stock owned by or for a partner shall be considered as owned by a partnership *Modified by 5% test in Prop. Regs. for SFC test*
- 318(a)(3)(C): If 50% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned directly, or indirectly, by or for such person

Specified Foreign Corporation

Examples

1

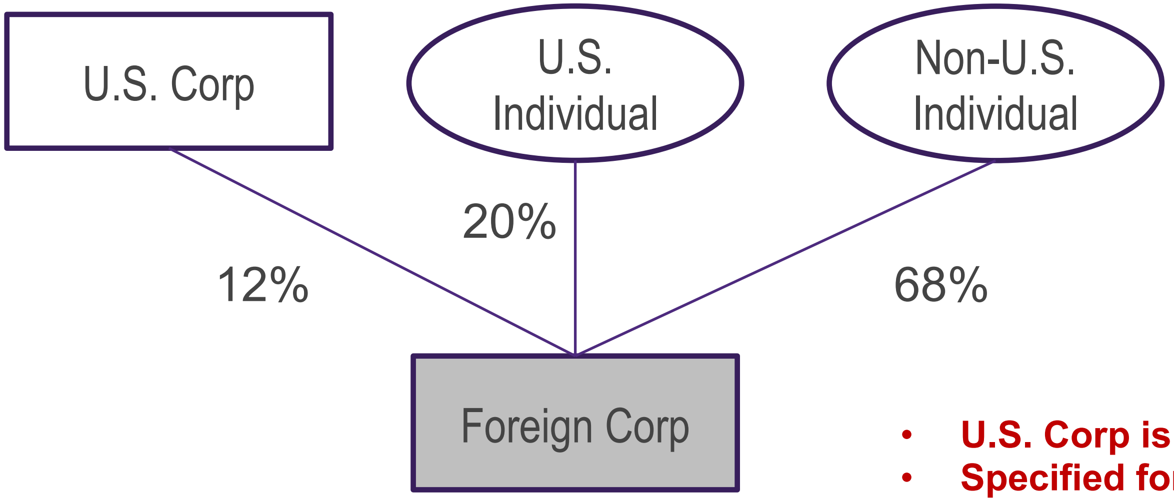


Not a specified foreign corporation

Specified Foreign Corporation

Examples

2

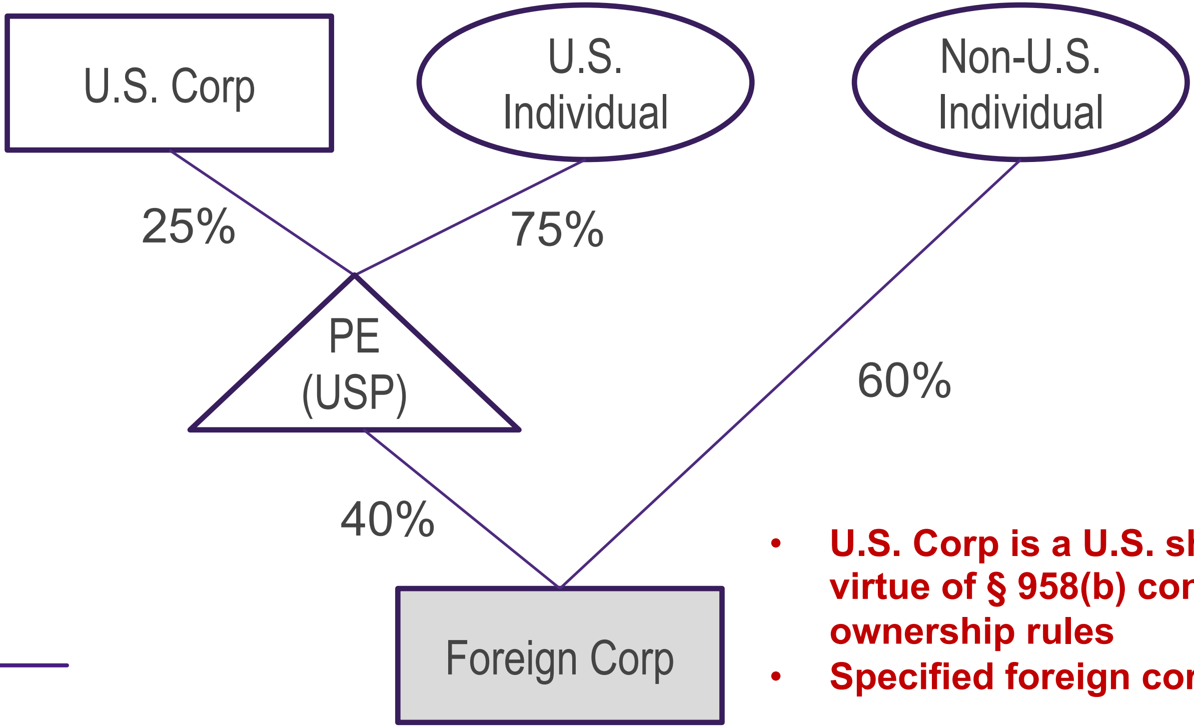


- **U.S. Corp is a U.S. shareholder**
- **Specified foreign corporation**

Specified Foreign Corporation

Examples

3

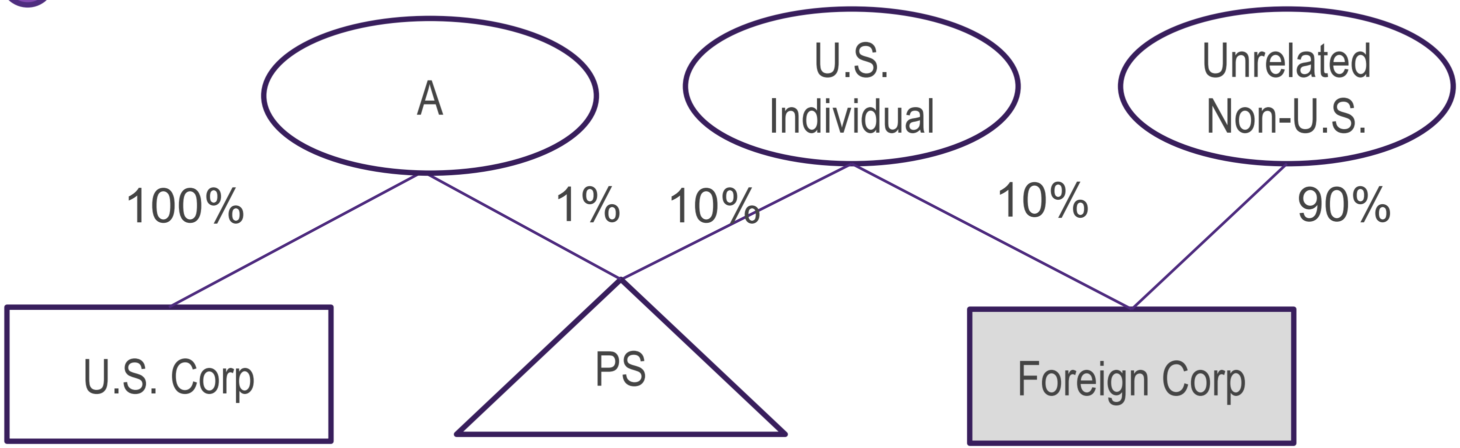


- **U.S. Corp is a U.S. shareholder by virtue of § 958(b) constructive ownership rules**
- **Specified foreign corporation**

Specified Foreign Corporation

Examples – Prop. Reg. 1.965-1(g), Ex. 1

4



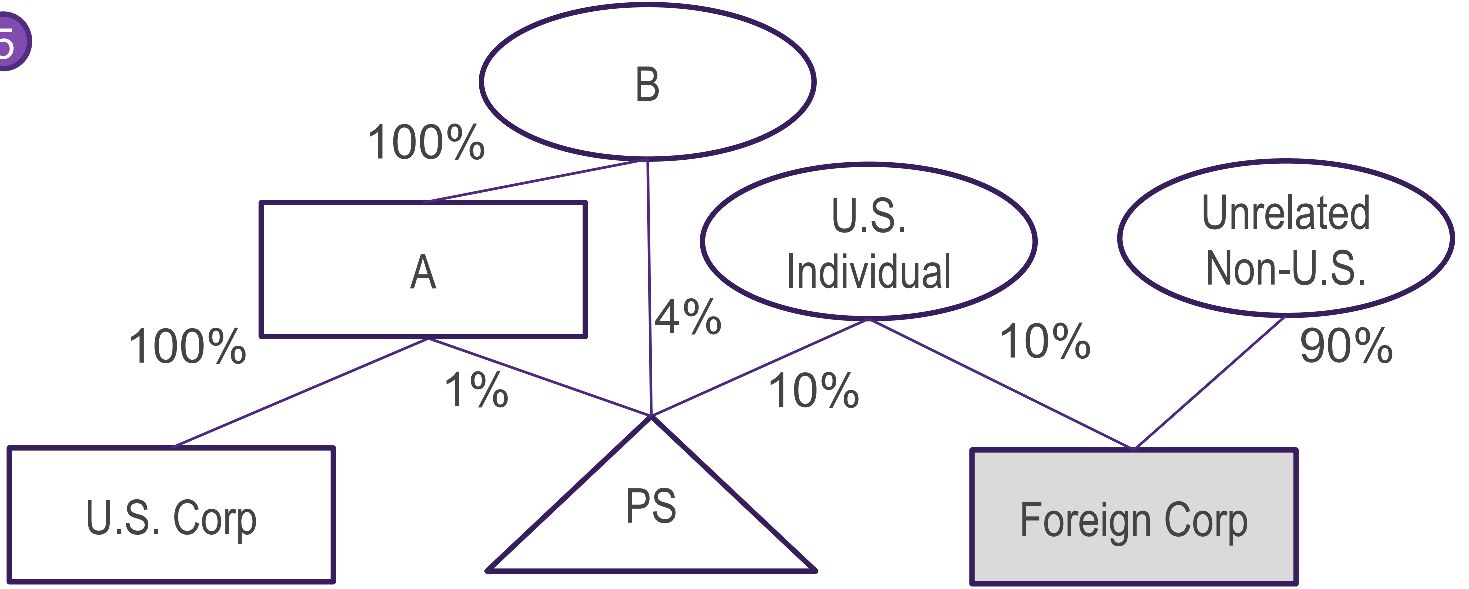
Solely for purposes of determining whether a foreign corporation is an SFC, the stock of DC owned by A is not considered as being owned by PS under the downward attribution rules **because A owns less than 5% of the interests in PS's capital and profits.**

See Prop. Reg. 1.965-1(f)(45)(ii)

Specified Foreign Corporation

Examples – Prop. Reg. 1.965-1(g), Ex. 2

5



B directly owns 4% of the PS capital and profits; A directly owns 1% of the PS capital and profits. A is treated as owning the interests in PS owned by B. A is treated as owning 5% of the PS capital and profits. **A's ownership in U.S. Corp is attributed to PS, and Foreign Corp is an SFC.**

Deferred foreign income corporation/ E&P deficit foreign corporation

Deferred foreign income corporation § 965(d)(1)

The term "deferred foreign income corporation" means, with respect to any United States shareholder, any **specified foreign corporation** of such United States Shareholder which has accumulated post-1986 deferred foreign income…greater than zero.

Post-1986 deferred foreign income

- Earnings and profits of the foreign corporation
- Accumulated in taxable years beginning after December 31, 1986
- The amount as of Nov. 2, 2017 or Dec. 31, 2017, whichever is greater
- While specified foreign corporation
- Add back dividends paid during taxable year (in general)
- Excludes PTI and ECI

E&P Deficit Foreign Corporation § 965(b)(3)(B)

[W]ith respect to any taxpayer, any specified foreign corporation with respect to which such taxpayer is a United States shareholder, if, as of November 2, 2017, such specified foreign corporation has a deficit in post-1986 earnings and profits, such corporation was a specified foreign corporation, and such taxpayer was a United States shareholder of such corporation.

*Includes PTI and ECI

November 2 Determinations

With respect to first testing date, November 2, 2017, controlling domestic shareholders have two options when calculating E&P:

1. Close the books of the specified foreign corporation on November 2

2. Elect an alternative calculation
   - October 31, 2017 balance
   - Gross up by two days

Alternative calculation election must be made with a timely filed return (taking into account extensions). Prop. Reg. 1.965-7(f).

Election is made by including statement with return in accordance with the proposed regulation

Agenda

1. Introduction to section 965
2. Key terms
3. **Basis Adjustments and PTI**
4. Reporting
5. Payment

Basis Adjustments and PTI

- U.S. shareholder has § 959 previously taxed E&P (PTI) with respect to a DFIC equal to the
  - § 965(a) inclusion amount *plus*
  - The amount of deferred foreign earnings that were offset with a § 965(b) deficit

- However, U.S. shareholder's tax basis in the shares of a DFIC (or property through which a DFIC is held) is only increased by the § 965(a) inclusion amount

- Potential for future distributions in excess of basis that trigger capital gain under § 961(b)

- § 986(c) gain/loss must be calculated on distributions of PTI
  - Based on movements in exchange rate between Dec. 31, 2017 and the time such distributions are made
  - Gain/loss is reduced in the same proportion as the § 965(c) deduction bears to the inclusion
  - *Does not apply with respect to § 965(b) previously taxed earnings and profits. Prop. Reg. 1.986(c)-1.*

Basis Adjustments and PTI

- Election available to shift basis from the E&P deficit foreign corporation
  - Increase basis of the DFIC by the § 965(b) allocated deficit
  - Reduce basis of the E&P deficit foreign corporation by the allocated deficit
  - Careful: reductions in excess of basis could trigger capital gain

- Notice 2018-78 allows taxpayers 90 days after the final § 965 regulations are published in the federal register to make the basis election
  - Elections previously made may be revoked within the same time frame

- See Prop. Reg. § 1.965-2

Agenda

1. Introduction to section 965
2. Key terms
3. Basis Adjustments and PTI
4. **Reporting**
5. Payment

Reporting Considerations

- IRS Q&A first released in April, 2018
- Provided for specific instructions to report 965 amounts on the return
    - Much of the return prepared ignoring 965
    - 965 Statement
    - Including 965 amount on specific lines
    - No instructions provided for Forms 5471, carryover schedules
- Draft Forms—Form 965
    - When will taxpayers be required to file this form, if ever?

Agenda

1. Introduction to section 965
2. Key terms
3. Basis Adjustments and PTI
4. Reporting
5. **Payment**

Payment

1. IRS Q&A provides for specific payment instructions on the "965 Tax Liability"

2. This is the amount eligible for the installment payment under § 965(h)

3. Determined by preparing a "with" and "without" calculation

4. Election permitted to pay in installments over eight years
    - Election be made on a timely filed return, pursuant to the proposed regulations. See Prop. Reg. § 1.965-7.
    - Installments generally due by the due date of the tax return (without extensions)

Payment

- Acceleration of §965(h) payments may be triggered if
  1. Failure to timely pay an installment
  2. A liquidation, sale, exchange, other disposition of substantially all of taxpayer's assets
  3. Any event that results in person no longer being a U.S. person
  4. Person that was not a member of a consolidated group becoming a member of a consolidated group
  5. Consolidated group ceases to exist or no longer file a consolidated return.

- Eligible transferee exception—transfer agreement must be filed within 30 days
  1. Acknowledgement that the transferee will assume the liability
  2. Agreement that transferee agrees to comply with § 965(h)
  3. Representation that transferee is able to make remaining required payments
  4. Transferor that continues to exist remains jointly and severally liable
  5. **No 9100 Relief for late filing**

Prop. Reg. § 1.965-7(b)(3)(iii); see also Q&A for additional guidance

Payment

- If an S corporation is a United States shareholder of a DFIC, each non-passthrough shareholder of the S corporation may elect to defer payment of the shareholder's section 965(i) net tax liability with respect to the S corporation until the shareholder's taxable year that includes a triggering event

- Triggering events include:
  - Corporation ceases to be an S corporation
  - A liquidation, sale, exchange or other disposition of substantially all of the assets of the S corporation, a cessation of the business of the S corporation, or the S corporation ceases to exist
  - Transfer of any shares of S corporation stock

- Transfer agreement exception
  - Shareholder and eligible transferee enter into agreement with the Commissioner
  - Eligible section 965(i) transferee is a United States person that is not a domestic pass-through entity
  - Must be timely filed, generally within 30 days of the triggering event date
  - No 9100 relief available

§ 965(i), Prop. Reg. § 1.965-7(c)

Questions?

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EXPAT TAX TOOLS FORM 8621 CALCULATOR

PFICs & CFCs

Presented by **Mary Beth Lougen** EA USTCP
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Overview

- Talk about what is a CFC (Controlled Foreign Corporation)
- Define PFIC (Passive Foreign Investment Corporation)
- CFC/PFIC Overlap Rules
- Unintended PFICs
- New U.S. shareholder definition ramifications

Similarities

- Foreign corporations with U.S. owners
- Both are anti-deferral regimes
  - CFCs – Subpart F
  - PFICs – §1291, MTM, QEF

What is a CFC?

- Controlled Foreign Corporation – IRC 957(a)
- Foreign corporation > 50% owned by "U.S. shareholders"
- "U.S. shareholder" – greater then 10% by vote or value
- IRC 951-965 – Tax rules

U.S. Shareholder – NEW

Defined in §951(b)

- With respect to any foreign corporation, a United States person who owns directly, indirectly, or constructively (§958(b)), 10 % or more of the total combined voting power of all classes of stock entitled to vote, or 10 % or more of the total value of shares of all classes of stock

U.S. Shareholder – OLD

Defined in §951(b)

- With respect to any foreign corporation, a United States person who owns directly, indirectly, or constructively (§958(b)), 10 % or more of the total combined voting power of all classes of stock entitled to vote

Taxation of CFC

- Prior to the Tax Cuts & Jobs Act – active business income was not taxed until it was distributed to the U.S. shareholder unless it met an exception
- Exceptions – annual inclusion of Subpart F income and earnings invested in U.S. property

What is a PFIC?

A foreign corporation that meets either the income or asset test:

- The income test > 75% gross income is passive
- The asset test > 50% assets produce passive income or that are held for the production of passive income.

PFIC is not the account – but the investment

What is Passive Income?

As defined in IRC 954(c) which lists:

dividends, interest, royalties, annuities, capital gains, foreign currency gain, gain on commodity transactions and the like

- NOTE – in certain instances personal service contracts are considered passive §954(c)(1)(H)

Common Types of PFICs

- Foreign Mutual Funds
- Exchange Traded Funds
- Foreign Real Estate Investment Trusts (REITs)
- Foreign Holding Companies set up as corporations
- Société d'investissement à capital fix (SICAF)
- Société d'investissement à capital variable (SIVAC)
- Privately owned foreign corporations that meet the asset or income test
  - – there are special rules for Controlled Foreign Corporations that are also Passive Foreign Investment Companies

How is PFIC Income Taxed?

- §1291 – Default
- §1295 – Qualified Electing Fund (QEF)
- §1296 – Mark to Market (MTM)

Not every PFIC is eligible for all three taxation regimes.

Taxpayer has a choice between actual income and punitive treatment or phantom income and gentler taxation.

§1291 – Default

- Distributions are divided into "excess distributions" and "nonexcess distributions"
- Nonexcess distributions are taxed under regular rules §301 (dividend, return of capital, capital gain)
- All gain from disposition is considered to be an excess distribution
- Excess distributions are allocated per day over the holding period
- All calculations are done per share – no aggregating shares with different holding periods

§1291 – Default

- Excess distributions then further broken down by
  - Pre-PFIC years – taxed as ordinary income
  - Prior PFIC years – used to compute §1291 tax using the highest tax rate for each year
  - Current PFIC year – taxed as ordinary income
- No losses are allowed until disposition
- Losses on disposition are capital

§1291 – Default

- U.S.T.P. purchases 10 shares PFIC on Dec 31, 2012 for $5,000
- Sells all 10 shares on Dec 31, 2015 for $14,000
- Total gain is $9,000 – allocation of $3,000 to each year in the holding period
- 2015 (current year) – $3,000 ordinary income
- 2012 & 2013 – $2,376 in §1291 tax plus interest as if $1,188 were due and payable on April 15, 2013 & $1,188 were due and payable on April 15, 2014

§1296 – Mark to Market

- Year over year appreciation in share value is included in income as ordinary income
- Appreciation included in income creates "unreversed inclusions"
- Decreases in value are allowed as ordinary loss to the extent of unreversed inclusions
  - MTM is only PFIC regime to allow losses prior to disposition
- Basis is adjusted up or down each year according to income or loss on tax return

§1296 – Mark to Market

Only PFICs that are "marketable" securities are eligible to make a Mark to Market election.

Marketable means

- Regularly traded
- Redeemable at NAV
- Financial statements
- Regulated
- Etc. etc. etc… Details! 1.1296-2

§1295 – Qualified Electing Fund

- Unrealized ordinary income & capital gains are reported as income on the tax return every year
  - Very similar to pass-through taxation – except unrealized losses are not allowed
- Most closely mirrors U.S. taxation
  - income retains its character
- Only election allows cap gains on unrealized income
- Requires the taxpayer receive an annual statement
- Optional

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Potential Required Forms

CFC

- Form 5471
- Form 926
- Form 965
- Form 8938
- Form 114-FBAR

PFIC

- Form 5471
- Form 926
- Form 8621
- Form 8938
- Form 114-FBAR

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The Murk – What Happens When:

- *A taxpayer has a start up that is a CFC?*
  - *Start up that is not a CFC?*
- A foreign corporation owns another corporation?
  - What if the lower corp. is a PFIC?
- A “U.S. shareholder” owns shares in a CFC that is also a PFIC?
  - What if they aren’t a “U.S. shareholder”?

CFC – PFIC Overlap Rule

§1297(d)

- A “U.S. shareholder” of a foreign corporation that is a CFC is not treated as a PFIC
  - U.S. shareholder is defined in 951(b)
    - Old 951(b) – includes only those U.S. persons who hold 10% or more of the voting power of the corporation
    - New 951(b) – includes U.S. persons who hold 10% or more of the voting power or value of the corporation
- Form 8621 would not be required

Unintended PFICs

CFCs
- Less than 10% ownership in a CFC that meets the income or asset test

Non-CFCs
- Start up Businesses (cash is a passive asset Notice 88-22)
- Mature (or not) companies that have raised cash or gone public
- Companies with little hard assets
- Active companies with losses
- Leasing companies

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PFIC – Start-up Exception (Non-CFC)

1298(b)(2) – PFIC start-up exception
- Corps are not PFICs for the first year they have gross income (start-up year) if:
  - No predecessor of the corp. was a PFIC, and
  - It established to the satisfaction of the IRS that it will not be a PFIC in the 2 years after the start-up year, and
  - It is not a PFIC in either of the 2 years after the start-up year

Meet exception – 5471 & 926 (if at least 10%), 8938, 114

Miss exception – 5471 & 926 (if at least 10%), 8621, 8938, 114

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Start-up Exception Example

- In 2016, 4 individuals create a foreign corporation to do custom crop harvesting in Canada
  - 2 are U.S. citizens
  - 2 are unrelated non-resident aliens
- Company is not a CFC
- Assets – several combines worth $3 million
- Bank account – $200,000

The Murk – What Happens When:

A foreign corporation owns another corporation?

- *What if the lower corp. is a PFIC?*

Parent/Subsidiary Look Through Rules

- Taxpayers often create foreign corporations that act as holding companies for other businesses or investments
- Parent/ Subsidiary look through – if a parent corporation has > 25% ownership of a subsidiary – then parent company is treated as owning the proportionate share of subsidiary's income and assets for the income and asset tests §1297(c)

Parent/Subsidiary Look Through Example

- U.S. taxpayer owns 9% of a HoldCo, foreign corporation, that is a holding corporation, they purchase shares in 2 businesses through the holding company.
  - 10% of Company 10
  - 30% of Company 30

FC & PFIC Look Through

When a foreign corp. with U.S. owners owns PFICs

- Must determine whether parent corp. is a PFIC or active business
  - §1298(a)(2)(A) – if parent is an **active** business AND the U.S. taxpayer owns more than 50% of the **value** of the shares – they are considered to own their proportionate share of any PFICs owned by the top tier company and must file on Form 8621
  - If an active business and the U.S. person does not own 50% or more of the value – no PFIC look through
- If the parent is a holding company – there is look through

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When a Foreign Corp Owns a PFIC

Active business – Not a CFC

- U.S.T.P. owns < 50% of value
  - First year – Forms 5471 & 926, if at least 10%, 8938, 114
  - Subsequent years – Forms 5471 & 926, as required, 8938, 114
- U.S.T.P. owns 50% of value
  - First year – Forms 5471, 926, 8621, 8938, 114
  - Subsequent years – Forms 8621, 5471 & 926, as required, 8938, 114
- STRATEGY – have U.S. person own less than 50% by value – maybe 49.99%

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The Murk – What Happens When:

A "U.S. shareholder" owns shares in a CFC that is also a PFIC?

- *What if they aren't a "U.S. shareholder"?*

CFC – PFIC Overlap Rule

§1297(d)

- A "U.S. shareholder" of a foreign corporation that is a CFC is not treated as a PFIC
  - U.S. shareholder is defined in 951(b)
    - Old 951(b) – includes only those U.S. persons who hold 10% or more of the voting power of the corporation
    - New 951(b) – includes U.S. persons who hold 10% or more of the voting power or value of the corporation
- Form 8621 would not be required

Owns < 10% of a CFC that is a PFIC

- Generally, if a U.S. person owns less than 10 percent of a CFC that is also a PFIC, it will be treated as a PFIC for that person
- Forms 8621, 8938, 114
  - Form 5471 may be required to report constructive ownership

Once a PFIC – Always a PFIC Rule

1.1291-1(b)(1)(ii)
A corporation will be treated as a PFIC if during the shareholder's period of ownership it or its predecessor in a reorganization was a §1291 fund at any time – even if it does not currently meet the income or asset test

New CFC – PFIC Overlap issue

- New CFC definition – TCJA
    - Old: > 50% control by vote
    - New: > 50% by vote or value

What if:

- 2 U.S. persons own the only shares in a foreign corporation that owns 100% passive assets
- There are only 2 classes of shares – Vote & Value
    - Shareholder 1 owns all the Vote shares
    - Shareholder 2 owns all the Value shares

New CFC – PFIC Overlap issue

1.1297-3 Purging elections –

- Deemed Sale
- Deemed Dividend (only available for CFCs)
    - File both Forms 5471 & 8621 in year of election, 8938, 114
    - No Form 8621 required in subsequent years

PFIC is now CFC

Foreign Corporation (FC) is created in July 1, 2007

3 owners with equal shares – 33.33% each

2 shareholders are NRA; 1 is a U.S. citizen (US1)

The foreign corporation meets the definition of PFIC in the first 3 years .
US1 is taxed under the PFIC Rules and files Form 8621 every year. They also file Forms 5471 & 926 in at least the first year.

PFIC is now CFC

After 10 years, on July 1, 2017, one of the non-resident aliens sells their share of the company to a U.S. citizen (US2).

FMV of foreign corp. is $6,000,000.

E&P is negative.

US1

July 1, 2007 – June 30, 2017

- US1 is a U.S. shareholder – but FC is not a CFC
- FC is a PFIC
- Form 8621 each year
- Forms 5471 & 926 in the first year, 8938, 114

As of July 1, 2017, US1 has to decide whether to continue to be taxed as a PFIC or make a purging election and be taxed as a CFC.

US1

Continue as a PFIC –

- Will file Form 8621 and 5471 each year, 8938, 114
  Move to taxation as a CFC

- Make deemed sale or deemed dividend election effective July 1, 2017
- Adjust US1's basis in FC
- File both Forms 5471 & 8621 in 2017 and only 5471 in subsequent years, 8938, 114

US1 – Choice of Purging Election

FORM 8621 CALCULATOR

Deemed Sale election will be a pretend sale for FMV

Gain = $2,000,000 ($6,000,000/3)

- Allocate gain over each year in holding period
  - Approx. $100,000 for 2007 & 2017 and
  - $200,000 for each year 2008 – 2016
- $840K – §1291 Tax/interest

US1 – Choice of Purging Election

FORM 8621 CALCULATOR

Deemed Dividend election is a pretend dividend of E&P

$0 – E&P on July 1, 2017

No tax

US2

US2 is a U.S. shareholder from the beginning of their holding period and will only be taxed under the CFC rules.

Forms 5471, 926, 8938, 114

- Oh yes – and as of July 1, 2017 – the foreign corp. is a specified foreign corporation for purposes of the §965 Transition Tax and GILTI – Oh Yay ☹

Sale of PFIC by CFC

- U.S.T.P owns 100% of the stock of a CFC.
- The CFC owned an interest in a PFIC which it sold for a gain
- No MTM or QEF election was ever made for the PFIC.

Sale of PFIC by CFC

Prop. Reg. 1.1291-3(e)(4)(ii)

Gain is taxed to U.S.T.P as an excess distribution under §1291. The income is not subject to inclusion under Subpart F (§951)

Prop. Reg. 1.1291-3(e)(4)(iii)

Basis is adjusted in shares of the CFC owned by U.S.T.P

Prop. Reg. 1.1291-3(e)(4)(iv)

Applies the principles of §959, previously taxed income, to distributions from the CFC to UST to the extent attributable to the gain taxed U.S.T.P.

Questions?

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Five Star Counsel:
Client Service Lessons from the Hotel Industry

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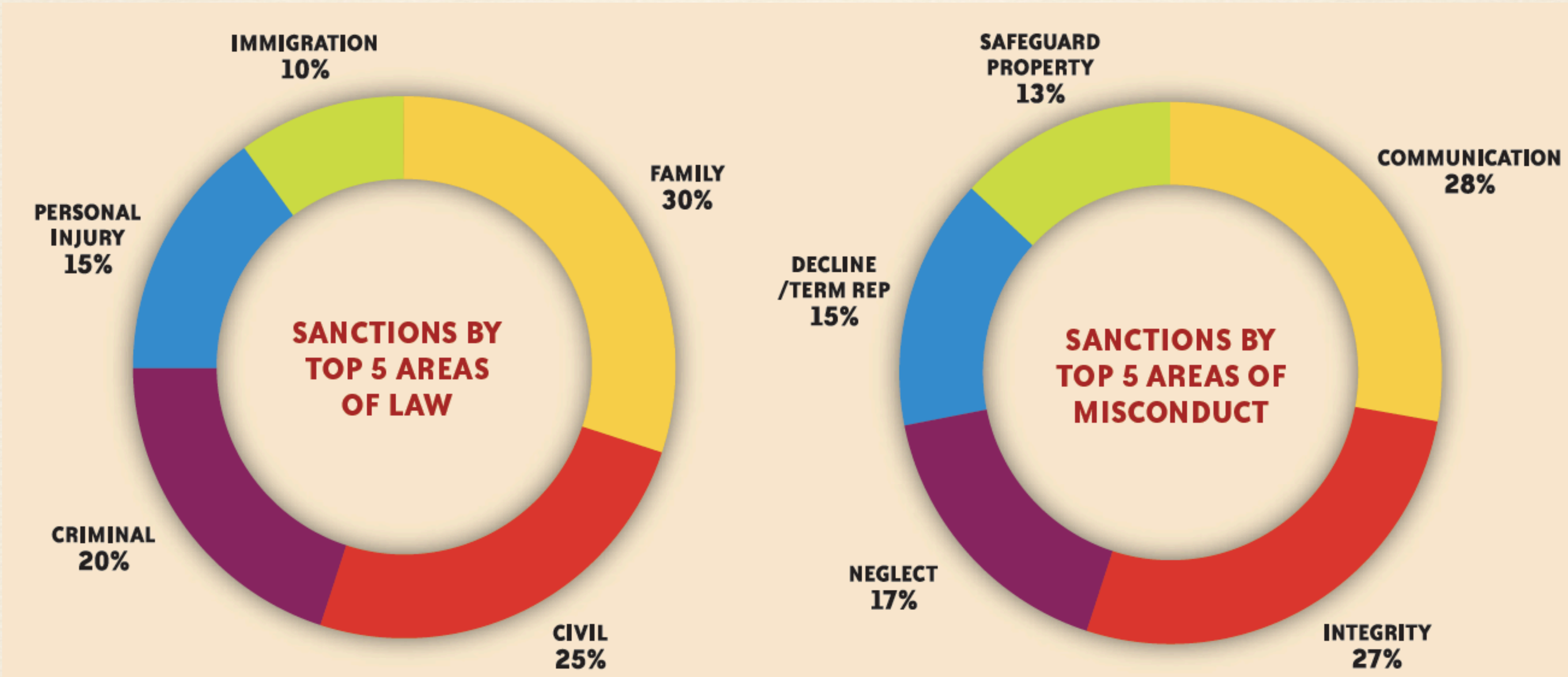
  - Income Tax Treaties & Estate and Gift Tax Treaties
  - A Whole New World: Trust and Estate Distributions to Foreign Beneficiaries
- I also homebrew beer and run marathons.

Client Service?

Treat the assigning attorney like the client.

Where do sanctions come from?



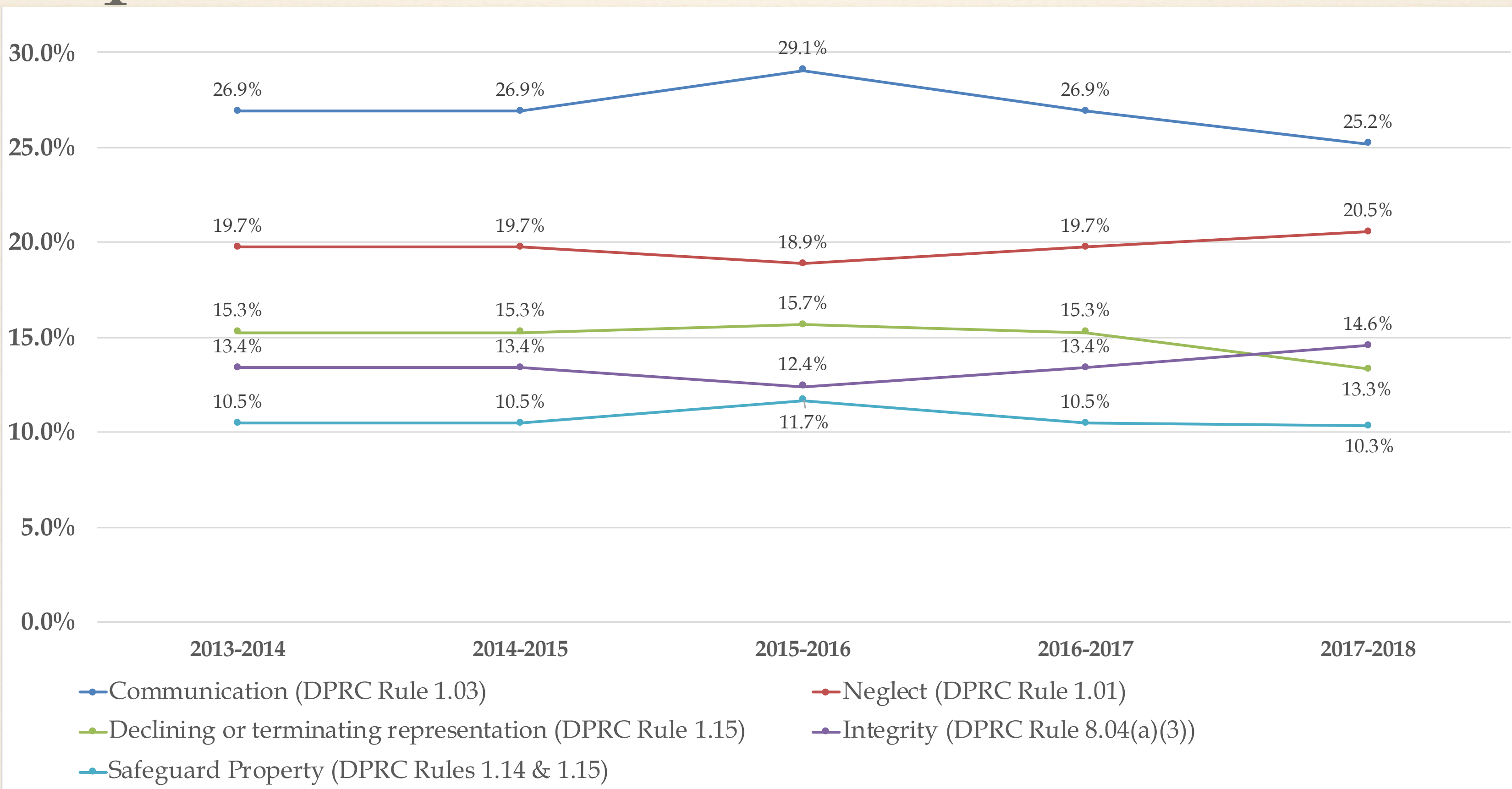
Source: State Bar of Texas Commission for Lawyer Discipline Annual Report, June 1, 2016—May 31, 2017

Where did the 2017-2018 grievances come from?

1. Communication (DPRC Rule 1.03)—25.2%
2. Neglect (DPRC Rule 1.01)—20.5%
3. Declining or terminating representation (DPRC Rule 1.15)—13.3%
4. Integrity (DPRC Rule 8.04(a)(3))—14.6%
5. Safeguard Property (DPRC Rules 1.14 & 1.15)—10.3%

Source: State Bar of Texas Commission for Lawyer Discipline

Top 5 State Bar of Texas Grievances



Source: State Bar of Texas Commission for Lawyer Discipline

Where do grievances come from?

How can you set up your practice to better serve your clients while minimizing your chances of receiving a grievance?

Business

Business Model

Business Framework

How the company makes money

How the company implements the model

Business Framework

- Administration (Back of House)
  - Physical Plant
  - Finance & Accounting
  - Training
  - Management
  - Compliance
  - Hiring & Onboarding
- Operations (Front of House)
  - Marketing
  - Sales
  - Client Service
  - Physical Product
  - Technical Product

What is client service?

A. The experience

B. that a business

C. Provides

D. beyond its

   1. technical or

   2. physical product.

What isn't client service?

- Your physical product, including finery such as fancy offices and bond paper for important documents.
- Your technical product, including the substantive knowledge that you bring to bear for your clients.
- Attention to detail that is already part of the technical or physical product.

The Hotel Standards

2018
Forbes
TRAVEL GUIDE

AAA
Five Diamond
Award

The Three Components of Service

People
Serve clients

Delivery
How people serve clients

Systems
The processes that people follow to serve clients in a measurable way

How can you improve right now?

Every interaction should start with a smile.

Improve your delivery by empowering your employees.

Build your systems.

How will you improve your practice?

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State and Local interplay with International Tax

Jeff Mealer CPA JD

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State Taxation before TCJA

- Most states did not have a "worldwide income" tax outlook
- "Water's-edge" limitations (30+ states)
- Some exceptions
  - 80/20 Companies
  - Tax Haven provisions
  - "Worldwide Combined" election for state reporting
    - AK, CA, CO, CT, DC, ID, IL, MA, MT, ND, NJ (7/31/19), UT, WV
  - Partial taxation of foreign dividends
  - Related party add-back

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State Considerations of Tax Reform

- Foreign DRD
- Global Intangible Low-Taxed Income (GILTI)
  - Section 250 Deduction
- Transition Tax
  - Sec 965 (c) Deduction
  - Foreign Derived Intangible Income (FDII)
- Base Erosion Anti-Abuse Tax (BEAT)
- Conformity with TCJA Tax Provisions
- When and if a state will enact these provisions

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Foreign Dividends Received Deduction

- Relief from double taxation
- Up to 100% deduction on dividends received by at least 10% US shareholder of foreign corporation
- Territorial taxation (exempting future foreign earnings from US taxation)

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State Considerations for GILTI

- How does it effect the state tax base?
- Does the state require a modification to the state tax base?
- Application of specific state rules for expense disallowance?
- Applying these modifications for state tax modelling purposes?
- Separate or Combined Filings
  - Is the state combined/consolidated filing group the same as the federal combined/consolidated filing group?
- What is the apportionment impact?
  - Are there sourcing implications?

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State Considerations of IRC 965

- Does the state conform?
- Separate or Combined Filings
  - Is the state combined/consolidated filing group the same as the federal combined/consolidated filing group?
- Are there differences in federal and state calculations for E&P and PTI?
- What are the state DRD rules?
- Are there disallowed expenses?
- What are the tax attributes of the repatriated funds?
- What is the apportionment impact?
  - Are there sourcing implications?

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State Considerations for FDII

- Separate or Combined Filings
  - Is the state combined/consolidated filing group the same as the federal combined/consolidated filing group?
- Does the state conform?
- Does the state disallow any deductions to FDII?
- State effective tax rate implications
- Potential credit & incentive implications
- 80/20 Implications

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State Considerations for FDII (Cont'd)

- What is the apportionment impact?
  - Is it included in the sales factor?
  - Are there sourcing implications?
  - Dock sale rules
  - Foreign throwback
  - Market-sourcing
  - Online sales and services
  - Intangibles

State Considerations for BEAT

- GILTI/FDII
- 168(k)
- Credit limitations (NOLs)

State Conformity with the IRC

- Annual Conformity
  - 6 states
- Fixed Date Conformity
  - 6 states
- Rolling Conformity
  - 17 States
- Select Conformity
  - 5 states

- 7 states have adopted changes made by PL 115-97

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State Developments

- Georgia
  - Deductions under IRC Sections 245A, 250, and 965 are deductible to the extent they are included in Georgia taxable income
- Idaho
  - Requires addback for IRC 965(c) but allows state DRD for IRC 965(a)
  - Other addbacks include IRC Sections 245A and 250
- New York
  - Requires addback of deductions taken under IRC Section 965(c)
  - Requires addback of deductions related to foreign-derived intangible income under IRC 250(a)(1)(A)

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State Developments (Cont'd)

- Virginia
  - Conforms for 2017 only, no conformity applicable to 2018
- Wisconsin
  - Adopted as of 2018 but decoupled from most of these provisions

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State Tax Impacts

- Consider how these provisions are interconnected.
  - Allowance/disallowance of certain deductions from state to state
  - Apportionment differences
  - Foreign tax credits
  - Inclusion of provisions by state
  - Additions to income from these provisions
  - GILTI Income adding to BEAT

Thank You

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TAX SECTION
State Bar of Texas

November 6, 2018

The Honorable Maurice B. Foley
Chief Judge, United States Tax Court
400 2nd Street, N.W.
Washington, D.C. 20217

Re: Suggested Change to Tax Court's Rules of Practice and Procedure

Dear Chief Judge Foley:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed comments suggesting an amendment to the United States Tax Court's Rules of Practice and Procedure, to provide for entries of limited appearance.

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 appreciate the opportunity to provide input on potential improvements to how the Court functions.

Respectfully submitted,

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

Enclosure

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COMMENTS ON SUGGESTED CHANGE TO TAX COURT'S RULES OF PRACTICE AND PROCEDURE

These comments on a suggested change to the Tax Court's Rules of Practice and Procedure are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Robert D. Probasco, member of the Tax Section's Council and former Chair of the Pro Bono Committee. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Jason B. Freeman, Co-Chair of COGS, reviewed and approved these Comments for COGS. Juan Vasquez, Jr. and Rachael Rubenstein, Co-Chairs of the Pro Bono Committee, and Richard Hunn, Co-Chair of the Tax Controversy Committee, also reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: November 6, 2018

I. BACKGROUND

As of April 30, 2018, the Tax Court had 21,158 cases pending, of which 7,833 were "small tax cases." In 68.7% of the total cases, and 91% of the small tax cases, petitioners were self-represented.[1] The Court has long understood the difficulties taxpayers face in prosecuting a case without representation and has taken steps to alleviate those difficulties. The Rules of Practice and Procedure provide an informal process for "small tax cases."[2] The Court also facilitates a robust program of pro bono assistance for self-represented petitioners. The Court invites both low income taxpayer clinics (LITCs) and Bar-sponsored calendar call programs to provide assistance at calendar calls. Over 100 LITCs and Bar-sponsored programs regularly appear at calendar calls and many also participate in "Pro Bono Days" with IRS Counsel to resolve cases well in advance of the calendar call. Many LITCs are also enrolled in the Tax Court's clinical program, in which the Court sends "stuffer notices" to self-represented petitioners to make them aware of local LITCs that provide pro bono services.

We commend the Court for its extensive efforts to make the process work better for all parties. We offer the following suggestion in hopes of improving the process even further.

II. CONCERNS REGARDING ENTRIES OF APPEARANCE

In 2017, LITCs and Bar-sponsored calendar call programs entered appearances in 678 cases and provided advice without entering an appearance in another 1,340 cases.[3] The clinics/programs can and do provide substantial help to self-represented petitioners without entering an appearance, but there are some instances where the assistance could be even more effective if the clinic/program entered an appearance in the case. Yet, these clinics/programs only enter an appearance for approximately one-third of the petitioners they assist at calendar calls. Based on our experience, we believe that one reason for this is a concern about the potential commitment resulting from entering an appearance in the case.

Bar-sponsored calendar call programs such as that of the Tax Section[4] as well as some LITCs solicit volunteers from private practice. In our program, we have found that the most experienced tax attorneys usually have relatively little time to spare from their busy practices and find it difficult to commit, if at all, to more time than the day of the calendar call. Because of this, young attorneys make up a significant portion of our volunteer pool. These young attorneys, however, not only face pressure for billable hours but also often have relatively limited experience. They may feel comfortable with, for example, presenting the status of the case and arguing motions at the calendar call. But they may feel less comfortable that they can provide other services, such as conducting a trial or filing post-trial briefs, in a competent manner.

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[1] "Update from the Tax Court," ABA Section of Taxation Pro Bono and Tax Clinics Committee meeting, May 12, 2018.

[2] U.S. Tax Court Rules of Practice & Procedure, Rules 170-174; I.R.C. § 7463.

[3] "Update from the Tax Court," *supra* note 1.

[4] The State Bar of Texas Tax Section's calendar call program was established in 2008, and serves petitioners in all five Texas cities where the Tax Court holds trial sessions.

LITC attorneys admitted to practice before the Court may not maintain a private practice and therefore may have more time to dedicate to pro bono services. However, they also may find it difficult to commit to more time than the day of the calendar call. In Texas, there are four academic LITCs, at which the attorneys often have obligations at their law school, such as teaching classes and around which they must schedule client services. There may also be workload constraints. Many LITCs, both academic and non-academic, receive more requests for assistance than they can accept and must either turn down prospective clients or place them on a waitlist. Limiting the services provided to one taxpayer at the calendar call may allow flexibility to help other clients whom the LITC otherwise would have to turn away.

Travel is also an important consideration in states such as Texas for both LITCs and the Tax Section's calendar call program. The Court conducts trial sessions in five different cities in the state. Due to limited numbers of tax controversy attorneys in some locations, the Tax Section frequently arranges for volunteers from other cities to travel to the trial session. Similarly, some Texas LITCs participate at calendar calls in cities other than where the LITC is based. Pro bono volunteers typically make travel arrangements assuming that there will be no need for their services beyond the first day of the trial session. Entering an appearance in a case might, depending on circumstances, require last-minute changes in those travel arrangements as well as rescheduling other commitments.

We believe that pro bono volunteers would be more likely to consider entering an appearance at calendar calls if their appearance could be limited to avoid the concerns described above. While individual judges have at times allowed our volunteers to enter limited appearances, providing for such limited appearances in the Court's Rules of Practice and Procedure would standardize the process and make it more effective.

III. SUGGESTED CHANGE TO RULE 24

We recognize that the Court may wish to implement a broad rule that would be available for anyone entering an appearance, not just pro bono volunteers, and would provide maximum flexibility and coverage. We have no serious objections to such a broad rule. However, we suggest that the Court also consider an alternative that is limited to pro bono volunteers, covers the most common situations faced by volunteers, and is both easy for volunteers and petitioners to understand and easy to administer. We believe such a process may be more effective than a more comprehensive approach.

In our experience, private practitioners engaged for a fee usually are not affected by the problems described above to the same extent as LITCs and Bar-sponsored calendar call programs. Normally, they enter an appearance long before the case is even set for trial, rather than meeting the petitioner for the first time at the calendar call or a Pro Bono Day. As a result, they can and do enter their appearances without limitations and rely on the ability to withdraw as counsel, if necessary, pursuant to the Court's Rule 24(c). Therefore, we believe that a new rule for entries of limited appearance could be restricted to services provided on a pro bono basis and still address the vast majority of situations in which a petitioner's representative would want to enter a limited appearance.

We further believe that a new rule limited to pro bono volunteers could be significantly simpler than typical rules for limited appearances in non-tax representations. The American Bar Association Standing Committee on the Delivery of Legal Services issued a white paper on limited scope services, "An Analysis of Rules That Enable Lawyers to Service Self-Represented Litigants," in August, 2014.[5] Many states have successfully implemented rules for limited appearances in their courts, whereby an appearance may be limited based on date, subject matter, time period, or activity.

We believe that the limitation could be expressed, for the vast majority of situations encountered by pro bono volunteers, as lasting until the end of specific categories of hearings or presentations to the Court. Alternatively, if needed, it could be expressed as lasting until a specified date/time. That could improve the understanding, and simplify the administration, of limited appearances, as there would be no uncertainty for the Court, IRS Counsel, or the petitioner regarding when the limited appearance would terminate. Based on our experience providing pro bono services in Tax Court cases, we believe the preferred termination point for limited appearances would most often fall within one of the following categories, which could be listed on the form entry of limited appearance to minimize confusion:

- The conclusion of the calendar call. This would allow volunteers to present petitioners' position and the status of the case to the Court without committing to argue any pre-trial motions.

- The conclusion of pre-trial activity. This would allow volunteers to provide substantial assistance after discussing the status at the calendar call without committing to conduct the trial.[6]

- The conclusion of trial. This option would allow volunteers to conduct the trial without committing to post-trial activity such as filing briefs.

- A specified date/time. This option would benefit volunteers who are willing to assist with pre-trial activity or even trial but cannot commit to return to court later in the week. For example, the volunteer might enter a limited appearance scheduled to terminate at the end of the first day of the trial session.

We believe that the category for terminating the limited appearance at the conclusion of pre-trial activity might be particularly useful. Prior to entering a limited appearance, the volunteers typically will know whether there will be any pre-trial hearings and the subject of the

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[5] Available at https://www.americanbar.org/groups/delivery_legal_services/resources.html .

[6] We note that the Court's procedures already provide substantial assistance to self-represented petitioners during trial. As part of the informal process for "small tax cases," judges typically faciliate petitioners' testimony. Most non-testimonial evidence is presented through the stipulation of facts, for which pro bono volunteers can assist petitioners without entering an appearance. Volunteers can also advise petitioners regarding relevant information to be presented through testimony. Thus, terminating a limited appearance at the conclusion of pre-trial activity would not necessarily severely disadvantage petitioners with respect to presenting testimony.

hearing(s). Pre-trial hearings in these types of cases are usually relatively straight-forward issues, such as motions to dismiss for failure to prosecute or motions for continuance. Less experienced volunteers often will be willing to represent the petitioner for such hearings even though they might not be comfortable representing the petitioner during the trial. More complex issues, such as discovery disputes or motions for summary judgment, rarely occur in these types of cases. In the event that they do, and if the volunteer is uncomfortable representing the petitioner for such hearings, the volunteer could enter a limited appearance that terminates at the conclusion of the calendar call.

For simplicity and clarity, we suggest that the first three categories be explicitly restricted to the currently scheduled trial session for the petitioner's case. When the volunteer meets a petitioner at calendar call, the volunteer may be able to anticipate her availability to assist the petitioner during that trial session. But if the case were to be continued, the volunteer may not be able to anticipate her availability to assist at a future trial session. Without certainty, the volunteer might be forced to assume that a motion for continuance would be granted and enter a limited appearance ending on the day of the calendar call, in order to avoid a commitment stretching months into the future. Then, if the case is not continued, the volunteer could enter a second limited appearance to continue assistance during the rest of the trial session.

By contrast, if the first three categories listed above are explicitly restricted to the currently scheduled trial session, the volunteer could enter a limited appearance for the entire trial session, if she is willing to conduct the trial and her schedule permits. If the case is continued, a second limited appearance might still be necessary but would be months in the future. Even then, a second appearance often will not be necessary to assist the petitioner after the first trial session. Our volunteers have found that they can provide substantial assistance – including informal discovery, facilitating discussions with IRS Counsel, reaching agreement on the stipulation of facts, drafting documents to be submitted to the Court, or reviewing computations under Rule 155 – without an entry of appearance and can potentially resolve the case before a rescheduled trial session.

We believe that a limited appearance, structured as discussed above, would cover the vast majority of situations encountered by pro bono volunteers. The limitation as described above is similar in many respects to the limitations based on date, time period, or activity found in many state court provisions for limited appearances. The approach we suggest does not address limitations based on subject matter. However, we believe the need for these will be relatively rare. When such situations arise, volunteers may be able to resolve them in the same way that private practioners do.

For example, potential conflicts of interest between two petitioners in the case might be avoided if the volunteer represents only one of the petitioners.[7] If a petitioner wishes to pursue a particular argument but the volunteer believes she cannot advocate for that argument ethically, the volunteer can simply refuse to enter an appearance at all. There may be some circumstances in which, without a limitation based on subject matter, volunteers will not be willing to enter an

[7] Representatives of more than one clinic/program attend some calendar calls in Texas, so that different volunteers could represent each petitioner.

appearance. However, as noted above, we believe that less than 100% coverage might be justified by a simpler process that is easier to understand and administer.

We further suggest that the petitioner consent to the scope of the limited representation by signing the entry of limited appearance. We believe this, instead of merely serving the represented party, would provide the Court and the volunteer with greater certainty. The Court could, if desired, confirm the petitioner's understanding and consent before accepting the limited appearance. Further, this representation will typically arise when the volunteer first meets the petitioner at the calendar call or an earlier Pro Bono Day; it should be easy to obtain the petitioner's signature. Some states provide for a certificate after the fact if the represented party is unavailable to sign, but we do not foresee that would be necessary.

An amendment to the Court's Rules of Practice and Procedure might take the form of a new Rule 24(a)(6) as follows:

> (6) *Limited Appearance*: At the Court's discretion, counsel providing pro bono services, including but not limited to through a low-income taxpayer clinic or Bar-sponsored calendar call program, may file an entry of limited appearance, which shall be subject to all requirements set forth in subparagraph (3) hereof and shall also specify when the representation terminates. The represented party shall sign such entry of limited appearance to confirm consent to the limitation. The entry of limited appearance shall be substantially in the form set forth in Form __ in Appendix I. The limited appearance shall automatically expire without leave of Court at the specified time and no notice shall be required by counsel. After the expiration of the specified time period, any service of papers required by Rule 21 shall be made upon the party rather than counsel. Counsel entering a limited appearance shall be subject to all other requirements applicable under these Rules.

A draft version of an Entry of Limited Appearance is attached.

IV. CONCLUSION

We appreciate the opportunity to provide suggestions to promote the Court's goal of effective participation by petitioners, aided by pro bono volunteers, in their cases. Thank you for your consideration.

ENTRY OF LIMITED APPEARANCE
(See Rule 24(a)(6))

UNITED STATES TAX COURT

_____________________________,	§	
Petitioner(s),	§	
v.	§	**Docket No.** ________________
Commissioner of Internal Revenue,	§	
Respondent.	§	

<u>ENTRY OF LIMITED APPEARANCE</u>

The undersigned, being duly admitted to practice before the United States Tax Court, hereby enters an appearance for the petitioner(s) in the above-entitled case, which shall terminate:

☐ At the conclusion of the calendar call for the current trial session;

☐ At the conclusion of pre-trial activity during the current trial session;

☐ At the conclusion of the current trial session; or

☐ ________________________________[specified date/time].

Date: ____________________

______________________________	______________________________
Signature	Signature
______________________________	______________________________
Printed name Petitioner(s)	Printed Name
	______________________________
	Office Address
	______________________________
	City, State, Zip Code
	______________________________
	(Area Code) Telephone No.
	______________________________
	Tax Court Bar No.

TAX SECTION
State Bar of Texas

January 31, 2019

Via Federal Express

Internal Revenue Service
CC:PA:LPD:PR (REG-115420-18)

Courier's Desk
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Attn. Erika C. Reigle, Office of Associate Chief Counsel
(Income Tax Accounting)
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Re: *Comments on Proposed Regulations Concerning the Deferral of Gain Recognition on Amounts Reinvested in Qualified Opportunity Funds*

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-115420-18, RIN 1545-BP03) issued on October 29, 2018 (the "Proposed Regulations"). The Proposed Regulations provide guidance regarding the application of Section 1400Z-2 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").

January 31, 2019

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 submit comments with respect to the Proposed Regulations.

Respectfully submitted,

Catherine C. Scheid

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

COMMENTS ON PROPOSED REGULATIONS CONCERNING THE DEFERRAL OF GAIN RECOGNITION ON AMOUNTS REINVESTED IN QUALIFIED OPPORTUNITY FUNDS

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 Chris M. Goodrich, Vice Chair of the General Tax Committee, Adam C. Harden, Co-Chair of the Tax-Exempt Finance Committee, and Nathan Smithson, Co-Chair of the Partnership and Real Estate Tax Committee. Brandon S. Jones reviewed the Comments and made substantive suggestions. Jeffry M. Blair also reviewed the Comments and made 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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I. INTRODUCTION

These Comments are provided in response to Treasury's and the IRS's requests for comments on the Proposed Regulations concerning the deferral of gain recognition on amounts reinvested in qualified opportunity funds. Code Section 1400Z-2 was enacted on December 22, 2017 as part of the TCJA. Code Section 1400Z-2 permits the deferral of certain gains on the sale of property where such funds are invested in a qualified opportunity fund (a "QOF"). As a result of such deferral, taxpayers making permissible investments may be able to defer the taxation of capital gains until the earlier of the date that such investment is sold or exchanged or December 31, 2026. In order for such investment to be valid, substantially all of the fund's assets must be timely invested in appropriate property.

The Proposed Regulations were issued to provide taxpayers with guidance as to making determinations with respect to the types of gains that may be deferred, timing of investments and methods for determining qualification within the Code Section 1400Z-2 rules. 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. RECOGNITION OF PASSIVE ACTVITY LOSSES ON DISPOSITION OF INVESTMENT

Proposed Regulation Section 1.1400Z-2(a)-1(b)(5) provides that if Code Sections 1400Z-2(a)(1)(B) and (b) require a taxpayer to include in income some or all of a previously deferred gain, the gain so included has the same attributes in the taxable year of inclusion that it would have had if tax on the gain had not been deferred. The Proposed Regulations do not, however, describe how the deferral of passive activity losses under Code Section 469 coordinate with the gain deferral rules of Code Section 1400Z-2. This is particularly important where a taxpayer sells or otherwise disposes his or her entire interest in a passive activity in accordance with Code Section 469(g) (relating to the disposition of an entire interest in a passive activity investment) or Treasury Regulation Section 1.469-4(g) (relating to the disposition of substantially all of an interest in a passive activity investment) and reinvests proceeds from that disposition in qualified opportunity zone property.

Consider for example a situation in which (i) a taxpayer has significant depreciation deductions from a passive activity that were previously suspended in accordance with Code Section 469, (ii) the taxpayer sells all or substantially all of the property used in that passive activity, which results in both depreciation recapture and capital gain, and (iii) the taxpayer reinvests in qualified opportunity zone property an amount of cash equal to that capital gain. Proposed Regulation Section 1.1400Z-2(a)-1(b)(2)(i)(A) would permit the deferral of capital gain, but not the deferral of the depreciation recapture. If the capital gain was not deferred under Code Section 1400Z-2, the taxpayer would have been entitled to deduct the previously suspended depreciation deductions against his or her depreciation recapture.

Code Section 469(g)(1)(A) requires that all gain or loss realized on the disposition of the taxpayer's entire interest in any passive activity be recognized before the suspended passive losses derived from that investment may be deducted. Taken literally, if Code Section 469(g)(1)(A) continues to suspend the passive losses due to the deferral of the capital gains, the taxpayer could be treated as recognizing the depreciation recapture under Code Section 1400Z-2 but continuing to have the original depreciation deductions suspended under Code Section 469. We respectfully submit that this result would be inconsistent with the purposes of both Code Sections 469 and 1400Z-2. Accordingly, in context of the foregoing example, we respectfully request clarification as to how Code Section 469(g)(1)(A) and Treasury Regulation Section 1.469-4(g) should be applied if capital gain is temporarily excluded pursuant to Code Section 1400Z-2(b).

We believe there are four alternative solutions to provide the clarity needed:

1) Treat capital gain as recognized (within the meaning of Code Section 469(g)(1)(A)) upon the sale of the passive activity investment but temporarily exclude such gain under Code Section 1400Z-2(b). All gain would be treated as recognized (i.e., both the capital gain and the depreciation recapture), and the suspended depreciation would be permitted to be deducted in the same year as the depreciation recapture. Code Section 1400Z-2(b) specifically states that in determining the amount of gain to be included in income under Code Section 1400Z-2(a)(1), gain is "excluded" rather than being subject to "nonrecognition." This language is in contrast to the language used in Code Section 1031(a)(1) where "no gain or loss shall be recognized." In addition, Code Sections 1400Z-2(b)(2)(B)(iii) and (iv) refer to the capital gain as being deferred rather than being unrecognized.

2) Clarify the Proposed Regulations to indicate that the sale of a passive activity investment would still qualify as a disposition of an interest in a passive activity under Code Section 469(g)(1)(A) and Treasury Regulation Section 1.469-2T(c)(2)(i)(A)(2) since the suspended deductions relate to depreciation and the depreciation recapture would be recognized.

3) Clarify the Proposed Regulations to indicate that the sale of a passive activity investment would constitute a partial disposition within the meaning of Treasury Regulation Section 1.469-4(g), thereby "unsuspending" the depreciation deductions associated with the disposition of assets.

4) Expand Proposed Regulation Section 1.1400Z-2(a)-1(b)(5) to state: "for purposes of section 469(g), the gain realized from the disposition of a taxpayer's entire interest in any passive activity will be considered to be fully recognized even if a portion of that gain is invested in a qualifying opportunity zone fund." This would incentivize passive investors to move their money into opportunity zone funds.

III. MEETING THE "SUBSTANTIALLY ALL" TEST FOR QUALIFIED OPPORTUNITY ZONE BUSINESS QUALIFICATION

Proposed Regulation Section 1.1400Z-2(d)-1(d)(1)(i) states that, for a trade or business to be a qualified opportunity zone business, substantially all of the tangible property owned or leased by the trade or business must be qualified opportunity zone business property (as defined in Proposed Regulation Section 1.1400Z-2(d)-1(d)(2)). Proposed Regulation Section 1.1400Z-2(d)-1(d)(3) states that the substantially all requirement is met if at least 70% of the tangible property owned or leased by the trade or business is qualified opportunity zone business property (as defined in Proposed Regulation Section 1.1400Z-2(d)-1(d)(2)). The Treasury Department and the IRS requested comments regarding the phrase "substantially all" in Proposed Regulation Section 1.1400Z-2(d)-1(d)(3)(i), as well as in the various other locations in Treasury Regulation Section 1.1400Z-2(d)-1 where that phrase is used.

We are in favor of the 70% test as set forth in Proposed Regulation Section 1.1400Z-2(d)-1(d)(3)(i). The purpose of the qualified opportunity zone rules is to provide incentives aimed at encouraging economic growth and investment in distressed communities. We believe that 70% test is the correct standard given the differences between how small businesses and entrepreneurs find funding sources versus large private equity firms. A 70% test will allow small businesses and entrepreneurs to have more flexibility in obtaining funding. Small businesses and entrepreneurs should be supported in this manner because they are more likely to help create a diversified local economy in the opportunity zones by investing in improvements on the lower end of the capital-intensive spectrum. Although investments from many sources are needed, a percentage greater than 70% would likely impair small businesses and entrepreneurs disproportionately.

One way small businesses and entrepreneurs would benefit from the 70% test is that this test gives them more flexibility to accept a third party's contribution of raw land located within an opportunity zone to a qualified opportunity zone partnership. For example, assume a proposed project for the development of a $44 million mixed use real estate project. The developers need $14 million of equity to obtain a $30 million loan. Under the 70% test, a third party could contribute to a qualified opportunity zone partnership $4 million worth of raw land located in an opportunity zone. Thus, the entrepreneurs would only need to raise $10 million of "deferred gain" cash for contribution to an opportunity zone fund, which would in turn contribute that cash to the same opportunity zone partnership which acquires the raw land. While the raw land would never constitute qualified opportunity zone business property, the improvements constructed with the $10 million of cash presumably could constitute qualified opportunity zone business property, and thus, the qualified opportunity zone partnership presumably would be able to pass the 70% test.

IV. ASSET VALUATION UNDER THE 90% AND 70% TESTS

We respectfully request that Proposed Regulation Sections 1.1400Z-2(d)-1(b)(1) and (2) as well as Proposed Regulation Section 1.1400Z-2(d)-1(d)(3)(ii) be clarified so as to exclude financial accounting depreciation when calculating the 90% test or 70% test. These Proposed Regulations state that the value of each asset of the entity as reported on the entity's financial statement for the relevant reporting period is to be used for determining whether a trade or business of the entity satisfies the 90% test or 70% test; however, the role of future depreciation is not discussed. If depreciation were to be taken into account, qualified opportunity zone funds and qualified opportunity zone partnerships which initially pass the 90% test or 70% test may later fail as the original "cost" of the qualified opportunity zone business property is depreciated for financial accounting purposes on the balance sheet of a qualified opportunity zone fund or qualified opportunity zone partnership. This result would be inconsistent with the purpose of the opportunity zone program.

V. 1231 GAINS ELIGIBLE FOR DEFERRAL

We would like to join other commentators in recommending that the language in Proposed Regulation Section 1.1400Z-2(a)-1(b)(2)(i)(A) be expanded to include all gains from the sale of Code Section 1231 assets. Code Section 1231 requires gains and losses with respect to 1231 assets to be netted against one another for a tax year, and to the extent such gains exceed such losses, the gain is treated as a capital gain for federal income tax purposes, and would therefore be subject to deferral under Proposed Regulation Section 1.1400Z-2(a)-1(b)(2)(i)(A). Partnerships, however, are required pursuant to Regulation Section 1.702-1(a)(3) to separately allocate gains and losses with respect to Code Section 1231 assets, and therefore the determination of capital gain versus ordinary loss is made at the partner level, rather than the partnership level. Without the expansion of the definition of gains to include gains from the sale of Code Section 1231 assets, partnerships would be unable to defer any gain upon the sale of Code Section 1231 assets. Further, as net Code Section 1231 gain at a partnership level may become a 1231 loss when ultimately netted by individual partners, the pool of funds available to be invested in QOFs may be diminished, frustrating the purpose of the legislation.

Expanding the definition of "gain" to include all gains from the sale of Section 1231 assets would be more consistent with the broader language included in Code Section 1400Z-2(a). This recommendation to include all gains from the sale of Section 1231 assets is not intended to suggest that the definition of "gain" should not also be expanded to other categories, such as unrecaptured 1250 gain, for instance. A broader definition of "gain" would provide more flexibility to all taxpayers, especially partnerships, in choosing to invest in QOFs.

VI. EXTENSIONS WITH RESPECT TO 30-MONTH PERIOD FOR MAKING SUBSTANTIAL IMPROVEMENTS

Proposed Regulation Section 1.1400Z-2(d)-1(c)(8)(i) provides that "tangible property is treated as substantially improved by a QOF only if, during any 30-month period beginning after the date of acquisition of the property, additions to the basis of the property in the hands of the QOF exceed an amount equal to the adjusted basis of the property at the beginning of the 30-month period in the hands of the QOF." Although a taxpayer may have a reasonable expectation and desire to spend such proceeds within a prescribed period of time, unforeseen challenges may cause reasonable delay in what would otherwise be considered achievable project schedules. In fact, in the tax-exempt bond context Treasury has recognized the possibility of these unforeseen events and has implemented certain temporary period expenditure timelines and safe harbors in Treasury Regulation Sections 1.148-2 and 1.148-7.

We respectfully suggest that Proposed Regulation Section 1.1400Z-2(d)-1(c)(8)(i) be expanded to address the real world challenges associated with spending in a timely manner certain funds for the purposes of constructing and/or improving tangible property. To that end, we recommend the application of expenditure schedule safe harbors similar to those found in Treasury Regulation Sections 1.148-2 and 1.148-7 be included in the Proposed Regulations with respect to good faith attempts to comply with the 30-month requirement of Proposed Regulation Section 1.1400Z-2(d)-1(c)(8)(i). Specifically, we recommend the following:

1) Creation of a 30-month spending safe harbor similar to the 2-year exception found in Treasury Regulation Section 1.148-7(e) that would allow a taxpayer to meet the substantial improvement test if it spent at least 10 percent of funds within 8 months (the first spending period), at least 50 percent of funds within 16 months (the second spending period), at least 75 percent of funds within 24 months (the third spending period), and 100 percent of funds within 30 months (the fourth spending period).

2) Extension with respect to the above spending schedule safe harbor for reasonable retainage similar to Treasury Regulation Section 1.148-7(e)(2), which states that an issue of tax exempt bonds does not fail to satisfy the spending requirement for the fourth spending period as a result of unspent amounts for reasonable retainage if those amounts are allocated to expenditures within 3 years of the issue date. If a taxpayer has a reasonable retainage at the 30-month deadline but spends such amount within the subsequent 6-month period, the taxpayer should still be considered to have satisfied the 30-month requirement of Proposed Regulation Section 1.1400Z-2(d)-1(c)(8)(i).

3) Inclusion of a special exception to allow for an expanded 5-year spending requirement for long-term projects, similar to the special rule found in Treasury Regulation Section 1.148-2(e)(2)(ii) in recognition that a taxpayer may choose to pursue certain long-term construction or renovation projects. In order to qualify for the expanded 5-year spending requirement, we recommend Treasury keep the additional requirement that both the taxpayer and either a licensed architect or licensed engineer must certify that the longer period is necessary to complete the project. Such certification should be made at the outset of the project based on reasonable expectations as of the certification date.

Further, we respectfully request that an exception be made if a taxpayer that reasonably expected to meet the 30-month spending requirement fails to meet the deadline due to the project being located in a federally declared disaster area. There exists a longstanding tradition of leniency by both the IRS and Treasury for taxpayers and businesses that suffer from qualified disasters. We suggest including a 30-month extension for those taxpayers who are located within such areas. Such extension may begin as of the date of the natural disaster or at a later date that may be deemed more appropriate as dictated by the scope of recovery.

We appreciate the opportunity to provide these comments and suggestions on the Proposed Regulations. Thank you for your consideration.

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.
Thurs - Fri 10/25/18 – 10/26/18	**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 (50th 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.
Tuesday 01/15/19	**Application Period Opens for Law Student Scholarship Program**
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)**
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.
Thur - Fri 02/21/19 – 02/22/19	**International Fiscal Association Annual Conference** The Ritz-Carlton 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**
Friday 03/29/2019	**2019 State Bar of Texas Property Tax Committee Meeting & Legal Seminar** Thompson Conference Center - UT Campus 2405 Robert Dedman Dr. Austin, Texas 78712
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.
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**
Saturday 04/06/2019	**Law Student Scholarship Application Deadline**

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.

TAX SECTION

STATE BAR OF TEXAS

LEADERSHIP ROSTER

2018-2019

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TAX SECTION
THE STATE BAR OF TEXAS
COMMITTEE CHAIRS AND VICE CHAIRS
2018-2019

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2.	**Continuing Legal Education**	**Dan Baucum** Daniel Baucum Law PLLC 2595 Dallas Parkway, Suite 420 Frisco, Texas 75034 *(214) 984-3658* dbaucum@baucumlaw.com **Michael Threet** Haynes and Boone, LLP 2323 Victory Avenue, Suite 700 Dallas, Texas 75219 *(214) 651-5091* michael.threet@haynesboone.com **Amanda Traphagan** Seay & Traphagan, PLLC 807 Brazos St., Suite 304 Austin, Texas 78701 *(512) 582-0120* atraphagan@seaytaxlaw.com	
3.	**Corporate Tax**	**Jeffry M. Blair** Hunton Andrews Kurth, LLP 1445 Ross Ave., Suite 3700 Dallas, Texas 75202 *(214) 468-3306* jblair@huntonak.com	**Kelly Rubin** Jones Day 2727 North Harwood Street Dallas, Texas 75201-1515 *(214) 969-3768* krubin@jonesday.com
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***New Committee – Amendment to Bylaws in process to add Law School Outreach and Scholarship Committee.**